The Private Enterprise Guidebook

A publication prepared by the President's Task Force on International Private Enterprise with the cooperation and support of the Agency for International Development.

December 1984
Washington, D.C.

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Foreword

The President's Task Force on International Private Enterprise believes that private sector activities are critical to building democratic institutions and strong economic systems. Those of you who represent the United States throughout the world have a unique opportunity to help promote sustained economic prosperity through private sector growth. For this reason, we have prepared a guide to demonstrate the contribution private enterprise can make to developing countries and to identify existing programs and policies that will assist you in supporting these efforts. It is our hope that you will find it to be a valuable resource.

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The President's Task Force on
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CHAPTER I

Introduction

Purpose of Guidebook

There is considerable historical evidence to support the idea that private enterprise, operating in open markets, is the best means of utilizing creative energy, allocating economic resources, and attaining higher levels of economic growth and development. The President's Task Force on International Private Enterprise commissioned this guidebook to provide U.S. ambassadors, AID mission directors, and others responsible for implementing U.S. economic assistance programs with the rationale, means, and benefits for promoting a private enterprise strategy in developing countries. The guidebook underscores the trend of U.S. assistance to support and work with private institutions. The Task Force believes that the ultimate objective of U.S. assistance should be to help foster economic development, primarily through private rather than state institutions, because it is the surest way to contribute to the growth and security of the free world. This guidebook is designed to support this objective. It is also designed to enlighten those professionals charged with carrying out U.S. policy in developing countries about the role of private enterprise in development.

The guidebook makes a distinction between the "private sector" and "private enterprise." The private sector encompasses a wide array of institutions, both profit and nonprofit in orientation. It can include educational, charitable, research, and other types of institutions which, while making valuable contributions to social, economic, and technical progress, are not directly engaged in for-profit business activity. U.S. assistance programs have provided significant resources to develop private sector institutions abroad and have utilized such institutions as delivery mechanisms for development programs.

The principal focus of this guidebook is private enterprise, a nongovernmental, economic decision-making activity that functions as an independent part of a larger productive system to produce and market a good or service. It is basically a self-starting, self-motivating, self-directing, and self-rewarding activity that produces goods and services. Experience has demonstrated that private enterprise is the most efficient and effective means of motivating individual economic creativity.

Economic development is basically a domestic process. Foreign assistance or investment can have a catalytic effect in hastening a country's economic development efforts. This document describes how to encourage and help create an environment that promotes individual effort and entrepreneurship as keystones in an economic development strategy and thus widen the opportuntities for private enterprise throughout the world. It also suggests ways officials can assist in that effort. Although this document is a guide, it cannot provide a formula that will apply to all circumstances. The variables within both the developing countries and the U.S. missions will be different in each case. It is up to the ambassador and his or her AID mission director to take the material contained in the guidebook and integrate it in the cultural, social, and historical context of the particular country in which they work.*

Guidebook Components

The first three chapters of this guidebook are action-oriented. This section provides the means for supporting private enterprise development. Included are a brief discussion of preconditions that should exist for a private enterprise strategy to take hold; a detailed, but not exhaustive, list of tools and ideas U.S. Government officials might use directly and indirectly; and woven throughout this section are examples demonstrating how these instruments have been successfully applied.

Chapters IV and V are informational and are intended to promote a deeper understanding of some of the issues involved. This section includes a chapter that identifies common prejudices in developing countries toward foreign private investment, and a brief historical analysis that traces the development of private enterprise internationally. An appendix outlines the central features of U.S. international economic policy and describes the evolution of the relationship between the United States and developing countries generally.

The guidebook is intended to be a useful introduction to the development of private enterprise as the basis for positive growth. It is by no means comprehensive. For those who seek further information, a selected supplemental bibliography has been included.

*Note: While the Task Force recognizes that there is an appropriate role for government action in development, this guidebook concentrates on private enterprise activities in the belief that they have been underutilized in the economic development process. They are an important resource in the current international economic environment. The guidebook is not designed to be a comprehensive treatise on ways to effect development. Rather, it focuses on those aspects of private enterprise development thought to be the most useful.

CHAPTER II

Preconditions for Private Enterprise Growth

An Overview

Cultural, political, and economic factors have a direct bearing on a nation's attitude toward private enterprise. Because of wide-ranging differences in background and approach, some countries eagerly seek the establishment of a broad-based private enterprise system; some prefer to target specific sectors for private enterprise development, while reserving others for larger state-owned and state-run enterprises; others may be willing to experiment with a private enterprise approach without being fully committed to a market-oriented system; and still others may be thoroughly opposed to any expansion of private entrepreneurship.

Despite the diversity among developing countries, there are signs for determining whether a particular country has, or is moving toward, a positive environment for private enterprise. Being sensitive to those indicators and then helping to shape the policy environment are appropriate and important activities for U.S. foreign policy professionals. Some factors, such as a transportation system, lend themselves to qualitative and quantitative assessment. Others, such as the degree of political stability, so crucial to risk-taking and long-range planning, cannot be assessed so easily.

Clearly, certain preconditions must exist—or be established—for any real private enterprise growth. There are two broad categories of prerequisite factors that must be considered: the external environment, which is important to the operations and objectives of the private sector in general; and the internal environment, which focuses more on firm-specific issues, such as identifying market opportunities with high rates of return on investment, or the ability to analyze and use information. Although these subjects are not ordinarily treated in discussions of this sort, in this case it is important for the reader to have a strong sense of the entrepreneurial point of view.

Growth Factors

EXTERNAL FACTORS

Government Policies

Government policies can either help or hinder private enterprise. Such factors as fiscal and monetary measures; trade, labor, energy, and agriculture policies; indirect measures such as licensing; as well as a panoply of other economic and administrative policies, all have an impact on the business environment. In some cases, state enterprises are favored over private entities in various ways—in allocating scarce foreign exchange, for example. The general political and economic environment bears on the ability of private firms to plan and to forecast the growth of business. Where there is a propensity on the part of government to experiment with policies and to change the regulatory environment, it adversely affects a firm's willingness to take risks. Where firms confront an unpredictable situation, they are less inclined to make long-term investments; when a government imposes harsh fiscal policies—even for what appear to be good, short-term reasons—private entrepreneurs are less inclined to introduce new products or to innovate generally. Although business can adjust to a wide range of policies over time, it has a difficult time adapting to rapidly zig-zagging policies. In such circumstances, entrepreneurs often become discouraged and decide to invest elsewhere. And, when government economic measures contribute to a negative economic picture and result in excessive deficits, high debt, high interest rates, and inflation, neither public nor private firms thrive. A government should determine whether its policies inhibit or encourage private enterprise and take corrective measures, if necessary. Officials must recognize that there is global competition between developing countries in attracting foreign investment; those with the most positive investment climate will succeed. Those who do not will fall further behind.

Attitudes

Public and individual attitudes play a crucial role in the development of private enterprise. The educational system and the media should be encouraged to understand the concept of business, the rationale for profit, and the function of the entrepreneur in society.

Fostering more positive attitudes toward risk-taking and its commensurate rewards is of crucial importance.

Generally, protected state-run enterprise managers and government officials involved in such activities have no concept of true risk-taking. Developing country government officials need to understand that an entrepreneurial risk is measured by real rates of return on investment. Foreign investors, for example, have long been satisfied with an average of 15 percent annual returns in Europe or Latin America– a figure that is reasonable and difficult to argue as exploitative. Developing countries cannot express their understanding of entrepreneurial "risk" through speeches only; they must demonstrate it by implementing policies that promote investment and innovation and provide for adequate returns for both domestic and foreign private enterprises.

Governing Law and Custom

The legal system must recognize, establish basic terms for, and enforce private contracts. Contractual arrangements between legal entities, such as corporations, must be governed by known, equitable rules that are fairly enforced. Governing law and custom must recognize, define, and protect associations of individuals for the purpose of doing business as private enterprises. This applies to an individual's freedom of association. In practice, associations must be given a legal status to permit the functioning of an enterprise. Governments must insure the freedom to make decisions that is fundamental to an enterprise and its operations. (This is the positive side of minimum government regulation.) Finally, a nation's governing law and custom must recognize and defend a system of generally accepted and enforceable property rights.

Infrastructure

The need for adequate physical infrastructure is apparent and generally acknowledged. Without reasonable transport, communications, water, and power, the problems of production and private entrepreneurship are multiplied many times over. The same is true for the technology infrastructure, though this is less well recognized. In some developing countries (for example, Brazil and South Korea), there is an extensive network of laboratories, educational institutions, consulting services, professional societies, and the like. However, in a great majority of developing countries, the network is small or nonexistent and the capacity to support domestic industry is weak. A particularly vulnerable area is in the dissemination of technical information; there may also be a lack of published information, professional societies, standards bureaus, and other entities that link research, education, and production. In some countries, the sharing of information is not encouraged by custom or tradition. Some of the very best networks for the diffusion of technical information are those between private companies. These channels must be preserved and protected from government intervention. Government should, however, play a facilitative role in promoting information exchange wherever possible.

One of the most constraining problems for private enterprise in developing countries is the lack of technically and managerially competent workers, i.e., the manpower infrastructure. In many cases, educational systems are slow to respond to the demand and are not linked to the needs of private enterprise. Usually government training programs are too isolated from the market to be useful. Almost all successful examples of training for business needs are those that enable individual firms or consortiums to set up programs that meet their specific and immediate needs rather than programs imposed from afar.

INTERNAL (FIRM-SPECIFIC) FACTORS

The individual private enterprise is affected immediately and directly by developing country government actions. The lifeblood of enterprise is to initiate and manage change in order to grow. "Change" in this context may include developing new products, improving production, expanding capacity, or starting up new facilities. To make such decisions an enterprise must analyze the market, assess potential competition, and identify its relationship to the local market as well as its international potential. The enterprise must be able to define its strengths and weaknesses and know how to capitalize on them. Constant feedback from the marketplace and individual clients verify a company's decisions and allow for adaptation. Government action—or inaction—represents an important factor in this equation.

Entrepreneurial and Managerial Attitudes

The acceptance of risk requires a corresponding reward. In business the reward is profit. Too often the ability to earn profits, particularly in critical industries such as food and energy production, is viewed as exploitative. Where such attitudes prevail, it is difficult to develop a managerial corps with the necessary skills and motivation. Further, if policymakers are hostile to private enterprise, they foster a "risk avoidance" attitude, leading to short-term investment rather than long-term commitment.

Planning and Information Utilization

Effective entrepreneurial planning requires knowledge of the commercial environment. In developing countries there is usually a dearth of useful commercial, demographic, or consumer information that can support effective planning and marketing. In many cases, however, even when such information is available, there is limited managerial ability to make use of it. What is needed, therefore, is both relevant data and managerial personnel able to assess their firm's needs, then obtain and apply the information.

In countries where there are business services available to assist the entrepreneur, they are often underutilized. Some public and private institutions that have been involved in providing business services have underestimated the need to actively market their services; consequently, they have had little impact on potential user firms. Brazil, South Korea, and Chile are countries where research and industrial assistance institutions are working to develop channels through which they can literally sell services to the business community.

Searching for and Acquiring Resources

The severe shortage of qualified managers, technical personnel, and skilled labor is almost always identified as a major impediment to growth. Governmental allocation of resources to education is helpful, but efforts devoted to improving the quality of education, developing industry-specific training, and creating conditions that will encourage entrepreneurship are insufficient.

Considerable attention should also be given to the need to build domestic managerial capabilities that will enable private enterprises to identify needs, search for resources, and maintain and ultimately adapt technology to domestic needs. The inability to diagnose problems and needs and to understand the requirements of, and benefits that accrue from, change also places businesses at a disadvantage in dealing with suppliers.

The above concerns, geared to external environmental and internal firm considerations, are summarized in Figure 1 prepared by the International Executive Service Corps (IESC) whose activities include providing management assistance to developing countries.

The Role of External Assistance

As we have noted, a legitimate objective of the U.S. Government, other industrialized nations, and the multilateral institutions is to assist a developing country in creating the conditions for private enterprise growth. There are various ways this can be done, one of the most important being through policy dialogue. Obviously, there are various fora for diplomats and other official representatives to influence the direction of economic policies in developing countries. The following identifies various types of situations, as well as the type and the scope of policy dialogue that may be appropriate to each.

POLICY DIALOGUE OPPORTUNITIES

IMF Stand-by Negotiations

The International Monetary Fund (IMF) often provides financing to member countries for balance of payments support and economic adjust-

FIGURE 1:
Preconditions for Private
Enterprise Development

Legal and Political Issues	Local Infrastructure and Economic Issues
Predictable policy environment	Adequate physical infrastructures (roads, power, communications, etc.)
Limited state enterprise activity	Adequate service and technical infrastructures (associations, societies, information sources, training systems, consulting services, research centers)
Access to cost-effective financing	International links to information systems and brokers
Legal system that protects private ownership and property	Accessible local and foreign markets
Legal system that supports contract security	Access to technology and supporting resources (spare parts, raw materials, etc.)
Effective arbitration and conflict resolution mechanism	Predictable exchange and currency policies
Reasonable import and export controls	Potential economies of scale for rapid growth
Appropriate fiscal legislation and incentive system	Functioning capital markets
Administratively efficient bureaucracy	
Positive public attitudes toward growth and entrepreneurship	
Physically and politically secure environment	Source: International Executive Service Corps.

Internal Enterprise Issues
Entry to market opportunities with high rates of return on investment
Ability to analyze and use information
Access to a pool of trained workers
Ability to plan and assess opportunities
Access to management resources
Access to capital, technology, and other resources
Access to international information linkages
Positive attitudes toward entrepreneurial risks
Belief in fundamental business ethics

ment measures. Much has been written about its resources and role in the international monetary system. It is important to point out that the IMF has become especially significant during the LDC debt crisis, not only in providing needed capital, but in tying its support to changes in policies that are market-oriented. While the IMF works with member nations as well as other international organizations in coordinating policy changes, it tends to operate independently.

Developing Country Consortia and Consultative Groups

These are groups, customarily chaired by the World Bank, in which the U.S. Government participates. Annual consortia meetings usually cover a wide range of macroeconomic policy issues. Agenda items are usually prepared by the World Bank staff with opportunities for donors to suggest topics. Some consortia have standing groups that meet frequently and offer a broader scope for continuing policy dialogue. In some instances, there are special sessions, each of which is devoted to a single policy area.

Witnin the context of development questions, consortia often focus on trade-liberalizing and market-oriented policy changes. They have also been helpful as a means of urging developing countries to lay out their broad policy strategies. Consortia can be particularly helpful in situations where a government has strong reservations about liberalization, where political considerations lead the U.S. Government to conclude that bilateral dialogue on basic policy change is not productive, or where the public record of consortia recommendations is beneficial to the developing country government in influencing its own public opinion.

And, of course, consortia meetings enable donor governments jointly to advocate policy changes. This can often help to increase the impact of all donor program funding; for example, in cases where donors convince the developing country government to lift food price controls, market forces can begin to determine price levels and provide an incentive for increased private food production.

Roundtables

Roundtables are the equivalent of donor coordination mechanisms for the least developed countries and have been developed in recent years by the United Nations Development Program (UNDP). They serve to assist the least developed countries in organizing and presenting their project financing needs to donors. Unlike consortia meetings, they tend not to concentrate on policy and program reviews that result in policy change, but on presentations by the developing country on perceived requirements.

AID Programming

In certain circumstances, these exercises offer an opportunity for broad policy reviews within a developing country. They usually occur in connection with the preparation of the annual long-term country development strategy exercise, the discussion of balance of payment programs, or sector assistance. The success of the Agency for International Development (AID) in these discussions sometimes depends on the size and importance of the AID program, the types of projects comprising the country program, and the AID mission's judgment on the relative importance to the developing country of private enterprise policy questions relative to other issues. Approaches can vary enormously, depending on conditions in the specific developing country. Clearly important in affecting AID's ability to influence policy directions through programming is the degree to which the mission director is respected and listened to by the developing country government and the quality of staff work done by both the mission and the agency in Washington to develop the U.S. position and agenda. Country teams need to identify development constraints and potential opportunities for using AID programming exercises to address these constraints.

The bilateral program offers additional opportunities to engage in policy dialogue. Individual project design discussions can orient implementation toward private enterprise with far-reaching effects. In Thailand, by using private sector contractors, for example, a project to improve rural roads ultimately led to major growth in the private, civil construction industry. The same can be said of the opportunities P.L. 480 provides to develop a private sector orientation on the part of the recipient country.

ILLUSTRATIVE CASES

Bangladesh

The case of Bangladesh illustrates several examples of efforts to change policy and the results derived from the process. AID had a long and continuous dialogue with officials in Bangladesh on the role of private enterprise. It focused particularly on the food sector, especially foodgrain prices and such production inputs as fertilizer. The role of government agencies versus private enterprise in marketing systems was also discussed. Newly independent Bangladesh inherited a system of government control and operation of the food distribution system. The system was both inefficient and a drain on government resources, but the government was inclined to maintain control because the availability and pricing of foodgrains were central to the country's policies.

Food system reforms were part of the general policy agenda of the World Bank's consortium meetings in which the U.S. Government actively participated. At the same time, the AID mission worked with the Government of Bangladesh on specific food policy problems. These meetings were conducted at a much more detailed level and with greater frequency. Extensive negotiations on these issues yielded policy changes and results.

Some of the policy changes involved reducing direct government operations in favor of private dealers and merchants, and increased reliance on the operation of the market to achieve foodgrain price stabilization. For example, AID focused its dialogue on the fertilizer distribution system to bring private competition into play and to stimulate more rapid expansion of fertilizer use by farmers. During 1983 the Bangladesh Government withdrew itself entirely from fertilizer sales at the retail level. AID then shifted its policy dialogue to the wholesale level, already partly privatized, and to the import level.

In the case of the Bangladesh industrial sector, the World Bank took the lead (and the U.S. Government supported its position in consortium meetings) in convincing the Bangladesh Government to undertake a divestiture program, beginning with the jute and cotton milling industry. As a result, a number of plants have been turned back to private ownership.

Convinced by donor agencies to privatize commercial banks, the government of Bangladesh also agreed to deposit a portion of local currency that was generated by U.S. food sales in private commercial banks. This was the first occasion in which government funds were placed in private banks rather than government-owned banks, thereby increasing the resources available to the private institutions and, through them, to private business.

At the project level, AID has supplemented its food production efforts by embarking on a program to help expand and strengthen the rural financing system. The focus is to provide private enterprise with access to needed capital.

Recent policy changes in Bangladesh represent sharp departures from past economic practices. Decisions were made at a time of considerable economic stress and recession by a government that was apparently reluctant and uncertain of the outcome, but now sees the results as positive.

Sudan

In the case of Sudan, the initiation of a general commodity import program (CIP) in 1980 brought AID into close contact with the country's macroeconomic problems. To understand the situation and identify the major policy problems to which AID might respond, two noted U.S. economists reviewed Sudanese economic conditions. Both concluded that greater reliance on the private sector was essential to address (1) the country's resource mobilization needs and (2) severe inefficiencies plaguing the transport, manufacturing, and other sectors heavily dominated by parastatal organizations.

Like the Bangladesh case, in addition to supporting an IMF-World Bank dialogue, AID emphasized certain policy areas that appeared particularly important and appropriate. The CIP allocation process gave AID entry into related subjects where dialogue with the government might be productive. For example, despite the poor record of small government-run sugar mills, the Sudanese Government had decided to establish a large new refinery. Because the new company needed access to import financing for its equipment under the CIP program, the government accepted AID's recommendation that a private management firm be hired to run the plant. A Louisiana firm was hired and ran the refinery as if it were a private company, e.g., free of civil service or pricing regulations or other government interventions.

At the project level, AID identified river transport problems as critical to Sudanese agriculture. Following three years of discussion, the government agreed to turn all boats and boating activities over to private owners and to limit state functions to facility maintenance (dredging, docks, etc.). With that commitment, AID initiated an assistance project.

The Sudanese experience is particularly interesting in light of recent AID actions in that country. AID took advantage of a "target of opportunity" provided by the sizeable increase in the FY 1984 CIP program to $120 million, compared to $80 million in FY 1983. This increase made AID a significant source of financing for Sudanese petroleum imports. Oil importing and distribution had been reserved for an inefficient state enterprise. AID suggested to the Sudanese Government (and other donors providing import financing), that petroleum import and distribution should be done by private oil companies on a competitive bidding basis. The suggested "privatization" was accepted, and purchases under the new system began this year.

Bureau for Private Enterprise

In recognition of the critical impact host-country policies can have on encouraging or discouraging private sector activity and investment, and in support of AID policy dialogue efforts, the Bureau for Private Enterprise (PRE) has committed funds in two specific areas: the privatization of business activities either owned outright or controlled by government and the provision of advice on enacting or revising investment codes to attract foreign investment and on capital and credit markets.

For example, in June 1984, the bureau made a $2 million "bridge financing" loan to help privatize a state farm historically owned and run by the government of Malawi. The farm had lost money and gone into receivership in 1980. The farm has attracted U.S. and Malawi private investors who intend to introduce rotational row cropping, a livestock operation, and other improvements. New workers would be hired and small farmers brought into the scheme. Because of the time required by investors to raise money for these projects, AID, Malawi commercial banks, and U.S. investors provided needed bridge financing so the next season's crops could be planted. The bureau will consider lending to the investors when the new management team takes over.

In India, Pakistan, Liberia, and Kenya, PRE provided technical assistance to review laws relating to the stock exchanges, investment laws, and capital markets and recommended appropriate revisions.

Conclusions

Several lessons emerge from experience with policy dialogue. One is that the ability to affect policy does not automatically flow from a large program. The program in Egypt is a case in point. Despite the large assistance program (over $1 billion per year) involving several modalities, the United States has not been able to significantly affect policy. While the espoused policy of Egypt is theoretically favorable to private enterprise, the Egyptian Government continues to overregulate and overcontrol the economy.

A second lesson is that form and timing are important; for example, where donors are in a position to provide funds to respond to potential policy shifts favorable to the private sector, such funds have a "value" and an impact greater than their size. In Somalia, leaders faced an economy in shambles when the Soviets withdrew their funding and assistance in favor of Ethiopia. Somali political and government leaders who survived the Soviet period, but doubted the wisdom of the country's previous economic course, regained control over policy and introduced an about-face. The basic shift made the government receptive to increased reliance on the private sector. AID is also helping the government carry out divestiture through a technical assistance project. Somalia agreed to change policy respecting private sector access to foreign exchange and ended the livestock ministry's monopoly on distribution of livestock drugs, opening this activity to the private sector. (This fact is important because livestock is a major economic activity in Somalia.)

A third lesson and corollary is that AID can capitalize rapidly on a favorable shift of government policy. Where a developing country government is moving toward market reliance and support for private enterprise, AID can quickly help define new lines of private enterprise policy. Sri Lanka is an unusual case of a country that recently made an about-face in economic philosophy through the election process. The new government is convinced that Sri Lanka should move sharply away from heavy state intervention and rely on the private sector and the operations of the market. The impetus for fundamental change in economic strategy appears to have arisen from within Sri Lankan government and political circles, not from international institutions or donor pressure.

Nonetheless, AID policy dialogue in the 1980s led to a significant change that affected the private sector. This is generally unrecorded, however, because the dialogue was informal and not directly related to conventional AID activity. The Sri Lankan Government was seeking to develop alternative approaches to food subsidy policies inherited from the previous government. The AID staff in Sri Lanka brought to their attention the U.S. food stamp system, which relies on private retail food stores rather than government distribution agencies. Discussion about the merits of the U.S. approach led Sri Lankan officials to visit the United States on their own and observe the workings of the food stamp system. The government subsequently shifted physical rationing, traditionally handled through government distribution, to a stamp allocation system operated through the private retail food distribution system.

A fourth lesson is that a donor's effectiveness is enhanced when it aligns itself with a significant policy shift supported by the World Bank Group and other major donors. The case of Kenya provides a good example of policy dialogue associated with a broad policy change agenda worked out between less developed country (LDC) governments and the World Bank. Kenyan development strategy has always been basically market-oriented with major reliance on the private sector. By the late 1970s, however, the effects of the rise in oil prices, mounting public sector deficits, and previous policies of protectionism and selected state intervention (especially in grain marketing), led to a need for a basic overhaul of the policy framework. In 1978-1979, AID proposed that its program become associated with the structural adjustment program defined by the Kenyan Government with World Bank assistance. This was done and is reflected in a FY 1983 $30 million AID program grant supporting the structural adjustment program. AID documentation spells out formally the policy agenda supported by the assistance, referring to U.S. policy dialogue with the Government of Kenya (GOK). This includes private sector aspects of the adjustment program of special interest to AID, such as "reduced Government participation in parastatals. . . rationalization of GOK regulations and procedures to promote investment and exports. . . increased reliance on the private sector to achieve development objectives."

Beyond the statement of broad policy objectives, the agreement contains "conditions," some of which are taken from specifics of the IMF stand-by and World Bank Structural Adjustment Loan understandings, and some are AID-specific. The latter are concerned with export promotion (simplification of export control procedures) and import of seed, fertilizer, pesticides, and other similar agricultural inputs (easing access to foreign exchange licenses for private importers), all of which are beneficial to the private sector and to the country. To sustain the dialogue, AID has instituted a system of informal monthly progress reviews and has also sketched out for the Kenyan Government areas of the adjustment process on which AID will focus under anticipated import financing support over the next few years. Finally, the package includes $2 million to finance consultants to assist the Kenyans in examining the details of several policy aspects of the adjustment program, including parastatal policy. A portion of these funds will also be used to evaluate the results under the FY 1983 agreement and to help define the policy content of the expected FY 1984 agreement.

The coordination of policy dialogue efforts within the U.S. Government is crucial. Advocacy of developing country change in economic, trade, monetary, and credit policies must be supported by a coordinated U.S. trade and investment policy position, articulated to the developing country as such.

Tools of the Trade

Introduction

This section outlines the "tools" available to U.S. officials for promoting private enterprise in developing countries. The listing is illustrative rather than comprehensive. Three types of assistance are described: direct bilateral programs and projects under U.S. Government control, multilateral programs and projects, and programs and projects over which the U.S. Government has some influence but no direct control. In the process of providing assistance to developing countries and strengthening private sector growth, U.S. officials may utilize all three means.

They may also call upon a plethora of U.S. agencies and organizations whose programs and projects complement and support private enterprise policy objectives, though they do not provide financial resources. For example, the United States Information Agency's (USIA's) visitors' program brings leading developing country economists, government officials, and others to the United States for interchange with counterparts. The Peace Corps also has a substantial number of programs directed to the private sector. There are numerous others.

U.S. Government-Sponsored Programs

The tools the U.S. Government has at its disposal for promoting private enterprise development have evolved from changes in U.S.-developing country relations, shifts in U.S. domestic concerns, and relatively recent PRE program design efforts. Created in 1981, PRE has been the AID bureau charged with primary responsibility for developing country private enterprise activities. Some of the major U.S. programs that support private enterprise in developing countries are described on the pages that follow.

INSTRUMENTS THAT PROVIDE FOREIGN EXCHANGE ACCESS AND SAVINGS

Since 1952, the U.S. Government has provided billions of dollars to developing countries to ease foreign exchange constraints. Such instruments include straight cash transfers, commodity import programs, and P.L. 480 programs.

Cash Transfers

Cash transfers provide dollar-denominated funds to developing countries. One form of cash transfer, the program loan or grant, is normally conditioned, meaning that policy modifications are expected as a result of the loan or grant. This lending instrument can influence developing country policies in such a way that the environment for private enterprise is improved. It is important, however, to set expectations at a reasonable level to avoid overconditioning these loans, and to allow enough time for policy changes to occur.

Commodity Import Programs

Commodity Import Programs (CIP) provide financing to meet the foreign exchange costs of imported goods and services in developing countries. (Practically all CIP procurement is of U.S. goods and services.) Since 1981, CIPs have been used increasingly to support private enterprise needs. In Egypt, for example, AID allocated a portion of its CIP funds to be used strictly for private sector financing. This resulted in the development of the Private Sector Production Credit Program, which enabled private Egyptian manufacturers and importers to have access to foreign exchange to purchase equipment and materials they might not have acquired otherwise.

P.L. 480

P.L. 480 is, among other things, a means to save foreign exchange for a developing country by allowing an extended period for food import payment. Local funds initially generated from the sale of U.S. agricultural commodities in local markets can be used by the developing country—in agreement with U.S. Government officials—for infrastructure, education, and intermediate credit. These funds also have been used directly by the private sector. In El Salvador, for example, local currencies generated under P.L. 480 have been used to support an industrial working capital fund.

The P.L. 480 program also demonstrates the integrated, multi-purpose nature of development assistance. There are three "titles" to P.L. 480, all of which have different objectives. Title I provides for the concessional sale of commodities to needy countries and requires that self-help provisions, often with a private enterprise component, be undertaken to improve agriculture production, marketing, storage, and so forth. Title II food donations are primarily humanitarian, and Title III, the food-for-development program, provides additional incentives to recipient countries, in the form of loan forgiveness, to assist them in improving capabilities for food self-sufficiency.

INTERMEDIATE CREDIT INSTITUTIONS

Capital market development is essential to private enterprise for accessing debt and providing necessary equity capital for start-up and expansion activities. The purpose of government-sponsored capital market development programs is to mobilize savings that can be used for productive investments locally. The major instrument has been the financing of Intermediate Credit Institutions (ICIs). AID's major ICI development assistance objectives have been to (1) develop institutional capability for appraisal banking; (2) extend medium and long-term credit and to provide equity financing where funds do not exist in sufficient amounts; (3) mobilize domestic resources by stimulating complementary investment; (4) direct investment to high priority development areas such as agribusiness or finance the start-up or expansion of productive facilities; (5) broaden access to the formal credit system and extend outreach; and (6) foster self-sustaining and financially independent institutions.

Because ICIs serve to improve the financial and business practices of firms applying for assistance, benefits to private enterprise are direct. Direct technical assistance to private enterprise customers or sub-borrowers is often provided by ICIs as well.

The period of greatest development activity involving ICIs occurred during the 1960s. An evaluative study of ICI investments conducted in 1969 indicated that from 1958 to 1968 AID provided 61 dollar loans to 45 ICIs in 34 countries, with an average loan amount of $5.2 million. Three-fourths of these loans were made in Latin America and Near East/South Asia, 80 percent to banks in more developed financial settings, and two-thirds to public ICIs for purposes other than seed capital. The trend then shifted in 1969 from financing provided to public ICIs in more financially developed countries to financing provided for seed capital in private ICIs in less developed financial settings. The study concluded that the great majority of AID's development assistance to ICIs had been successful. Most institutions created with AID seed money are now self-sufficient and provide needed financing and services to new and expanding enterprises, some of which would be unable to obtain credit in the commercial market.

In the area of mobilization of resources, it was found that most ICIs provide between one-third and two-fifths of the total investment required. The remainder is mobilized externally.

The study concluded that the loan application procedures of many ICIs serve to improve the financial and business practices of firms applying for assistance. There are, however, certain problems with ICI programs. ICI operations are sometimes subject to price structure distortions in the markets in which they operate. Government policies of protectionism, overvalued currency, or lack of investment incentives—among other things—can distort the allocation of scarce medium- and long-term resources available to ICIs, along with the economy in general.

There is a tendency for ICI subloans to be directed to larger or better established enterprises. Small-scale enterprises (SSEs) may receive little attention, due primarily to their high-risk nature, the higher relative cost of loan administration, and the need for more extensive technical assistance for these enterprises. Inadequate appraisal banking capabilities were also identified as a problem in some instances. This can result in excessive reliance on high-collateral or very short-term loans to compensate for the risk factors involved. This problem was generally solved by providing additional technical assistance to the ICI staff.

Specific examples of successful projects are numerous. The Industrial Credit and Investment Corporation of India, Ltd. (ICICI), which received dollar loans from AID in the early 1960s, is frequently cited as a prime example. The AID loan effectively increased the foreign exchange available for re-lending to the private sector and provided an incentive for the purchase of American equipment (subloans were made to private sector companies intending to use U.S. goods in their projects). A considerable amount of supervision for the re-lending operation was provided by the New Delhi AID Mission. The project also served as an information source for private companies. This information was also useful in the policy dialogue between AID and the Indian Government on investments, as well as private sector regulatory and fiscal policies.

During the 1960s, capital and technical assistance were provided to two public banks in Korea—the Medium Industry Bank and the Korea Development Bank—and to a new private bank—the Korea Development Finance Corporation. These three projects were all considered highly successful from the standpoint of the subprojects financed, the increased availability of investment credit for the private sector, and the upgrading of the appraisal banking capabilities of each bank.

The Latin America/Caribbean Bureau has been very active in ICI assistance, providing over $1 billion in development loan financing to 91 ICIs since 1961. In addition to assistance to development banks, the bureau has also supported credit unions and savings and loan associations. Savings mobilized by credit unions grew in Latin countries from $78 million in 1962 to $600 million in 1978. Membership grew during the same period from $300 thousand to $2.5 million, while the number of credit unions almost tripled. Savings and loan association figures are similar to those for credit unions.

In Africa, major development loans to ICIs were made to the Ivory Coast Development Bank, the Credito Somalo, and the West African Development Bank—all of which were considered generally successful.

Regarding project failures, it is difficult to identify any project as a total failure because in all cases credit is supplied to a large number of sub-borrowers, among which there are individual successes. However, it would appear that the loan to the Entente Fund's African Enterprises Program was less successful than most other ICI loans. Technical assistance was not readily available to the sub-borrowers because the technical assistance office for the fund was separate from the development banks (the Entente Fund was the recipient of the AID loan and then on-lent funds to national development banks in the five Entente countries). The loan was also used to fund too many projects in the Ivory Coast, the most developed of the five countries, rather than being spread evenly among all five. Larger firms were generally favored over the smaller ones and inside contacts were used to obtain funds.

A development bank project in Afghanistan failed in the early 1970s primarily because of the lack of a supportive political climate for an institution serving small private industrial companies. The lack of trained staff for subproject selection was also identified as a problem.

A more recent example of an ICI project is PRE's investment in Thailand's Siam Commercial Bank, which matched the bureau's $2 million loan to form a $4 million pool of funds for small and medium-sized rural Thai agribusinesses. These business funds were awarded to a new type of bank client; they received medium- and long-term loans at fixed rates. (Loans to smaller firms usually generate more direct and indirect jobs per unit of invested capital than do loans to larger firms.)

At this time, 13 borrowers have drawn on the fund for start-up or expansion. These enterprises range from a fish farm in south Thailand to a rice mill in Thailand's underdeveloped northeast. The first six of these borrowers are in the process of adding 144 full-time and 263 part-time workers to their payrolls. Five borrowers are exporting and earning foreign exchange—a factor that is important in combating Thailand's trade deficit. Indirect benefits of these loans—to farmers, manufacturers, and others linked to agribusiness—cannot be measured precisely. But this ripple effect can be demonstrated by the following example.

One borrower, Pongsathorn Ltd., a family business, used its loan to buy two new machines to convert raw cassava into pellets for animal feed to be sold abroad. The new machines doubled production and, because they produced better-grade pellets, more than doubled earnings. This had a significant impact on employment. The firm is hiring eight additional skilled workers, two new drivers, and 10-15 seasonal workers. The company expects this to generate about $25 thousand in additional annual income in the community at large. The new machines led to cassava purchases from at least five more farm families in income-hungry northeast Thailand and boosted business for the factory south of Bangkok that supplied the new machines.

A similar loan fund was set up by the Kenya Commercial Bank in January 1983. The bureau's $2.5 million loan was matched by the bank to create a pool earmarked for Kenya-owned smaller enterprises in agribusiness and rural manufacturing. The poorer western section of the country is a special target area. It is estimated that these 27 borrowers will create 462 jobs.

Again, the ripple effect will benefit small farmers and other rural Kenyans. Another borrower, OCAF (Oil Crops and Allied Foods) Limited, buys sunflower seeds from local farmers to make cooking oil, an arrangement that gives these farmers an assured market. Extension services from the borrower help increase yields. OCAF now deals with 1,000 farms and plans to expand this to 6,000 farms. Two other borrowers haul sugar cane from farms to a central processing plant, giving market outlets to thousands of farmers living far from the plant. In all, some 128,000 rural Kenyans are expected to benefit from employment and income-generating opportunities that flow from AID fund loans.

In the case of both the Siam and Kenya banks, PRE loans contained a small grant component. These funds pay for technical assistance to help the banks evaluate new types of loans and provide advisory services to help borrowers use the money productively.

Another kind of capital market, serving very small enterprises that are largely run by women is represented by Women's World Banking (WWB). WWB is an independent financing institution with offices in New York. Its purpose is to serve Third World women who have found it particularly difficult to get credit. WWB joins with local affiliates in developing countries to guarantee bank loans to promote female entrepreneurship. PRE helped fuel this process with $500 thousand in loans for guaranty collateral. Of this, $100 thousand each has been disbursed for projects in the Dominican Republic, Thailand, and Kenya. An additional $50 thousand was awarded to projects in Colombia. The remaining $150 thousand will fund projects in Jamaica and Haiti. Microbusinesses that have been served range from clothing shops and dollmakers to food vendors. WWB also provides borrowers with expertise in buying, marketing, and management.

A pilot dairy project in Thailand illustrates how WWB functions. Three women's organizations in Bangkok grouped together to form a local affiliate, Friends of WWB, in July 1983. This organization raised $250 thousand in loan guaranty money toward a pilot dairy project and convinced a local bank, Bangkok Bank, to put up $1 million. Another $100 thousand came from the bureau. An AID-assisted private voluntary organization provided more seed money and technical support.

It was up to the local affiliate to provide the enthusiasm, political muscle, and organizational know-how to get the project off the ground. Two rural project sites were chosen and borrowers were screened. Local governors were encouraged to incorporate the two dairy farms in their development plans. This meant official sanction for roads, reservoirs, access canals, and other infrastructure. Eighty-two families and a village cooperative borrowed a total of $900 thousand from Bangkok Bank, which waived some of its regular client requirements. Government extension agents were enlisted; cattle were imported from New Zealand. The dairy enterprise is now a working project, due not only to seed money from outside but, more important, to bootstrap efforts by local women entrepreneurs.

Another project with wide potential geographical impact is PRE's Agribusiness Loan Pool, established in September 1983. The pool will make outreach programs possible to small farmers from a private core company. Borrowers in Sri Lanka and, later, other countries will be served. Participants include the American Express International Banking Corporation and Abu Dhabi International Bank.

Still another source of capital for small business is made possible under AID's Productive Credit Guaranty Program (PCGP). Begun in 1974 and presently restricted to Latin America, the program encourages private banks and other local lenders to serve customers they would not otherwise serve by offering a partial guaranty. AID's guaranty is up to half the total portfolio of such loans and no more than three-fourths of any single loan. Given responsibility for the program in early 1983, the bureau negotiated an arrangement with Royal Bank Jamaica. PRE also streamlined the PCGP process to allow a more direct relationship with the bank, and earmarked guarantees for only very small and microrural enterprises. As of mid-1984, Royal Bank had made 37 of these loans, totaling $150 thousand. In this instance, bureau guaranties are 65 percent of single loans.

A bureau loan in September 1982 to help capitalize Sogewiese Leasing—Peru's first leasing company—represented an early attempt to mobilize a different kind of intermediate institution as a source of capital.

Several proposals with capital market-building features are being studied. They include a capital market access project in South America and a leasing project in the Near East. The first would match a PRE loan with funds from two local private development banks (financieras). This would create a pool of medium-term credit (two to seven years) for small to medium rural firms. A special feature of this project would place the AID dollars in a U.S. bank. The U.S. bank would then issue a standby letter of credit as a virtual guaranty for securities issued locally. These would provide local currency for pool customers, thus cushioning the foreign exchange risk of borrowing dollars.

The second proposal would help establish an independent leasing firm as a mechanism for delivering credit to small local businesses in manufacturing, agriculture, mining, construction, and other industries. The pool would be large enough to cover 500 enterprises and offer great potential for job generation. The International Finance Corporation (IFC), the World Bank's capital window for private enterprise, would participate.

There are occasions when U.S. embassies and AID missions identify and direct ICI efforts to the special needs of small and medium-sized private enterprises, both in agriculture and industry, whose credit risk might be perceived as too problematic for normal commercial banks. They have to be sought and diligently developed. Those who develop small or medium-sized lending projects should be given considerable recognition by each country team.

Two further in-depth examples illustrate long-term experience through a variety of business conditions. In early 1961, the Government of the Philippines asked AID to assist in the establishment of a private development bank there. AID, the World Bank, and private sector interests in the Philippines joined to form the Private Development Corporation of the Philippines (PDCP). Total initial capitalization was the Philippine equivalent of $28.46 million, consisting of approximately $7.2 million equity, a $6.3 million AID soft loan repayable in local currency, and a $15 million foreign currency loan from the World Bank. IFC subscribed to a portion of the equity. The function of the AID loan was to attract hard loans and to provide a subsidy and additional leverage to attract a broad range of private investors to the public stock offering. The AID local currency funds were drawn from peso counterpart funds. The PDCP was incorporated in February 1963, held a successful public stock offering in March 1963, and began operations in August 1963.

The objectives of AID in assisting in the establishment of PDCP were consistent with the objectives of the Philippine Government, i.e., to establish a privately owned and controlled development finance institution that would facilitate the mobilization of foreign and domestic capital and increase long-term financial assistance (loan, equity, guarantee, and underwriting) to private industrial and other productive enterprises in the Philippines.

The highly concessional nature of the AID loan terms and the nature of the "quasi-equity" agreement created some concern during the organizational phase. The primary concerns involved the possibility of excess profits to the shareholders and the possibility of control of the corporation by a limited group of private investors that could result in preferential treatment to interlocking corporations. These issues were resolved through AID and World Bank agreements designed to minimize concentration of financial assistance to major stockholders and directors of PDCP; provide for accelerated repayment of the AID loan in the event of "excess profits"; provide AID with the option to accelerate repayment in the event of impairment of PDCP's capital; and establish reserve requirements for payment of the AID loan. The Bank was required to hire an expatriate executive vice president during the first two years. The PDCP received immediate disbursement of the AID loan, which it used for short-term placements, thereby generating revenues used to finance internal training programs.

PDCP's 20-year history shows a gradual build-up of operations. In the first 10 years, PDCP financed 271 projects or 21.8 percent of the 20-year total approvals and 12.7 percent of the total funds over 20 years. Over the next 10 years, projects approved increased 400 percent, while peso volume of approvals increased 900 percent. By the end of 1982, PDCP had approved 1,241 projects with an aggregate value of approximately $742 million.

PDCP also launched an active small-scale industry program in 1973. By the end of 1982, fully 45 percent of the approved projects were small-scale industries.

PDCP's operations over 20 years resulted in a significant contribution to Philippine net domestic product, large foreign exchange savings, and generated over 61 thousand jobs.

From the investors' standpoint, small Philippine shareholders (many of the "class A" shareholders) received a good return on their initial investment, but little real appreciation of traded stock value. Foreign shareholders did not receive as good a return when exchange losses were taken into consideration. However, it is clear that the AID loan did not result in excess profits as was feared at the time of the loan. The World Bank, the Asian Development Bank, and AID have evaluated PDPC and have given it high marks for making a "significant contribution to the development and financing of private enterprise in the Philippines."

The Costa Rican Industrial Financing Corporation (COFISA) was instituted in 1963 as a private development finance company to help meet the capital requirements of the private industrial sector. The official banking system of Costa Rica, which is state-owned and government-controlled, has been characterized as slow, highly conservative, and unable to mobilize local savings to any significant degree.

The need for a private industrial financing corporation became apparent to the AID Mission in Costa Rica as early as 1963. The first $5 million loan was granted at that time. COFISA secured a second AID loan of $5 million in 1969. A 1978 AID financial study indicated that COFISA was a healthy lending institution with good management and consistent profitability. It was recommended that AID permit the COFISA debt/equity ratio to rise to 10:1.

By 1980 the company had increased

commercial financing to $69.7 million, establishing itself as a commercial (retail) financing company. However, COFISA was never able to generate local savings to finance its lending program and was forced to depend almost entirely on international commercial bank credit (by 1980 it had borrowed from over 70 different international banking institutions).

The onset of Costa Rica's financial crisis affected COFISA as heavily as any institution in the country. A Costa Rican Supreme Court decision allowing debtors to service their dollar-denominated loans in grossly inflated colones (local currency) resulted in a loss equal to almost twice the corporation's stock value. A complete study was undertaken to reschedule COFISA's debt with its creditors.

Based on that rescheduling, a $10 million loan agreement between AID and COFISA was signed in 1982 to serve three purposes: (1) assist with the resolution of the Costa Rican productive private sector liquidity crisis, (2) enhance the private sector's capacity to earn foreign exchange, and (3) reestablish COFISA as a development-oriented financial institution. A subsequent court decision compounded the problem, forcing COFISA to abandon some of its development objectives in order to survive. Believing that development objectives can eventually be met, AID continues to work with this institution and is convinced that a withdrawal of AID support would severely damage the private sector lending in Costa Rica.

COFISA is an example of the dependency of a private bank upon the macroeconomic policies of the country in which it is located, despite relatively good management and a history of successful lending. In Costa Rica, the overvalued currency led to the flight of domestic capital and a consequent dependence upon foreign borrowing. That borrowing, from the standpoint of the total economy, led to massive debt and an even further weakened colon. The court rulings brought the situation to a crisis level, but the prospects of not continuing to support COFISA were far bleaker than those of an additional loan.

INSTRUMENTS THAT PROMOTE FOREIGN PRIVATE INVESTMENT

Foreign investment can bring capital, technology, and market access to the host country; to assist LDCs, the U.S. Government has developed various mechanisms to promote U.S. overseas investment. Naturally, American investors have access to private resources for penetrating overseas markets, but U.S. Government mechanisms are available for special sectors or countries where long-term risks or costs need to be reduced. These include the following specific programs.

Investment Insurance and Guarantees

Investment insurance and guarantees are administered by the Overseas Private Investment Corporation (OPIC).

Created in 1971, OPIC provides insurance for private investment against war, revolution and insurrection, expropriation of assets, and currency inconvertibility. (In 1983 this amounted to $3.9 billion.) Coverage is extended to investments that are minimally three years and up to 20 years. The program is used heavily by banks and oil-services companies; however, in 1983, of over 100 new projects assisted, one-third were investments undertaken by small businesses. (Among special product areas, energy contributed strongly, including a geothermal project located in Indonesia.)

OPIC also has direct loan and investment guarantee programs. Most of the annual $110 million maximum for these programs is committed to smaller U.S. businesses. OPIC estimates that the total of 124 OPIC-assisted projects in 1983 will replace about $385 million of LDC imports and earn $865 million annually for their additional exports. Significantly, more than half of these projects are located in the poorest developing countries, while about 40 percent of these projects were sponsored by, or largely involved, small U.S. businesses or cooperatives. An OPIC direct loan of $300 thousand went to a small U.S. business-sponsored leather tannery in Haiti to expand existing operations and add new product lines. (This will enable one of the last kidskin tanneries in the United States and several U.S. shoe manufacturers to remain competitive with imports.)

OPIC's $80 thousand grant to Warner-Lambert's effort in French West Africa is an example of private industry-government cooperation. In analyzing the manufacture of important drugs in West Africa, Warner-Lambert recognized that the critical primary need would be to have adequate distribution and appropriate use of drugs among the general population. The company decided to offer to produce and present primary health care education and training programs in Senegal, Ivory Coast, Cameroon, and Zaire. Six audiovisual programs, produced in cooperation with local health ministries and health care leaders, provide instruction on diseases endemic to the region, focusing on prevention through drug and non-drug therapies. No product promotion is included. The OPIC grant supports a specific audiovisual program, part of which enables Warner-Lambert field personnel to devote one day a week to presentations in health care facilities.

Bureau for Private Enterprise

AID's PRE Bureau views the encouragement of domestic and foreign private investment as the most positive solution to the problem of job creation and has undertaken a variety of investment promotion activities to implement longer term efforts to improve the host-country business climate. Early bureau projects included support for a one-year program to train investment advisers serving several Caribbean governments. This was undertaken by the United Nations Industrial Development Organization (UNIDO). Increasingly, AID field missions have designed programs to help governments attract foreign investments, often with PRE assistance. Sri Lanka, Thailand, Jamaica, and—on a regional basis—Africa are examples.

However, there is some question as to why some investment promotion programs work and some do not. To find out, PRE commissioned SRI International to conduct case studies in five countries. That analysis provided guidance to governments and AID missions and established a frame of reference for designing future efforts and evaluating past efforts. (SRI International agreed to provide staff for follow-up work in developing countries.)

The Housing Guaranty Program

The Housing Guaranty Program, managed by AID since 1961, promotes basic shelter and related services and facilities for low-income people in developing countries. AID mobilizes U.S. private sector resources in the form of loans made to foreign governments or their agents, and provides a full faith and credit U.S. government guaranty of the loans made, generally by U.S. private lenders.

This program has over $1 billion in guarantees outstanding and a default rate of less than 1 percent. Conditioned loans in such cases may motivate policy changes that open new markets for housing construction, as was done in Honduras. In this case, legal changes were made regarding low-income housing. The incentive was a loan that encouraged the safe lowering of excessively high municipal construction standards, thereby making housing affordable to the lower income population. In Honduras, this meant that lower income families now have access to public housing finance, whereas a decade ago they had none. Greater private sector participation in the financing and construction of housing has resulted as well.

Investment Centers and Groups

Investment centers and groups have been created to attract U.S. direct private sector investment to key developing countries. AID has set up or provided assistance for centers in the United States for India, Korea, Taiwan, Thailand, and Indonesia. Grant assistance has been provided to the Caribbean Association of Industry and Commerce, which aids its members in promoting investment opportunities and services. Assistance is also provided to local chambers of commerce and business associations for similar purposes. This program offers information and other services for U.S. investors seeking new business opportunities or wishing to enter international markets for the first time.

An example of a successful promotion initiative funded by AID was the International Conference on New Enterprises (ICONE) held in 1979. The goal was to stimulate international cooperative efforts to establish small and medium-sized enterprises in developing countries and to expand employment at a reasonable cost. ICONE provided good information on coventures and served as a platform for advocating public policies advantageous to small business. The conference resulted in 19 business ventures amounting to over $27 million in potential investments. The ICONE concept could be applied on a regional or country basis.

Investment Project Identification

Investment project identification mechanisms are important first steps in promoting investments by private U.S. companies in developing countries. Preinvestment surveys performed by the OPIC Survey Program, for example, promote and support a potential investor's visit to a country of interest and a subsequent in-depth study of the economic and financial elements of the project. Market potential, availability of raw materials, communications, labor, and government regulations are assessed. To qualify, investors must demonstrate they are seriously interested in undertaking the project as well as having the necessary capital and capabilities to do so. AID's PRE Bureau also has limited funding for feasibility studies that help promote Third World investments with substantial development payoff. These may involve only local enterprises or be joint ventures between the United States and local partners. The bureau pays half, or $50 thousand—whichever is less, of the cost of studies funded up-front by sponsors. The sponsor must reimburse AID only if the study proves the project commercially viable. However, PRE may decide later to help finance the resulting project.

Feasibility studies can be a loan origination device. This year, the focus of the studies is expanding to include all sectoral priorities—agribusiness, intermediate financial institutions, and health. As of July 1984, the PRE Bureau had funded 15 feasibility studies for projects in eight individual countries and the Caribbean Basin.

The Trade and Development Program (TDP) also provides funds for feasibility studies. TDP assesses foreign investment projects that contribute to a country's development effort and provides funds for studies likely to lead to substantial U.S. exports. (TDP is more fully addressed in the export promotion and development section.)

Another type of investment identification device is the project identification unit. One such unit was established recently for the Caribbean. The Caribbean Project Development Unit—involving the World Bank, AID, and other bilateral donors—is designed to identify projects in the Caribbean in the $500 thousand to $5 million range. This tool is useful in alerting potential U.S. private investors who are unaware of smaller projects in a region of great interest to the United States. The scale of target projects in the Caribbean is particularly well-suited to the involvement of smaller U.S. investors.

The PRE Bureau has helped fund two similar efforts in collaboration with OPIC. The first program was the Caribbean Investment Opportunities Program in late 1982-early 1983. This featured a seven-city "telemission" hookup by satellite to inform potential U.S. investors of opportunities in this strategically important region. Follow-up teams to several Caribbean countries brought representatives of U.S. business together with Caribbean counterparts. Investors expected projects totaling $85 million, producing 1,200 jobs in Jamaica; investments are expected to total $37 million and generate more than 2,400 jobs in the Eastern Caribbean; some $44 million in investments were forecast for Haiti.

PRE and OPIC also collaborated on "Operation Opportunity" in November 1983. Again using satellite communication, the program informed American companies about U.S. Government programs that help them do business abroad. About 5,000 executives in 44 cities participated.

Cofinancing

Cofinancing with commercial banks or multilateral development banks, is a means of leveraging private sector funds. For AID, an advantage in this approach is that the cofinancing partner can assume the administrative and monitoring responsibilities. Two examples demonstrate the intent and potential of cofinancing.

The Latin American Agribusiness Development Corporation (LAAD) is a private investment and development company owned by leading agribusiness and financial corporations mostly from the United States. LAAD finances and develops agribusiness projects in Central and South America and the Caribbean, involving all phases of production, processing, storage, services, technology, and marketing in a wide variety of agriculture-related fields. The objective of the company is to improve the production, distribution, and marketing of agricultural-based products.

Over the years, AID has entered into five separate loan agreements with LAAD. The AID funds carry concessional interest rates, but are provided only in conjunction with certain matching capital contributions from LAAD itself. LAAD acts as an intermediary in identifying small and medium-sized agribusiness projects, then provides funding and an introduction to new technology and business methods. LAAD makes its own lending decisions and closely monitors its investments.

The development impacts include employment generation, expansion of nontraditional exports to generate foreign exchange, and the establishment of strong linkages between businesses in the agricultural sector.

Another AID cofinancing project involves BANEX, a private Costa Rican export bank that provides one of the few alternatives to financing through state-owned banks. AID's funding allows BANEX to offer export-oriented banking services, make credit available to export producers, and create a trading company to assist exporters in Costa Rica. These and similar examples are tools for supplying both capital and know-how for new business development in the private sector.

EXPORT PROMOTION AND DEVELOPMENT

Trade growth is important to LDC economic development. Expanding trade often precedes interest by foreign companies in investment. American companies with positive trade experience in a developing country are more likely to broaden their involvement. Thus, U.S. Government programs that enhance U.S.-LDC trade should be seen as mutually beneficial. Special attention must also be given to increasing the ability of LDCs to expand trade with the United States. The foreign exchange generated by LDC exports is critically needed to pay off foreign debts and to import equipment, parts, and materials vital to local industries.

A number of U.S. Government agencies provide assistance to facilitate the international movement of goods and services for the benefit of private enterprise.

Expanding United States Exports to LDCs

The Trade and Development Program (TDP), a component of the International Development Cooperation Agency (IDCA), finances feasibility studies for development projects when there is a strong likelihood that they will generate exports from the United States. TDP funds help to assure that U.S. firms are more fully engaged in Third World development projects that expand trade, attract U.S. investment, and provide an effective link between trade and aid.

U.S. ambassadors and the American business community consider the program to be a valuable tool in helping U.S. firms get in on the ground floor of the development of major projects. Projects such as mines, hydropower facilities, electric generating plants, and telecommunications facilities are lucrative markets for U.S. construction, engineering, and equipment manufacturing firms.

TDP is also an important resource in countering grants made by foreign governments that offer free feasibility study financing in order to capture major export markets for their firms. For example, through a cooperative effort in Tunisia, the U.S. ambassador and representatives from an American firm were able to utilize TDP funds to secure the contract for the planning of a major phosphate mine. In this case, two other countries offered the Government of Tunisia subsidized financing packages to shut out their American competitor, a medium-sized engineering firm. In turn, TDP offered grant financing of the feasibility study to the Tunisian Government on the condition that the grant be passed back to the U.S. firm bidding for the project. The Tunisian Government accepted the TDP offer, and thereafter the American engineering firm was given a significant follow-on contract of several million dollars for additional planning and design work.

TDP has been successful because it has been able to move quickly, often making a commitment of several hundred thousand dollars in a matter of days. An evaluation indicated that some

$25 million spent by the program on feasibility studies for major projects has enabled U.S. firms to capture some $500 million in sales of goods and services associated with these projects, with substantial future sales anticipated.

The Export-Import Bank (Eximbank) is the prime U.S. Government trade financing institution, authorized to have at any one time outstanding dollar loans, guarantees, and insurance in an aggregate amount not in excess of $40 billion. (The U.S. Government's official financing only supports 5.8 percent of total U.S. exports, compared with 9.1 percent in West Germany, 26.6 percent in France, 32.4 percent in the United Kingdom, and 37.1 percent in Japan.) The Eximbank provides official guarantees and insurance for U.S. export financing, thereby enabling U.S. firms to export equipment, products, and services without undue risks of nonreceipt of payment. The Eximbank also provides direct loans to foreign borrowers, primarily for larger sales of U.S. capital goods. However, it will usually finance only a portion of the U.S. costs, with the balance coming from the borrowers' own resources.

Mixed Credits have become an increasingly important form of financing as competition for international markets increases. Because of the widespread use of this trade financing instrument by others, the U.S. Government, which views mixed credits as a trade distorting tool, has authorized Eximbank funds to be used, under certain conditions, to match offers from competing countries so that U.S. exporters can provide competitive financing rates. Within the Eximbank, this authority exists in the Tied Aid Credit Export Subsidies Program. To a far lesser extent, AID is also authorized to blend Economic Support Funds (ESF) for this purpose.

To demonstrate how the mixed credits program works, in March 1984 the Eximbank learned that the French Government was planning to offer predatory financing to an Indonesian aircraft manufacturer for the purchase of machine tools. Eximbank offered support to a U.S. machine tool manufacturer in the form of an export credit designed to match, but not exceed, the terms offered by the French. The terms offered by Eximbank were a 6.5 percent interest rate, a grace period of 13 years, a repayment period of 20 years, and financing to cover 100 percent of U.S. costs. These terms are significantly better than usual Eximbank terms; they can be offered only under circumstances in which heavy subsidies are necessary to meet predatory, officially supported foreign competitive financing. The export subsidy is large and costly. The United States has attempted for several years to persuade other governments to cease the practice entirely; it has adopted the policy of retaliation as a means to support its negotiating position.

The Foreign Credit Insurance Association (FCIA), an association of commercial insurance companies formed by Eximbank in 1961 to provide credit protection for U.S. exporters, has facilities for smaller U.S. exporting firms. Insurance policies issued by FCIA insure repayment in the event of default by a foreign buyer. Policies cover short-term and long-term transactions including tangible goods, service contracts, leases, and other special situations. Eximbank guarantees repayment to commercial banks that finance medium-term transactions for U.S. exporters.

The Commodity Credit Corporation (CCC) in the Department of Agriculture facilitates the orderly distribution of U.S. agricultural commodities. The CCC offers, among its functions, services for agricultural commodities similar to those of Eximbank including credit guarantees and direct financing for food exports.

Expanding LDC Exports to the United States

The Caribbean Basin Initiative is a special regional program of the U.S. Government. It provides duty-free access to the U.S. market for a majority of Caribbean Basin country exports under the concept of "one-way free trade." Established in 1981, this incentive program will be in effect for 12 years. Additional trade with the region as a result of these incentives will provide new opportunities for private enterprise to develop.

The Generalized System of Preference (GSP) is another incentive program for developing country exports to enter the U.S. market. GSP grants duty-free entry of imports from eligible developing countries as an incentive for diversifying their production and export base. GSP is not designed to be a permanent measure, but is a temporary mechanism to enhance developing country competitiveness.

The World Trade Institute provides educational assistance to individuals in developing countries. Supported by AID, it offers educational, training, and technical services for export development and trade promotion assistance to developing countries. This program is valuable because most developing countries do not have specialized institutions with trained manpower to assume responsibility for a comprehensive export promotion program.

The AID Private Enterprise Bureau has incorporated the foreign exchange generation factor as a part of several major projects because of its development impact. The bureau has also designed several specific investments solely or largely as export promotion vehicles. One of these is the FINADE project signed by the AID administrator in April 1984. It was the first bureau loan processed through the Private Sector Revolving Fund.

Banco de Desarrollo FINADE, a private development bank in the Dominican Republic, matched AID's $2 million loan to build a $4 million financing pool. These funds are set aside for small and medium-sized Dominican borrowers producing nontraditional products for the U.S. market. Handicrafts and winter vegetables are two examples. Designed to earn foreign exchange, the project thus supports the country's efforts to diversify exports beyond those—such as sugar and tobacco—on which the country had relied. It also serves U.S. Caribbean Basin Initiative objectives by boosting the economy of an important neighbor.

In addition to the loan, AID is providing a matching grant to help develop a marketing plan for these products. The plan would be put together by a new export trading company, Commercializadora Dominicana (COMEDOM), using U.S. export trading company expertise. COMEDOM is being capitalized by FINADE and other banks and by borrowers from the loan pool. All have a large stake in its success.

Another project, designed primarily to promote exports, is in the drafting stage. PRE would join other lenders in setting up a hard currency pool for "pre-export" business credit in Caribbean nations. This would serve exporters who cannot get the foreign exchange needed to buy packing materials, chemicals, fertilizers, and other imported production process inputs.

An additional support mechanism that is currently being studied would stimulate a short-term export credit facility in a North African country. AID's loan would be matched by a private commercial bank in that country to serve smaller-scale enterprises. Exports stimulated would be nontraditional, agribusiness-related, and products manufactured by light industry to sell to European markets. The new credit pool would be one alternative to host-government export credit sources. In the particular country involved, these sources have been strained to the limit, putting pressure on the national budget and causing deficits to rise.

Export promotion is a recurring theme in PRE's assistance to AID field missions. For example, it funded studies that led to development of a concept paper on African export financing needs that identified opportunities for fashion industry exports from Costa Rica and that helped the Belize fishing industry develop lobster traps for export.

Free Zones are being used around the world to generate new export-oriented investments that add value to products. Successful experiences in newly industrialized countries such as Taiwan, Hong Kong, and Singapore have spurred interest in free zone development in other Third World countries. The needed information, however, is largely uncollected.

A guidebook is being prepared for PRE on how to develop and operate an effective free zone. It will include data on management structure, policies, and procedures; types of services required; the appropriateness of incentives; and marketing practices.

TRAINING

Recognizing that limited available trained manpower is one of the major constraints of developing countries, LDC institution-building projects have been financed for universities, technical schools, and other entities to improve management and other skills necessary to enhancing private sector growth. LDC students are also brought to the United States for these purposes. It has been found that students trained in U.S. institutions tend to have a better understanding of, and a long-term preference for, goods and services provided by U.S. firms.

Currently, AID has two broad-based categories of training—training of LDC participants in the United States or third countries, and training in the participant's country. Over 9,000 AID-sponsored participants receive academic or technical training each year in the United States. This program had as many as 13,500 participants in 1969 and as few as 6,700 in 1978. The program costs roughly $150 million annually. Figures 2 through 4 summarize the 1983 AID participant training program by demographics, subject areas, and regions. AID in-country training is limited primarily to on-the-job training of local nationals working under AID development projects. Training is usually in the functional areas of agriculture and nutrition, population and health, or education and human resources, but can range from academic degree programs or technical seminars to on-the-job instruction.

Effective training support for private enterprise development requires that a number of activities be undertaken. Among these are:

- ☐ improving the ability of each enterprise to identify internal needs and relate them to training strategies;
- ☐ expanding the technical infrastructure so that universities and other organizations better serve local business needs;
- ☐ popularizing training as a valuable tool for business growth;
- ☐ establishing linkages to provide more industry-specific information and resources for better training development; and
- ☐ promoting overseas scholarship programs that incorporate direct contact and experience (perhaps internships) with private enterprises.

FIGURE 2:
General AID Participant Training Program Demographics for FY 1983

	Number	Percent (0 – 25 – 50 – 75 – 100)
Total	9,012	
Contract	5,689	63
Non-contract	3,323	37
Academic	4,016	45
Technical	4,996	55
Male	7,390	82
Female	1,622	18

FIGURE 3:
AID Participant Training Programs by Subject Area for FY 1983

Academic, 4,016
Technical, 4,996
Total, 9,012

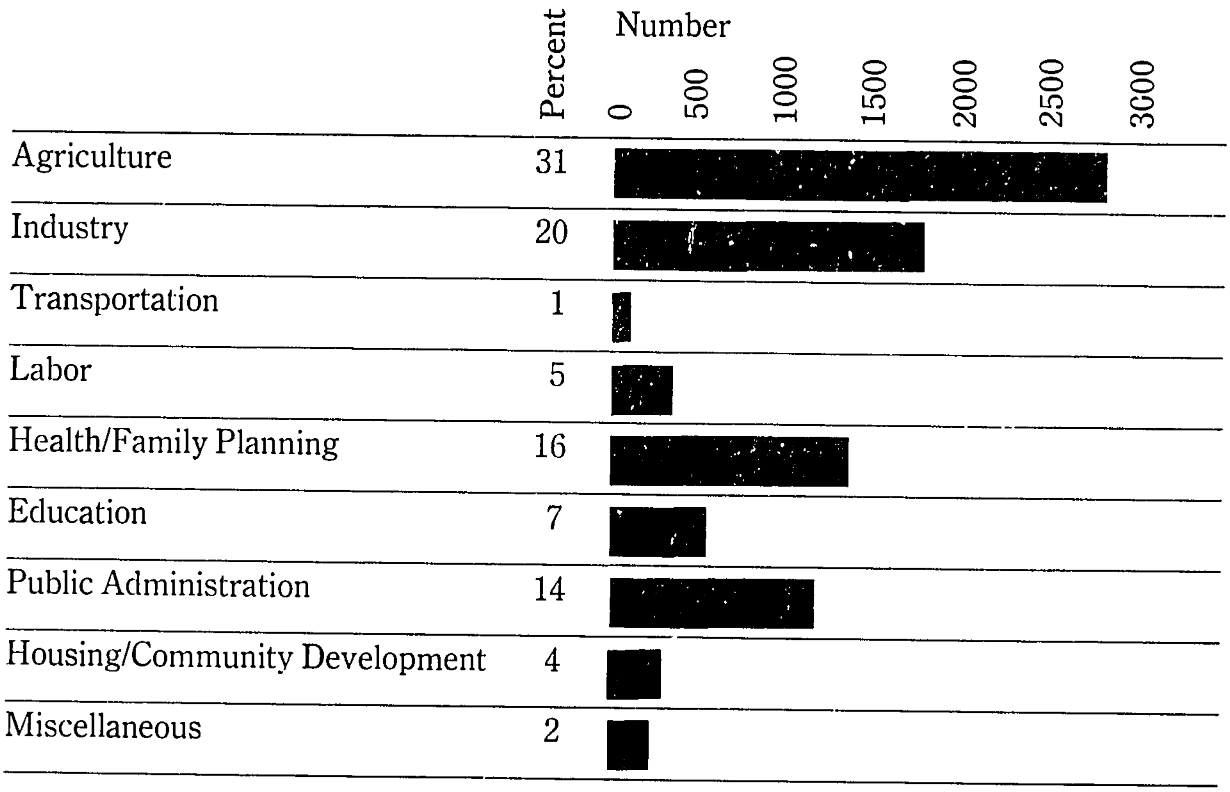
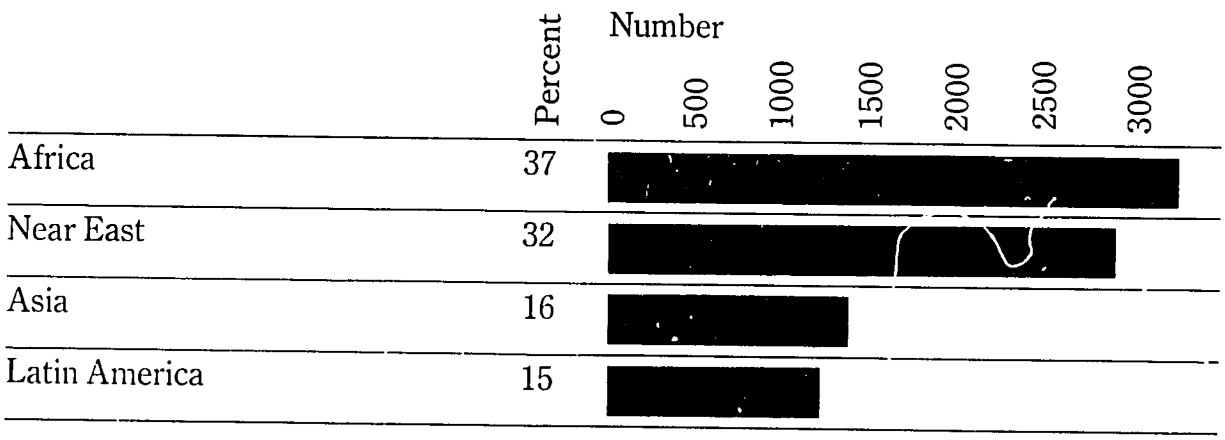


FIGURE 4:
AID Training Program Participants by Region for FY 1983

Academic total 4,016
Technical total 4,996
Total 9,012



Source: Office of International Training, Agency for International Development (1984).

The closer training is to real needs, the better. In specific situations, governments should do what they can to encourage privately sponsored training directly related to the needs of business. The self-interest in this regard must be long-term; education and training lead to more effective participation by developing countries in world markets.

The following are some examples of areas and types of AID involvement in developing country training that reflect the increased emphasis on private enterprise development.

Vocational Skills

Vocational skills training has been supported through the building or expansion of institutions, such as specialized institutes, private sector training firms, employer organizations, chambers of commerce, and private voluntary organizations.

By providing a $1.2 million grant in 1982, for example, the U.S. Government joined with Peruvian business leaders in establishing a vocational school in Lima, the Instituto Tecnologico Superior (TECSUP). AID provided the seed money, but TECSUP is structured to be self-sustaining through local business contributions. Grant funds provided finance curriculum development by the Delaware Technical and Community College as well as needed equipment. Training for jobs in mining, refining, construction, and chemical industries is to be emphasized. TECSUP courses will be designed with business input to assure relevancy.

The Young President's Organization (YPO) has assisted in the hands-on training of LDC managers. YPO is made up of 3,600 heads of mainly small and medium-sized U.S. businesses. One out of three YPO executives built their businesses from the ground up, and all headed their companies by the age of 40. A $255 thousand AID grant promotes visits by YPO problem-solving teams to five target countries—Indonesia, Jamaica, Kenya, Sri Lanka, and Thailand. Six to ten YPO members with diverse industrial expertise and teaching skills are on each team.

A good example of an industry-specific effort is the U.S. Telecommunications Training Institute, a consortium of firms such as AT&T, IBM, GTE, and many others, which trains individuals in the application of telecommunications technology. The Institute, in conjunction with the Academy for Educational Development in Washington, D.C., trained over 200 people from 65 developing countries in 1983, its first year of operation. Training and administrative costs were donated by the participating firms and most of the training took place in corporate facilities. International development institutions, including AID, funded 70 percent of the costs of transportation and sustenance. The program is designed to introduce developing country participants to the products, services, and technologies of the U.S. telecommunications industry. Participating businesses regard the program as a long-term investment that will eventually lead to commercial benefits.

Funding for the program comes out of the marketing rather than training budgets of many of the firms. Participating companies have benefited from the development of technical assistance relationships, new business contacts, and a better understanding of developing country markets.

In another case, several East Coast transportation companies arranged and paid for an observational training program for five urban planners to study mass transit. AID funded the per diem and international travel.

In 1982, a consortium of international education and exchange organizations, Partners for International Education and Training (Partners), was established to manage programs for approximately 2,000 AID-sponsored participants each year. While most placements are in U.S. academic institutions, Partners has found many short-term positions for developing country participants in U.S. businesses. About 20 percent of the participants have direct contact with U.S. industry. A recent program, for example, placed 39 Caribbean participants with muffler manufacturers, furniture companies, food processors, and other private businesses.

AID's Office of Women in Development (OWD) brought 33 businesswomen from developing countries to the United States. They spent three weeks in a small enterprise development program conducted by the International Marketing Institute (IMI) in Boston. An optional observation study tour followed the official program. Visits to many U.S. firms, small and large, were included.

Management Training

Management training is also institution-based. In Central America, AID supports schools such as Instituto Centroamericano De Empresarios—Central American School of Business Administration (INCAE), which offers MBA and continuing education programs of high quality. Exposure to U.S. management techniques through American universities is beneficial; however, better coordination between areas of study and actual employment demand in the host country is needed to insure greater program efficiency. Numerous institutes throughout the world have been started or supported with AID funds.

In a dynamic economy like that of Thailand, the supply of trained business managers can barely keep up with the demand required by the pace of growth. Drawing heavily on both the American and Thai private sectors, one solution to this problem was the establishment of the Institute for Management Education for Thailand (IMET). IMET was founded in September 1982 with a $1 million AID grant. The money was not spent on costly new buildings and grounds or on staff salaries. It went for training materials, curriculum development, and special courses for middle managers that could be developed by existing institutions. Supported by the AID grant, four Thai management institutions joined together to design and teach these high-impact training courses, using U.S. business school models. Over an 18-month period, seminars were held for 1,000 male and female entrepreneurs from all of Thailand's 71 provinces. American university professors went to Bangkok to help prepare teachers and build up a cadre of Thai instructors in marketing, accounting, personnel management, finance, and other subjects. Feedback from students, who are working mid-level managers, ensures that the curricula match real-world business needs.

IMET's board of directors is composed of 20 leaders from business, banking, and the universities. There is no government participation or direction. The organization is designed to be financially self-sustaining. The IMET board is conducting an energetic campaign for additional funds from both Thai and Thailand-based American businesses so it can continue after the AID grant funds have been depleted.

Other examples include support for the Barbados Institute of Management and Training to assist with its private sector training and upgrade management and technical skills that are critical for business expansion, new investment, and employment opportunities. In Honduras, the National Training Institute provides improved skill training for middle managers, i.e., mechanics, carpenters, electricians, and machine operators. An AID grant in the Dominican Republic is helping to start a graduate training program in business administration at an existing university. A new institute for executive training and a management research center will also be established.

TECHNOLOGY TRANSFER PROGRAMS

The development and application of technology, or the productive use of knowledge, plays an important role in the long-term economic growth of developing countries. Technology advancement results from an interaction of available resources, a positive environment for innovation, and appropriate infrastructure to supply information, manpower, tools, and equipment. Innovation and technology development derive from personal efforts, whether by individuals, or groups of individuals, who respond to opportunities and incentives to develop new knowledge. Other factors, such as the size of the local market and incentives for foreign technology transfer, also affect the technology development environment. These same factors also tend to affect the maintenance and adaptation of technologies that are transferred from abroad.

It is difficult for the U.S. Government to be involved directly in the process of specific technology development. Where U.S. Government programs can make a difference is in helping to address the long-term needs for an appropriate environment for technology development. This assistance might include:

☐ support for an active private business and commercial environment with incentives to develop new products and services;

☐ help in establishing scientific and technical institutions that support the

development of practical technology;
- encouragement of professional and scientific associations that act as linkages and disseminating organizations;
- support for information linkages that stimulate the exchange of ideas, models, and concepts; and
- promotion of an effective standards bureau and patent system to provide guidance for product development.

In addition, the U.S. Government can support intermediaries that have the requisite technical expertise or skills in technology transfer and development. Several private voluntary organizations have expertise in transferring technology and receive support from AID to provide a variety of services. Technical assistance is usually managerial; production technology assistance is available to small and medium-sized businesses. For example, Appropriate Technology International (ATI) implements projects that combine technology, financial support, technical assistance, and knowledge of development methods to produce positive changes in developing country institutions.

Agribusiness Technology

Agribusiness technology has been recognized as a strong vehicle for private sector development in the 1980s. LAAD financed private sector outreach operations that were designed to reach the smallholder. Small farmer linkages to their suppliers, technical assistance, and agricultural credit are provided by the agribusiness rather than the host government.

Similarly, the Joint Agricultural Consultative Corporation (JACC) was established to facilitate the technology transfer process and attract private U.S. investment in developing country agribusinesses. JACC represents a number of medium-sized U.S. companies which, without JACC assistance, would probably not be involved in developing country agribusiness projects. JACC committees, set up in key developing countries, have both U.S. and Third World agribusiness participants, who exchange information and pursue joint ventures.

Project SUSTAIN (Shared U.S. Technology to Aid in the Improvement of Nutrition) is a joint effort by U.S. food companies and AID to upgrade food processing companies in developing countries. AID serves as the link between food processing companies in developing countries that need assistance in preventing food losses, ensuring food safety, promoting quality control and enhancing the nutritional value of food products, and U.S. food processing corporations willing to share their technical expertise. Under the terms of the project, funding is shared. Salaries of U.S. private company consultants are paid by the company, while international travel is provided by AID. In-country local currency costs for per diem and logistical support are borne by the host country requesting the technical assistance. Technical assistance requests have included such activities as food canning and thermal processing in Jamaica, manufacturing tomato paste in Peru, bread baking and poultry processing in

Panama, and managing processing equipment in Costa Rica. In Kenya, assistance has been provided in the form of a technology seminar on preservation, processing, and packaging; in Pakistan, a company has requested help in making biscuits; and a recent mission to Egypt attempted to determine how U.S. food manufacturers could help solve food processing problems.

Management Technology

Management technology is a critical need in developing countries. The International Executive Service Corps (IESC) has been an important transfer agent of management and other technology. IESC retired business executives are active in some 30 countries, providing consulting and management assistance services to developing country firms, while reinforcing sound problem-solving techniques among local managers. With about 40-50 percent of its budget provided by AID, IESC to date has engaged in nearly 9,000 technology transfer projects over the past 20 years, resulting in increased employment, a greater number of foreign private sector investments and—in about 1,500 cases—enduring relationships with U.S. firms.

The efforts of the BIRD Foundation (Binational Industrial Research and Development Foundation, in Israel), represent another exciting program approach. It involves the establishment of a joint U.S.-developing country board of directors to oversee local currency funds generated by U.S. Government programs in order to finance either pure research or research in product adaptation—especially by joint ventures—for either import or export between the United States and the developing country. (If the financed research succeeds in a profitable venture, there is a cost recovery feature.) This approach actively involves both the U.S. and developing country private sectors throughout the entrepreneurial process.

A "core" agribusiness concept, with outreach to small satellite farmers as a means of transferring management technology, is also under development. Farmers receive extension services from the core business and act as suppliers. These efforts have a synergistic impact on rural production and income. Business International, a New York-based corporate research and public policy firm, was commissioned to survey models of this approach in nine developing countries. These models ranged from production of seed corn in the Philippines to swine breeding in Thailand. Core firms represented many types of businesses from multinationals to very small companies and involved both domestic, foreign, and joint ventures. Case histories demonstrate that the concept not only works, but is often the spark that is needed to move small farmers from bare subsistence to the cash economy. The arrangement offers the farmer assured markets, higher income, extension services, and increased production, while it usually means faster-than-usual earnings for the company. Firms reported a net profit the first year and a respectable return on investment after two or three years.

The study recommended an active role for LDC governments in supporting the core agribusiness concept. This is consistent with policy dialogue objectives in improving the climate for economic growth through private business investment—a major part of AID's overall strategy. For example, the study urges Third World governments to change policies that discourage farm output and distribution and keep farmers' prices too low. Donor governments like the United States were urged to encourage these reforms in daily contacts through embassies and AID missions.

The Commercialization of Technology Program (CTP), a PRE program under study since late 1983, is another illustration of the ongoing emphasis on technology as a tool in business performance. The program is designed to generate and adapt technology by or for smaller Third World enterprises. This is achieved through investments involving production by local firms of U.S. technologies adapted to local markets. The limited R&D (research and development) partnership is one device. The technology commercialization effort will develop further in coming months, especially as PRE extends its activities into the health sector.

For example, two direct PRE loans to Third World businesses, made in the fall of 1983, all have technology transfer components. These projects include the Antiqua Shrimpery and Sayyed Machinery Ltd. of Pakistan.

☐ Antigua Shrimpery—This company received the smallest loan in the PRE portfolio. A loan of $150 thousand supported a project using prototype shrimp farming technology to diversify the economy of the eastern Caribbean country of Antigua. Cofinanced with the Bank of Antigua, with the involvement of American and local investors, the project comprises 25 acres of ponds used to breed shrimp for a local market dependent on frozen imports. By replacing those imports in about two years, the locally bred shrimp will save valuable foreign exchange. The basic technology could be replicated elsewhere in the area.

☐ Sayyed Machinery Ltd.—Technology is one major feature of this project involving an $800 thousand PRE loan to a local firm in Lahore, Pakistan. The technology will be used to produce farm machinery—reapers, harrows, and plows—adapted to local soil conditions. Higher yields, greater productivity, 120 new jobs, a rise in rural income, and skills training for farmers are among the benefits.

Indonesia and Thailand are locations for a health-related technology project undergoing final bureau negotiation. It would utilize a U.S.-based private voluntary organization, the Program for Appropriate Technology in Health (PATH), to identify products and technologies that could be adapted and transferred to developing countries for manufacture and marketing by private firms. PATH's experience throughout the Third World has been that for-profit and other private organizations are often more effective than governments in getting needed health products into the hands of low-income families.

Examples of products already identified by PATH for Indonesia and Thailand are vaccines, vitamin products, anhydrous glucose for oral rehydration salts (used in combating dehydration from diarrhea), and larvicides and mosquito repellents. Consideration is being given to a PATH program that will survey the U.S. health industry for transferable technologies and negotiate with local firms for manufacture and marketing. This type of product technology project illustrates how grant and loan programs can be coordinated for maximum impact.

Another product technology project would support the conversion of coffee pulp waste into animal feed and other commercial uses. The technology was developed jointly by Subproductos, a Costa Rican firm, and a Florida-based company. A bureau loan would finance improvements in the Costa Rican plant and bring it to full production. The project would not only transfer technology, but also add value to a local resource in a nontraditional area, provide extra income to coffee growers and processors, and alleviate pollution resulting from coffee wastes. Caffeine, alcohol, tannin, and pectin are also expected to be extracted for commercial purposes. The technology could be adapted in other coffee-growing countries.

Multilateral Institutions

U.S. ambassadors and AID mission directors have limited control over the direction of multilateral development bank (MDB) programs. Typically, contact with the MDBs and their programs occurs when the country team is asked to comment on proposed projects for consideration by the U.S. executive director for an MDB. Informal courtesy calls are paid by MDB staff traveling in the country. Sometimes regular contacts are maintained with MDB representatives who chair or staff consultative groups. For the most part, however, U.S. ambassadors and AID mission directors do not play a major role in shaping MDB programs or policies.

At the same time, multilateral institutions can often provide a wealth of information on a developing country. American officials charged with program development and implementation should understand generally how the multilateral institutions function. Thus, coordination between U.S. representatives participating in MDB deliberations and U.S. officials in each country is important.

MULTILATERAL DEVELOPMENT BANKS

Generally, the major MDBs have two primary facilities—a hard capital loan window and a soft loan window. Hard capital loans are provided at interest rates and terms determined by markets.

FIGURE 5:
A Comparison of World Bank Group Entities

	International Finance Corporation (IFC)
Objectives of the Institution	To promote economic progress in developing countries by helping to mobilize domestic and foreign capital to stimulate the growth of the private sector.
Year established	1956
Number of members**	124
Types of countries assisted	All developing countries from the poorest to the more advanced
Types of activities assisted	Agribusiness, development finance companies, energy, fertilizer, manufacturing, mining, money and capital markets institutions, tourism and services, utilities.
Lending commitments*	$580 million
Equity investments*	$32 million
Number of operations*	65
Terms of lending:	
Average maturity period	7 to 12 years
Grace period	An average of 3 years
Interest rate**	In line with market rates.
Other charges	Commitment fee of 1% per year on undisbursed amount of loan.
Recipients of financing	Private enterprises: government organizations that assist the private sector.
Government guarantee	Neither sought nor accepted.
Main method of raising funds	Borrowings and IFC's own capital, subscribed by member governments.
Main sources of funds	Borrowings from IBRD.

SOURCE:
The World Bank and The International Finance Corporation, 1983
NOTE: *Fiscal Year 1982
**As of April 1, 1983

Soft loans are usually highly concessional and are generally set aside for the poorest developing countries. The World Bank Group's hard capital loan function is handled by the International Bank for Reconstruction and Development (IBRD), while its soft loan window is the International Development Agency (IDA). Respective functions within the InterAmerican Development Bank (IDB) are the Ordinary Capital/ Inter-Regional Capital and the Fund for Special Operations; for the Asian Development Bank (ADB), the Ordinary Capital and the Asian Development Fund; for the African Development Bank Group (AfDB), the African Development Bank and the African Development Fund.

Each MDB mobilizes its capital funds through various world capital markets, generally through bond issues. Usually loans from this window carry near market rates of interest. Hard capital loans are issued for long periods of time and are targeted toward key sectors such as power generation and agriculture.

Soft loan funds are raised through contributions of member nations. These funds are interest-free, with principal repayment over long periods of time.

Figure 5 summarizes the important characteristics of World Bank activities. The types of activity and terms of loans are similar in the regional development banks as well, although none of them yet has an operating entity similar to the IFC.

Among the most important nonmonetary MDB functions are the donor-

	International Bank for Reconstruction and Development (IBRD)	International Development Association (IDA)
	To promote economic progress in developing countries by providing financial and technical assistance, mostly for specific projects in both public and private sectors.	
	1945	1960
	144	131
	Developing countries other than the very poorest. Some countries borrow a "blend" of IBRD loans and IDA credits	The poorest: 80% of IDA credits go to countries with annual per capita incomes below $410. Many of these countries are too poor to be able to borrow part or any of their requirements on IBRD terms.
	Agricultural and rural development, energy, education, transportation, telecommunications, industry, mining, development finance companies, urban development, water supply, sewerage, population, health, and nutrition. Some nonproject lending, including structural adjustment.	
	$10,330 million	$2,686 million
	IBRD and IDA do not make equity investments.	
	150	97
	Generally 15 to 20 years	50 years
	Generally 3 to 5 years	10 years
	10.97%	0.0%
	Front-end fee of 0.25% on loan. Commitment charge of 0.75% on undisbursed amount of loan.	Annual commitment charge of 0.5% on undisbursed and service charge of 0.75% on disbursed amounts of the credit.
	Governments, government agencies, and private enterprises which can get a government guarantee for the IBRD loan.	Governments. But they may relend the funds to state or private organizations.
	Essential	Essential
	Borrowings in world's capital markets	Grants from governments.
	Financial markets in U.S., Germany, Japan, and Switzerland.	Governments of U.S., Japan, Germany, U.K., France, other OECD countries, and certain OPEC countries.

donee consultations managed by MDBs and the policy influence exerted by the MDBs in recipient developing countries. MDBs also serve as catalysts for mobilizing capital through cofinancing activities with private banks. For example, more than 40 percent of all IBRD-assisted development projects receive financial support from other lenders.

There are opportunities for AID to cofinance larger, complementary programs with MDBs. Financing and programming coventures can foster a pooling of resources and efforts and provide a more intensive lever in dialogue with developing countries to influence them to adopt and implement private enterprise policies. Depending on the amount of U.S. funds available, it is also possible to influence the nature of the cofinanced project itself.

Especially in agriculture and rural development sectors, AID has often participated in such cofinanced projects with the World Bank and IDA, its affiliate. For example, a 1980 project in Somalia was designed to develop all-season roads and a complementary farm system to preserve land productivity. Total cost of the entire infrastructure project was $43.4 million, of which $10.5 million was AID support. In this case, AID supported the increase of crop and livestock production through the purchase of goods and services. The funds from the World Bank and AID were, therefore, mutually reinforcing.

THE INTERNATIONAL FINANCE CORPORATION (IFC)

The most important private enterprise-oriented MDB entity is the IFC, which is a member of the World Bank Group. Established in 1956 as an affiliate of the IBRD, the IFC promotes and assists productive private enterprises in developing countries. It now has over 120 member countries and by 1983 had approved equity and loan investments of about $4.7 billion. It is a financial institution whose services include financial, legal, and technical advice.

The IFC plays a catalytic role in identifying and promoting private enterprise ventures, finding sponsors for them, and encouraging others to invest in them. The IFC invests with others in the projects it assists—mobilizing and supplementing private capital rather than replacing it. To underscore this policy, the IFC will not accept government guarantees for repayment of loans. It will, however, make an investment only if the government of the member country has no objection. Although the IFC can hold equity in companies, it will not participate in management or serve on boards of directors. The IFC prefers to sell securities from its portfolio to investors in the country in which the enterprise is located.

IFC financing is not earmarked according to types of projects. It can be used for such purposes as equipment purchases, covering foreign exchange or local costs, working capital, or other legitimate business needs. The funds invested are untied except for the provision that they be spent in an IBRD member country or in Switzerland.

IFC investments must, however, contribute to one of the following objectives: stimulate greater foreign-exchange earnings or smaller foreign-exchange outlays; foster increased employment, improvement in skills of both labor and management, or higher productivity of capital and labor; promote the acquisition of appropriate technological and scientific knowledge and skills; or support the development of a country's natural resources on fair and reasonable terms. The test of financial criteria requires that the ventures it assists must be financially sound.

IFC, like the other MDBs, mobilizes financing from other investors, with cofinancing coming substantially from private commercial banks. During the 1960s, the IFC attracted an average of about $2 million annually; in 1984 cofinancing from private commercial banks reached $305 million. Almost 40 percent of its holdings were syndicated, demonstrating the IFC's catalytic role and the interest in the joint private-public financing of ventures.

Geographically, the IFC's investments in 1984 were divided as follows: 21 percent in Latin America and the Caribbean, 25 percent in Asia, 20 percent in Africa, and 34 percent in Europe/Middle East. The IFC works in all member developing countries, from the poorest to the most advanced. Sectorally, manufacturing occupies about 75 percent of the IFC's portfolio, with the largest category of investments in cement and construction. About 10 percent of its investments have been made in other financial institutions, such as venture capital companies, development finance corporations, leasing companies, and security-marketing companies. Most recently, there has been increasing attention given to energy development and agribusiness production.

IFC support for development finance companies has been particulary active. By mid-1983 IFC had invested $42 million of equity in 37 such companies, lent $209 million of its own funds, and syndicated another $194 million to 16 development finance companies. (Development finance companies, also known as development banks, provide medium- and long-term financing to investment projects of productive enterprises.)

The IDB is in the process of organizing an entity specifically to support private enterprise, the Inter-American Investment Corporation. It is expected to operate in a manner similar to the IFC.

Other Donor Country Assistance

U.S. Government officials need to be sensitive to how the United States could work more efficiently with other donor country programs to complement U.S. efforts while being sensitive to host country concerns that decisions may be made without their participation. Ambassadors and AID mission directors find they have frequent contact with other major donors in a variety of circumstances. In the vast majority of cases, they are informal meetings or special occasions, offering opportunities to discuss program objectives as they relate to private enterprise. In either setting, opportunities arise to share private sector "success" stories. For example, if an American company with U.S. Government assistance develops a small farmer supply relationship that might be replicable elsewhere by companies from other countries, there is every reason to share such information. Expanding the information base and raising the consciousness of other donors to private enterprise development possibilities will, in due course, have a multiplier effect on their programs and be of benefit to the host country.

With respect to more formal private enterprise project and program development, there are several opportunities for intergovernmental cooperation. For example, educational institutions that develop a wider managerial and entrepreneurial resource base can be funded by several countries; support for market-oriented policies, such as the lifting of energy or food subsidies, can be researched and endorsed separately by donor country officials in their conversations with developing country officials; policies that would move a developing country economy toward a more outward-oriented approach can be emphasized similarly by donor leaders; seminars and conferences can be jointly undertaken, such as having the IFC organize a conference on capital markets with major donor countries providing both resources and talent.

Perhaps some of the most natural opportunities will arise in cofinancing institutions designed to make resources available to indigenous entrepreneurs. When such institutions either begin operating, or their absorptive capacity allows, there is often room for additional capital from different sources that can be made available to private enterprises, especially small and medium-sized concerns. Other donors should be encouraged to join in such efforts, especially in the provision of technical assistance and capital. Coordination of U.S. and other donor resources, as well as foreign commercial banks could all be effectively applied to the needs of host country private enterprise through greater support for ICIs.

Conclusion

This chapter has identified many of the tools of the trade that are important to U.S. policymakers and program designers. It does not provide a comprehensive listing of all of the tools available to U.S. officials operating within developing countries. Rather, it is intended to stimulate interest in integrating various foreign assistance programs and instruments in innovative and productive ways and contribute to the overall promotion and development of international private enterprise.

CHAPTER IV

Foreign Investment: Common Prejudices and Responses

Introduction

Historically, tensions have existed between developing countries and foreign direct investors. Whether for real or perceived reasons, developing country governments have attempted to control, in varying degrees, foreign direct investment by private corporations. On the whole, countries that have encouraged domestic private enterprise have also been receptive to, and in many instances have actively sought, foreign direct investment. Conversely, countries that have limited their own private firms have tended to exert extensive limits on foreign companies through legislation and regulation.

The 1960s and 1970s were decades that were characterized by substantial tension between large international companies and many nation-states. The perceived power of the global corporations was the subject of numerous studies and polemics, resulting in highly restrictive legislation and deep mistrust of such entities in many developing countries. Nonetheless, foreign direct investment grew throughout this period as foreign private investors balanced newly imposed government limitations against the opportunity of developing new markets. Meanwhile, developing country governments weighed the "risks" of big-company influence against the need for capital, technology, and access to foreign markets.

In the past, the industrialized countries have been the source of most of the large companies and most foreign direct investment. In more recent decades, a growing level of investment has originated within the developing countries. This is, of course, a desirable trend.

It is likely that direct foreign private investment in the form of wholly foreign-owned ventures has caused more political activism and resulted in more legislation than other types of business arrangements—such as joint ventures, licensing arrangements, management contracts, or technical assistance agreements. This is because direct investment, particularly by a large foreign company, is much more visible and therefore tends to reinforce prejudices developing countries have about foreign private enterprise.

Small and medium-sized firms have also engaged in overseas investment; however, there is considerably less information on the nature of such investments. Smaller firms probably have preferred arrangements with less direct exposure, i.e., joint ventures, subcontracting, management contracts, coproduction, technical assistance agreements, and so forth. For both small and large enterprises, the major consideration is whether a local market can support an economical level of production, and whether host country policies are stable and favorable to private enterprise.

Common Prejudices and Responses

Many developing countries actively seeking foreign investment are nonetheless ambivalent about whether such investments will serve their national objectives. Obviously, national development and international private enterprise (IPE) objectives will not be identical and may result in conflict. Problems arise between the country and its development objectives on the one hand and the needs of each company on the other. The conflict becomes readily apparent when they meet in the negotiating process or operating stage.

In addition, every foreign investment negotiation or international business transaction involves a number of different parties and considerations—direct and indirect—including:

- ☐ the IPE obligation to its stockholders, global work force, management, other host country governments, and clients;
- ☐ the IPE's home government, which is concerned with how the investment may affect its own social and economic interests in the areas of exporting technology, transferring jobs, or creating new trade competition;
- ☐ the host country government, concerned with its labor, market, technology, and trade objectives; and
- ☐ the local business community, which has its own views on constraining or exploiting the IPE.

Various commonly held prejudices concerning IPEs and some responses to those prejudices have been included in this guidebook. More extensive information is available from other sources, but the reader should be at least sensitive to those that follow.

Prejudice #1

No matter how small or large, IPEs do not owe their allegiance to the countries in which they transact business. Their main interest is the global integration of production and sales, not achieving host country industrial goals. They pose the threat of economic hegemony, which is sanctioned (if not encouraged) by developed country governments.

Response #1

The evolution of the IPE is a result of the international shrinkage of space through new modes of communication, travel, the computer, and so forth. This trend has led toward greater interdependence, evident in higher levels of trade, and greater movement of both capital and people. With such economic links growing rapidly and seemingly without direction, some LDC leaders have feared their national autonomy and freedoms are being constricted without their consent. Because the IPE is perceived as the epitome of interdependence, it is singled out for criticism.

IPE organization and patterns of management often appear to be capable of rapidly and efficiently moving capital, technology, and other resources around the world and then reassembling them for various business development purposes. There is, therefore, a bias against a wholly-owned subsidiary of an IPE because the LDCs do not believe they can exercise adequate control to protect their national interests. Whether or not this is an accurate judgment of the situation, the fact is that there is a much smaller percentage of wholly-owned IPE subsidiaries in the developing countries (36 percent) than in the industrialized countries (60 percent). Because IPEs established such a large proportion of joint ventures of either a minority or majority type in developing countries, it suggests that they were prepared to be flexible, though this form of entrepreneurship may not have been the preferred or most desirable approach. Even when investments are wholly-owned, many day-to-day decisions are made at the subsidiary level by employees who are host country nationals. Furthermore, LDC governments can insure that what they perceive as the need for greater oversight can be achieved in ways other than pressing for multiple ownership.

LDCs should recognize that the IPE can take risks that domestic enterprises cannot or will not take to develop new products or services, build for economies of scale, and access raw materials. An IPE's global distribution of resources and marketing abilities has far greater potential for improved products and services for all of its customers. Case studies conducted by the Fund for Multinational Management Education, the U.S. Council for International Business, the Chamber of Commerce of the United States, and other organizations have demonstrated that benefits are accrued by all four principals—home and host governments, foreign private investors, and domestic suppliers.

Nationalism is also a factor in developing country reluctance to long-term dependence on IPEs. The difficulty is perceived as lying between the IPE objectives, which are to optimize company operations globally, and the nation-state goals, which are to develop and benefit the local economy. One response is that IPEs provide incremental resources to the local economy in the form of capital, technology, information systems, and access to markets.

In addition, in most cases IPEs profit only if a business enterprise in a given country is successful over the long term. When IPE operates in a particular country, it is also subject to local laws, policies, and regulations. To some degree then, it is a captive to that country unless it is prepared to forfeit its investment and market position.

Much of the fear of large international companies reflects the frustrations LDCs have felt as they face increasingly global markets. This trend is not likely to change. For this reason, their policies need to be directed to respond to changes in the international marketplace, rather than to controlling the activities of IPEs.

Prejudice #2

International companies are large economic units that can exert enormous power in and over local markets. Their capacity to transfer resources and knowledge for production gives them monopolistic positions that inhibit local business development and contribute little to the local economy.

Response #2

Developing country governments clearly have the power to establish the policies and legal structure they consider appropriate for their own development. Policies vary considerably from those that attract and encourage foreign private enterprise to those that exclude it almost entirely from the country or from various important sectors. For example, Brazil excludes foreign investors in the informatics sector for "national security" reasons.

Legislation and regulation are powerful tools developing countries can use to diminish excessive perceived IPE power. Governments can reserve certain sectors for domestic firms, encourage development of smaller-sized local firms, and take other measures that mitigate the strength of an IPE in an economy. If a government unduly constrains IPE operations, however, it may forego all or some of the benefits, including new product development, employment, improved productivity, and export potential.

It is interesting to point out that companies, such as Gulf & Western Industries, Inc., are heavily criticized about their size, control, and financial arrangements regarding remittance of profits while they remain in the investment. But once such companies announce intentions to divest, as Gulf & Western did in the Dominican Republic, a country often tries to find good reasons for them to stay.

If unduly constrained, foreign firms are less likely to invest in local business development and market expansion. For example, in Brazil, foreign investment in the paper industry brought significant benefits to the country in terms of employment, balance of payments contributions, and local supplier development. A study conducted by the Fund for Multinational Management Education in 1976 *(Social and Economic Impacts of Transnational Corporations: Case Studies of the U.S. Paper Industry in Brazil),* showed a net contribution to the balance of payments by one company of almost $70 million over 17 years, with no profits repatriated during that period. The study also showed that the growth of local purchases quickly outstripped that of imported goods, and that 300 domestic suppliers were providing in excess of $26 million of inputs during the five-year period under investigation. There are numerous other illustrations; for example, Sears International, which tailors its overseas programs to develop supplier relationships, has purchased from local firms most of what it sells through its retail stores abroad.

Case studies, such as those done on the Brazilian paper industry, also indicate that IPEs commit their resources for the long term. Once committed, such assets as physical plant, investment in channels of distribution, training, and supplier relationships, cannot readily be shifted to other locations.

While macroeconomic data are not available to prove the point irrefutably, a number of case studies demonstrate that IPE operations provide the impetus for development of the local economy in many ways.

Prejudice #3

Developing countries are dependent upon a limited group of IPEs for product development and technology. As a result, the developing countries are at a disadvantage and have little negotiating leverage.

Response #3

Since the 1960s, many more firms of various nationalities—including those of developing countries such as Mexico, Brazil, Korea, and India—have entered the international marketplace, thus providing LDCs with greater choices in products and technology. For example, out of 572 foreign-owned projects reported in the Central American Common Market in the mid-1970s, 43 were identified as owned by enterprises in other Latin American countries. And, out of 360 foreign firms in Thailand surveyed for the years 1966-1973, 15 came from India, 10 from Malaysia, and 93 from Taiwan. International competition has thus grown considerably, providing developing countries with substantial bargaining leverage. The key question is whether or not a developing country government is providing the right balance of incentives and conditions to attract the widest array of foreign investment.

Prejudice #4

Foreign private enterprises seek investments in developing countries in order to reap excessive profits.

Response #4

Earnings from foreign investment by large companies have averaged slightly over 14 percent annually from operations in Latin America. This figure is only slightly more favorable than similar returns on investment from Europe. Return on investment from Africa has been nearer the 20 percent level, but this is primarily because of the greater perception of risk in that region. These statistics, taken from the U.S. Department of Commerce's Survey of Current Business, suggest that returns on foreign investment in developing countries tend to be reasonable and not substantially greater than returns in the developed countries.

One way for developing countries to reduce negative perceptions of risk and attract foreign investment is to enact and implement legislation that is nondiscriminatory toward foreign enterprises and to minimize administrative and regulatory burdens.

Prejudice #5

The business practices of large companies are abusive. Direct government intervention in negotiations, ownership, and regulation is the only way to protect developing country societies and to force IPEs to make positive contributions to development.

Response #5

Developing country governments fear that IPEs have the power and the necessary means to make the best deal for themselves at the expense of the LDC. As a result, many LDC governments establish regulatory offices that supervise every aspect of investment, technology transfer, technical assistance contracts, and other links between their own markets and outside suppliers, purchasers, and investors. Those with a more positive approach try to make government a stimulant for foreign investment and technology transfer by actively searching for technology suppliers and by publishing information on those sectors where foreign investment is desired. Others go even further in simply identifying a short "negative list" of industrial sectors where foreign investment is not desired, leaving the rest of the economy open to whomever chooses to invest. This is the approach used by the Republic of Korea. Mexico's investment and technology transfer registry serves as a model for other governments. The United Nations Industrial Development Office (UNIDO) created an office to assist member governments that wish to establish registries similar to that of Mexico.

Each government intervention adds costs, complexity, and uncertainty to investment and commercial negotiations. Where intervention is substantial, there is little likelihood that smaller and medium-sized foreign investors will attempt to enter the market; the process is too difficult and expensive.

There are several examples of the establishment of government controls on entry that rapidly resulted in the waning of foreign investor interest. One example is the initial approach taken by the Andean Pact countries of South America. A 1969 decision (known as "Decision 24") was thought to be a bold effort to pool economic power in a joint policy toward multinational companies. The policy denied foreign-owned enterprises the advantages of the incipient free-trade area unless they committed themselves to a divestiture program that would place majority ownership and control in local hands. Foreigners were to have limited participation in certain sectors; contractual ties between parent and subsidiary were to be restricted. Andean Pact countries have since eased these controls considerably; they recognize that production and marketing know-how accompanies foreign investment and contributes positively to development.

There is concern that IPEs absorb local debt financing that could be directed to domestic firms. Today this is an especially touchy subject in debt-ridden developing countries. When resources of any kind are directed to the "most efficient" organization, there are often arguments against such financing flowing to foreign investors. If a country expects to attract investment, one answer lies in the need to treat foreign and domestic investors equally. Also, IPEs tend to develop and use supplier networks domestically. They are often more efficient and thereby provide a greater multiplier effect. In addition, while no conclusive data are available, many U.S.-based IPEs have reached the limit of their financial capabilities to further finance their subsidiaries out of headquarter accounts. In tight domestic financial situations, governments that make central decisions tend to rank private enterprises last for access to available foreign exchange and financing, thereby limiting the country's ability to attract the management and technology benefits of foreign enterprises where such firms cannot also provide financial resources. The politics of such "economic" decision making are short-sighted.

Developing country governments also believe that the resources of large U.S. companies can be used to encourage bribery and corruption. In fact, the U.S. Foreign Corrupt Practices Act is the world's most stringent law of its type. While the ethical and cultural characteristics of some countries encourage special fees and remuneration agreements between business and government, both U.S. Government and business executives monitor this area closely to remain in compliance with U.S. law. The penalties to U.S. business for noncompliance include personal as well as market considerations. The solution is not to drive IPEs away, but to tighten laws in both host and home countries dealing with bribery practices.

Finally, some developing countries feel that the IPE, through the use of "transfer pricing," can avoid taxation and local controls by overvaluing imported items from its network and undervaluing exports or other activities to its subsidiaries. To control possible abuses, the governments have established regulatory bodies, and many have allowed IPEs to operate only with local joint venture partners. This forced participation is also designed to help develop local business capabilities and ensure the IPE's adaptation to local needs. Forced participation has not worked as well as incentives for creating closer ties. And the concern over transfer pricing abuses can normally be controlled by effective tax and commercial law rather than bureaucratic measures, which tend to limit cooperation.

Prejudice #6

Because IPEs are often viewed as representing the most unequitable aspects of private sector activity, anti-private sector sentiments are often directed at them. A commonly held view in this regard is that even though an expanding private sector may result in more rapid economic growth, the benefits generated will be unfairly and unequally distributed, to the disadvantage of the majority of people.

Response #6

Many of the LDCs that have relied most heavily on, and have been most successful in pursuing, the private sector approach—such as Taiwan and Korea—show very positive income distribution patterns. In fact, such countries have much better track records in terms of the distribution of income, than some allegedly more equity-oriented governments. Like an organism that grows as its cells divide, prosperity increases by being shared. It is in the nature of economic growth that activity begets activity. Further, pursuing a private enterprise development strategy does not mean there is no regulatory role or distributive responsibility for government. With expanded economic growth comes a larger Gross Domestic Product (GDP), which generates tax revenue and can be used to enhance equity objectives. (This subject is more extensively covered in the next section.)

Prejudice #7

As an instrument of industrialized country policies, IPEs will neither share technology, research, and development facilities nor transfer such facilities to developing countries. The payment for such technology is excessive. The goal is to keep developing countries dependent on IPE suppliers.

Response #7

Third World concern over technology transfer is only part of a much greater uneasiness with industrialization generally. In its broadest sense, the technology concept includes hardware (factories, machines, products) and software (knowledge, know-how, organizational forms, and procedures). During the 1960s, the focus was on stimulating growth through industrialization—regardless of the source of capital or the comparative advantages of a particular commodity or industry. This gave way in the 1970s to a focus on technology in a broader sense as the critical impediment to development. The control of technology was dominated by the large multinational corporation.

Many developing countries do not understand the primary motivations and means by which technology is actually transferred; many are interested primarily in increasing controls over payment and the utilization of licensed technology. The high cost of innovation, central to technology development, suggests that those who risk the resources to create, adapt, or invent and commercially apply technology must be able to benefit from that risk.

Attempts to unbundle industrial packages for large projects, so that technology and other components can be separated out and costed, have not generally worked well. Entire turnkey operations have become quickly obsolete without the necessary technology or management to run them. Some large countries like Brazil choose to pursue industrial development on their own because potential foreign suppliers will not agree to the stringent governmental requirements for technology transfer and development. In the computer industry, for example, Brazil developed its own product with heavy incentives and protection. The size of the country enabled it to create this industry, but it is certainly not a realistic model for smaller countries. However, the desire to save foreign exchange and attain a degree of independence came at what must continue to be a tremendous cost. In fact, large IPEs often collaborate very well—either directly or indirectly—with small and medium-sized LDC firms through the use of subcontracts. Also, many smaller scale industries are extremely effective in transferring management and marketing skills to LDC purchasers. Even industries that are relatively self-contained can be prevailed upon to draw on domestic suppliers and, in the process, transfer the relevant technology. Civil engineering and trading firms have been particularly effective at encouraging subcontracting practices.

The high cost of research and development today prevents all countries from developing their own facilities for product, service, or process development. Developing countries have uneven and inadequate infrastructures to permit such development. Today, much research is done in concert between private and public institutions (genetic engineering, for example). Incentives provided by governments encourage private innovation and the application of new methods and techniques. Without the internal capability to generate their own technology, developing countries must rely on transfers from abroad. Foreign direct investment is often the best vehicle for transfer and for more extensively stimulating technical infrastructure. Technology imports cannot overcome weak infrastructures; each country needs a specific strategy tailored to its own environment.

Not all technology is proprietary and in the hands of individuals or corporations. The U.S. National Technical Information Service (NTIS), a government agency, provides information on technology in the public domain that is available to potential users. However, this is only a first step in providing information and making it useful. The application of available information requires specific know-how that may not be available at the local level. In fact, many developing countries and firms have purchased such information with little success of application.

Most companies operate abroad to produce and distribute products in markets they cannot effectively serve through exports. Technology is transferred as part of this commitment, not as a primary business. Excessive regulations, controls, and international activism will only reduce the flow of technology. Developing countries that take a constructive attitude and seek technology for their own benefit will experience faster growth, higher productivity, and greater efficiencies because of market-oriented approaches to innovation. This has clearly been the case with the East Asian success stories. Such governments tend to find that a New International Economic Order is less critical to economic growth than a new internal order that allows risk taking, business expansion, and private initiative to build a commercial infrastructure capable of working with and utilizing international resources.

Summary

Foreign governments have legitimate concerns regarding the impact of foreign private enterprise on national development goals. While there is no magic formula, those who attempt to create a positive environment with incentives are more likely to succeed than those who try to control directly each business transaction. The former approach is most productive when the objectives for development are made clear, the investment and involvement of efficient resources and organizations (whether domestic or foreign) are encouraged, and stable policy "rules of the game" exist.

Experiments by developing country governments with foreign investment control in the 1970s have been at least partly abandoned in favor of inducements for foreign investment. Private capital in some circles is now seen as an important, if not indispensable, tool of development, especially after the excessive debt financing of the late 1970s and early 1980s. Thoughtful private and public cooperation will be required to mobilize efforts at all levels to restart and sustain economies.

To help focus thinking about foreign private enterprise in developing countries, Figure 6 outlines the major differences between the objectives of developing countries and foreign direct investors.

FIGURE 6:
Summary of Developing Country and International Private Enterprise Objectives Related to Foreign Investment (IPE)

Developing Countries	International Private Enterprises
Promote local ownership	Maintain global standards and efficiency
Increase local control	Minimize cost and complexity of delivering technology and capital
Change payment characteristics and reduce duration of contracts	Receive just returns for risks
Minimize source firm's control over use of technology and capital in user nation	Gain assurance regarding proper use of resources
Unbundle technology from traditional investment package	Provide technology as part of long-term production and market development
Remove restrictive business clauses in investment and technology agreements	Maintain ability to affect the use of capital, technology, and associated products
Minimize proprietary rights of suppliers	Increase protection of property to encourage greater technology transfer
Reduce contract security	Use contracts to create an environment of stability and trust
Encourage transfer of R&D to user environment	Maintain efficiency of R&D
Develop appropriate products for domestic environment	Gain global economies of scale to lower cost of products to consumers

CHAPTER V

Perspectives on Economic Growth in Developing Countries

Introduction

"Economic growth before 1940 was largely private enterprise growth, though government's infrastructure contribution was usually substantial. But since 1945, private enterprise in most third world countries has been in retreat. Public ownership, government regulation, economic planning, and the welfare state are in vogue."[1]

Most literature on Third World growth and development deals with how government can promote economic growth. When governments themselves take on the responsibility of intervening in economies through greater direct control and ownership, pervasive regulation of private domestic and foreign investment, and very high taxation coupled with large public expenditures, the result is usually negative. When a government allows and encourages private enterprise and investment to take place, the results have been much more positive.

The conviction that economic growth is more effectively achieved when governments assume a private enterprise strategy is supported by a growing body of research. Research findings conclude that accelerated growth is achieved when the direct role of government in the economy is reduced over time. They suggest that a government's role in productive economic activity should be indirect, through policy formulation and program assistance, rather than direct, through ownership and management. The findings further indicate that reduced government expenditure, taxation, borrowing, and regulation coupled with a greater reliance on private enterprise not only result in faster growth, but also in more efficient use of resources.

Pursuing a private enterprise strategy does not imply that there is no role for government. A country's government must decide initially to allow market forces to operate in the economy, encourage individual initiative to find full commercial expression, assist in creating an environment conducive to risk-taking and innovation, and provide the necessary infrastructure. It does suggest that government must define its policies carefully and avoid impeding private sector growth.

The Context for Understanding Third World Economic Growth

During the last 150 years, internal domestic conditions and external global conditions have together determined the ability of developing countries to attain levels of real growth (per capita output greater than population growth). Real growth can be contrasted to stagnant growth, e.g., when population and productive output grow at the same pace, a condition that can persist for long periods of time. In China, for example, it prevailed for about six centuries. Today, countries such as Afghanistan, Nepal, Bangladesh, Ethiopia, Sudan, Mozambique, and Zaire are marked by stagnant growth.

Factors that affect a nation's ability to move from stagnant to real growth include the transfer of political control to a progressive, stable government; the absorption of technological changes; the adoption of changes that enable food output to exceed population growth; infrastructure development that reduces transportation costs and improves communication, both domestically and internationally; and the growth of manufacturing production outside the household. In most cases, rapid growth is also associated with a marked rise in a country's exports as a percentage of its Gross National Product (GNP), signifying greater integration with international markets. The U.S. growth pattern is an exception. During much of its history, the United States had an internal market that was so large and its resources were so vast that it did not need to rely heavily on trade for economic growth.

Over the last 150 years, there have been periods when rapid growth has been either relatively easy or very difficult. From 1850 to 1914, a world economic boom saw rapid growth in Europe and North America and trade opened with other continents. During this period, almost all of Latin America and a few Asian and African nations began to experience positive growth. The Third World's share of international trade during most of this period was about 20 percent.

The period from 1914 to 1945 was marked by major wars and the Great Depression. Annual growth in industrial production in the developed countries fell from an average of 3.6 percent in 1913 to 1.3 percent in 1938. Few Third World countries sustained high levels of growth during this time, but those that did were Korea, Morocco, Venezuela, and Zambia. During this period, the annual growth of Third World exports fell from 3.7 percent to 1.9 percent.

The period from 1945 to 1973 was one of great global economic growth. In this post-World War II epoch, during which many former colonies became independent, Western industrialized countries, essentially the Organization for Economic Cooperation and Development (OECD) countries, experienced aggregate annual growth rates of just under 5 percent. Many—but not all—developing countries tended to focus on import substitution policies and internal market development. While many experienced phenomenal domestic growth, relatively speaking, they did not fare as well in external trade. The Third World as a whole saw its exports as a percentage of world trade fall from 25.3 percent to 17.7 percent. Significant changes occurred during this period in the composition of developing country exports. As a proportion of total exports, foodstuffs fell by more than 10 percent. This reflected increased internal demand fueled by population growth and often counterproductive or poorly designed agricultural policies. Developing country manufactured exports rose to 16.7 percent of total exports in 1970, compared to 7.6 percent just 15 years earlier. To some degree, the growth of manufacturing exports in many developing countries was at the cost of the agricultural sector.

The period from 1973 to 1980 was marked by oil price increases and high rates of inflation almost everywhere. Third World countries fared differently during this period. Seemingly, oil exporting countries that were foreign-exchange rich did extremely well, while oil importing countries without offsetting goods to sell fared badly as they incurred massive debts to pay for oil. On the other hand, newly industrializing countries that had established efficient, low-cost industries—many of them built with direct foreign investment and designed for export—experienced even faster growth than did OECD countries.

A significant characteristic of rapidly growing developing countries during all of these periods is that one of their most important growth stimulants has been trade with the developed countries and, increasingly, other developing countries. Third World exports have tended to move in tandem with developed country economies. When developed countries expand, as they did from 1850 to 1913, developing countries benefit; when the developed economies are in trouble, as they were during three decades of world wars and the Great Depression, developing country economies stagnate; and when developed countries revive, as they did between 1950 and 1973, developing countries grow more quickly.

Regional Comparisons of Growth Strategies

As indicated earlier, a country's attitude toward private enterprise as the means to promote economic development is a crucial factor. It accounts for the difference in public policies, regulations, and public versus private approaches employed by Latin American and Far East nations. While the growth rates of the two regions were very similar during the 1950s, once the East Asians went through a relatively short period of import substitution and infant industry protection, they made their domestic industry more outward-looking and efficiency-oriented, while the Latin Americans continued their primarily inward orientation. The East Asians aggressively promoted the development of private enterprise while the Latin American governments tended to invest heavily in state enterprise.

During the 1960s, the divergence between the two regions increased. Growth rates reached 6 to 7 percent in the East Asian countries, while Latin America (excluding Mexico) remained at about 2 to 3 percent. During the 1970s, with debt problems resulting from the first oil price shock and the recession, the differences were further exacerbated.

What were the key policy differences between East Asia and Latin America that contributed to the different growth rates? To begin with, governmental policies toward agriculture were different. Agricultural development is important in generating savings that can then be invested to diversify a nation's industrial base. The East Asians were much more willing to let private enterprise participate in the agricultural development process, even during the import substitution phase of the 1950s. Nor was discrimination in East Asia against the small and medium-sized farmer nearly as severe as it was in Latin America. Once the East Asians reached the end of the import substitution phase, they turned outward with the same labor-intensive manufacturing policy that they had relied on for their own domestic markets. In contrast, the Latin Americans moved quickly into sophisticated technology and capital-intensive goods. They continued to rely on import substitution-related policies, including market protection and low interest rates, all of which contributed (albeit often inadvertently) to high inflation.

The effects of the two approaches show up in some key figures. Savings rates of about 8 percent in Latin America compare unfavorably with a rate of 15 percent in East Asia, where small and medium-sized farmers and entrepreneurs contributed significantly. Both regions had comparable exports to GDP rates of 15 percent in the 1960s and 1970s. By the end of the early 1980s, however, the East Asians reached 50 percent, while the Latin Americans stayed in the 15-17 percent range. The composition of exports also changed dramatically. East Asian countries shifted from land-intensive, agricultural exports to manufactured exports, which comprise 90 percent of their total exports today. Latin America remains a heavy natural resource exporter with manufactured exports comprising about 20-25 percent of their total. Rather than capitalizing on their comparative advantage in labor-intensive industries, the Latin Americans invested in capital industries and subsidized them heavily.

Clearly, the two regions have had very different development strategies, producing very different results. Natural resources combined with readily available foreign exchange meant that, for a period, Latin America countries did not face up to the need to restructure their economies, readjust policies, and make efficient use of human resources. Their problems are now much more acute than in East Asia and, therefore, any adjustment will be more difficult.

As of July 1984, six countries in Latin America had debt in excess of 200 percent of their exports. (The only country in East Asia with that debt-to-export ratio was the Philippines.) During the most recent recession, the East Asians generally attempted to obtain external financing as did everyone else, but they also carved out larger pieces of the world export pie through their more competitive private enterprise policies.

An enormous difference between the two regions is reflected in how their governments intervene in the economy. The East Asians intervene through the market, rather than trying to replace the market as was done in Latin America. The East Asians try to use governmental policies to enhance the market. Thus, they encourage savings with high interest rates, and allow the market to allocate resources rather than permit civil servants to make such decisions. The Latin Americans have centralized government functions, such as the buying and allocation of resources and the operation of large-scale (state) enterprises. The East Asians gave balanced support to large, small, and medium-sized private enterprises, both in the agriculture and the manufacturing sectors. This approach enabled the East Asians to raise domestic savings and to be competitive exporters.

Agriculture and Industry: The Need for Balanced Growth

Individual countries have handled questions of diversification of industry and the balance between industrial and agricultural development to achieve higher levels of growth very differently. "The contrast between Argentina and Australia is particularly instructive. These two countries began to grow rapidly at the same time (in the 1850s) and sold the same commodities—cereals, wool and meat. In 1913 their incomes per head were among the world's top ten."[2] Australia managed to choose a set of policies that allowed both their agricultural and industrial sectors to grow at a sufficient pace. On the other hand, Argentina failed to adopt the appropriate policies that would have allowed for balanced economic growth.

Most countries that have sustained relatively high rates of growth have maintained a reasonable balance between agricultural policies and industrial output. Each country's experience is different due to differing capacities of land, labor, capital, and technology. But in most cases, the starting point is the ability of a country to produce enough food to feed its people and keep up with population growth. In other words, high-cost industrialization should not be a substitute for reasonable agricultural self-sufficiency.

Prior to 1945, most of the rapidly growing developing countries were able to increase food output to meet moderate increases in demand by simply expanding crop plantings to previously unused land. After 1945, many countries—Chile, Peru, Mexico, Venezuela, Burma, Ceylon, Malaysia, Egypt, Iraq, and Iran, for example—began to emphasize trade in nonfood products for food imports. (Often this was accompanied by a lessening of emphasis on agricultural development.) At the height of the "quick capital intensive industrialization" period, many governments did not recognize that agricultural sector development and agricultural productivity were needed to generate savings that could be reinvested in other sectors, such as manufacturing.

Since 1945, many developing countries have emphasized industrialization as the key to economic growth, but often at the expense of agriculture. In some cases, they have formulated trade and exchange policies unfavorable to agriculture and set price controls that have discouraged agricultural production. Only recently has the glitter of rapid, capital-intensive industrialization begun to fade and the importance of a strong agricultural sector become appreciated more widely. It is significant that in a survey of 41 developing countries, of the 12 ranking lowest in GNP growth during 1950 to 1980, 10 also show a decline in per capita food output. Reversing past policies, however, is a difficult and sometimes dangerous undertaking for the government in office. The experience of Tunisia and the Dominican Republic in 1984 are testimony to the dilemma governments often face when they seek to remove food price ceilings or subsidies. Clearly, stimulating domestic production is a necessary and worthy objective, but how best to do it can be a major political problem.

In the 1950s, national pride figured prominently in early plans for industrial development. Countries built large-scale plants to demonstrate their independence and reflect some sort of parity with major developed country competitors. Such high visibility was attained inefficiently and at a cost to neglected small and medium-sized enterprises (in both manufacturing and agriculture), which consistently accounts for one-half or more of developing country employment.

The Public Sector

Over the last 40 years, public sector interventions and ownership in developing countries have dominated Third World development strategies, whereas the pre-1945 period was an era of small government. Public-goods spending represented only an average of 5 percent of Third World GNP until about 1914. Governments limited their role in capital formation to infrastructure projects, such as rail transportation and power generation, and to other traditional government expenditures.

Since 1945, however, public ownership, regulation, economic planning, and welfare have grown rapidly, especially among countries that borrowed heavily to finance rapid growth through large state-run enterprises. This tendency was reinforced by nationalist sentiments, which often required transfer of economic activities from foreign to indigenous (most frequently government) control. It is estimated that the median share of public consumption was 15 percent of GNP by 1980, with several countries already in the 20-25 percent range. Demands for public services in rapidly growing urban areas, subsidies for food and petroleum product consumption, and military support were among the primary reasons for this public spending increase. However, there was also a marked increase in public ownership and control of economic activities going beyond infrastructure to mining, manufacturing, finance, and trade. Government management of these activities, supported by public investments, was supposed to result in a more rapid pace of industrialization and growth than were private investments, which depended heavily on reinvested earnings. A large number of developing country governments account for half or more of national capital formation.

There was also a clear overall tendency toward increasingly complex regulation of private economic activity. Regulation can be found in trade and exchange controls, licensing requirements for new private enterprises, price controls for farm products, government marketing systems for these products, interest rate and wage rate regulations, and others. These regulations, often representing wholesale intervention, have the effect of driving enterprises out of business, creating an underground economy, promoting capital flight (estimated at more than $25 billion from Mexico—$9 billion in 1982 alone—and more than $20 billion from Argentina),[3] and otherwise discouraging private initiative.

LDC government share of manufacturing ownership today ranges between 20-25 percent and up to 75-80 percent, depending on a host of cultural and ideological factors. This high degree of public ownership is consistent with a tendency of LDC government investment banks to acquire majority equity ownership of industry, and therefore responsibility for management, as is done in Argentina, Brazil, and Mexico. Also, it is typical in some countries that it is not just government, but the military that has moved heavily into the industrial sector.

Exports today account for more than 20 percent of the GNP of the most rapidly growing developing countries. Generally, those countries that have had the most effective policies have balanced industrial and agricultural development. They participate in international competition by allowing the market system to function relatively freely. Moreover, the upper-level developing countries have been able to achieve increased productive capacity, higher per capita incomes, and more equitable distribution of income. Today, about one-half of developing country manufactured exports come from Taiwan, South Korea, Hong Kong, and Singapore. Another quarter comes from Brazil, Argentina, Mexico and Colombia.

Factor endowments of land, labor, and capital partly explain why some countries developed and some did not. But such factors are clearly not the whole answer, as some countries with relatively poor natural resources (Taiwan, Hong Kong, and South Korea, for example) have done well, while some resource-rich countries have done poorly. A major variable is the administrative competence of governments and their willingness to promote private enterprise and individual initiative. Simply stated, successful governments project an attitude that supports favorable conditions for private entrepreneurship and risk-taking rather than wider public sector direct engagement in the productive sectors of the economy.

Fiscal Policy

Decisions by developing country governments to play a central role in their economies mean that public expenditures take a higher share of GDP. Revenues must be raised through taxation, which is often the vehicle for carrying out public policies. But, there is increasingly conclusive evidence that taxation negatively affects economic growth. Countries that impose a lower effective average tax burden on their populations appear to have achieved substantially higher rates of GDP growth than do highly taxed countries. A study by Keith Marsden of the World Bank demonstrated that during the 1970s, low-tax countries attained an average GDP rate of growth of 7.3 percent, while the high-tax countries had 1.1 percent growth.

The links between fiscal policy and economic growth operate through the capital, labor, and product markets. Taxation is a critical factor in a nation's approach to growth in that it affects the amount of capital available by encouraging or discouraging domestic savings (and therefore domestic investment) and foreign investment. It can be used to divert investment from one sector to another. To the extent that a government wants to support growth-promoting industries, tax policy is crucial. It also influences the level and productivity of labor as well as technology choices (whether labor or capital intensive). There is also evidence that less tangible factors, such as entrepreneurship and technical progress, can be influenced by fiscal policy. Thus, the effects of tax policy are immensely important as an instrument of a government's economic growth policies.

Rising government expenditures for public services are no guarantee of quality, nor are they an indication of whether they reach those who need them the most. On the other hand, the Marsden study showed that higher rates of economic growth allowed a substantial rise in real living standards in the low-tax countries; this is revealed in higher levels of private consumption. At the same time, growth expanded the tax base and generated increased revenues, which financed a more realistic expansion of expenditures for necessary government services. In short, the supply-side theory related to taxation and government revenues seems to apply to low-tax developing countries; by lowering taxes and eventually increasing the tax base, a nation can expand its public expenditures without constraining private investment.

Taxes tend to affect growth in two ways: first, by influencing the overall supply of the main factors of production through raising or lowering their after-tax returns; and second, by influencing the efficient use of resources. Private companies usually finance their growth through reinvested earnings. Those companies that reinvest heavily are more apt to apply more efficient management and production techniques and to seek out innovations in high-growth sectors. When governments allow private enterprise to thrive by creating the correct fiscal environment and insuring institutional flexibility, the mobility of capital, technology, and know-how, there are often spin-off benefits in that backward sectors begin to emulate the faster growing sectors as successful techniques are disseminated.

There is also evidence that much of economic growth can be attributed to technical change—which encompasses product innovations, improvements in technology, and managerial techniques. Much of product and process innovation is driven by competition. Low effective tax rates are associated with high rates of technical change. Lower corporate and personal income taxes provide entrepreneurs with the resources to launch new firms and new products and to introduce new technologies. Stability in such policies over an extended period of time enhances the deepening of this mentality toward innovation and competition. Such policies also contribute heavily to the diversification of industry, especially when tax incentives exist to encourage new start-ups.

The research on innovation indicates that while there may be some benefits from government-funded research and development programs, in-company research and training is generally more cost-effective and useful. Government programs tend to be too far removed from the practical realities of production and marketing. The ability to establish effective private research and development programs depends upon corporate liquidity, which is partly affected by the tax incentives available to a firm. Because much innovation is embodied in new capital equipment, fiscal and other measures that stimulate investment accelerate the spread of innovation throughout the economy. Innovation is critical in establishing and maintaining a competitive position in both domestic and international markets.

Because of the high rate of unemployment and underemployment, the effect of fiscal policy on people and productivity in developing countries is important. In some countries, the rate of underemployment approaches 50 percent of the working population. As with other considerations, low-tax countries have more rapidly growing employment and productivity. Labor productivity rose 5 percent annually in low-tax countries, compared to a 0.1 percent decline for high-tax countries during the 1970s. This came about because the low-tax countries opened their economies to investment, which allowed more corporate freedom and the adoption of modern technology, and led to the promotion of growth-inducing exports.

High taxes also tend to affect employment growth by pushing up the cost of employment to corporations and discouraging the efforts of workers, with a concomitant negative effect on productivity. Heavy taxation of the professions has also contributed to the brain drain from developing countries.

Findings indicate that governments with growth-promoting strategies, including low taxation, increased expenditures for education and training at much faster rates than did high-tax countries. Predictably, in fast growing countries, individual families are more apt to pay directly for education and companies are more inclined to finance their own training programs.

Trade and Investment Policy

Recent research has demonstrated that private investment in developing countries does promote economic growth. But mistaken governmental policies can distort the effects of private investment. For example, if government restricts imports severely, domestic industry might profit even if it is inefficient. Excessive protection has resulted in investment in some sectors (such as automobiles), which are uneconomic for a variety of reasons—too small a market, lack of skilled labor, and so forth. There is evidence that the industrial sector only helps growth if it appears naturally. Countries with a larger share of industry than is typical for their income level do not necessarily grow faster. Thus, all the funds being used to promote industry may not be helping growth.

Low-tax countries have experienced substantially higher rates of overall investment growth than have high-tax countries. (Marsden's study found an 8.9 percent annual growth rate versus 0.8 percent.) Reasons include lower corporate tax rates, which permit increased amounts for reinvestment and expansion; increased efficiencies, which have led to greater competitiveness; encouragement of export industries with high economic returns; and the ability to attract foreign investment because of the strength of the domestic economy.

Further, when a nation's policies encourage growth through entrepreneurial application in a low-tax environment, net foreign direct investment increases. For example, it tripled in Singapore between 1970 and 1977. Foreign investment is worth attracting because it is a mechanism for accessing capital, technology, and the channels to export markets.

While the share of investment in GDP rose to 29 percent in 1979 for low-tax countries, it fell to an average of 18 percent in high-tax countries. High-tax countries took in increased public revenues which, in fact, diverted domestic capital and deterred foreign investment. In the 1960s and 1970s, many developing country governments that sought foreign investment for natural resource development, reversed policies and raised taxes in an attempt to retain a higher proportion of the resource "rents" generated by this investment. While the new tax rate brought short-term increases in revenues, it had long-term negative effects as foreign investors began to look for other sources of supply in more conducive environments. For example, it is estimated that the real value of bauxite/alumina production fell by 37 percent in 1975-1976 in Jamaica following the introduction of a bauxite production levy in 1974.

Studies have shown that there is a clear correlation between exports and income growth. One study estimates that South Korea's growth would have been reduced by 43 percent if all it did was match the average ratio of exports to income growth in a sample of 10 countries. Production for both export and domestic consumption encourages a more efficient allocation of resources, allows for economies of scale, produces technological improvements, and enhances competitiveness. This approach also contributes to increased employment.

High-tax countries, because their growth rates tend to be low, believe that a decline in the terms of trade, especially the prices received for commodities and primary products, explains more fully their poor economic performance than does their overall policy approach. Evidence does not support this view. The terms of trade index in 1979 were on the average of 13 percent below the level in 1960 in the low-tax countries and 14 percent below in the high-tax countries. There is virtually no difference in these figures to support the terms of trade argument for explaining poor growth. The difference is that the low-tax countries were able, because of their policies, to diversify their industry and exports. During this same period, low-tax countries increased their share of world markets, while in each instance the share of the high-tax countries dropped.

High-tax countries also tend to have high tariff protection, and the result of these policies is negative. Especially when aimed at protecting state-run enterprises, the effect is to remove the drive for competitiveness, to fail to achieve economies of scale in even those areas where there is comparative advantage, and to misallocate resources.

Manufacturing output grew more slowly in the 1970s in high-tax countries, averaging 1.5 percent annually compared with 9.1 percent in low-tax countries. Agricultural output grew twice as fast in the low-tax countries in the same period.

Credit and Monetary Policy

With respect to available credit and monetary policy, developing country governments influence growth either positively or negatively. Some studies show that countries that provide private enterprise with wider access to credit realize more rapid growth. Conversely, government control of additional funds tends to result in lower growth. Among the reasons are the tendency of governments to use funds for social objectives rather than efficiency goals, to respond to patronage pressures rather than productivity goals, and to have the ability to finance heavy losses without having to prove a project's economic viability. Further, the diversion of national income to the public sector frequently stimulates greater regulation and control over private enterprise decisions. Thus, the effect of a greater portion of credit channeled through government has a doubly negative effect on the private sector. The competition for scarce funds crowds out private investment. Increases in public spending often go hand in hand with increased regulation of private enterprise.

High government deficits represent another drag on potential growth. This is due first to substantial public sector borrowing, which raises interest rates and takes credit access away from the private sector; second, often deficit financing is used to prop up unprofitable public enterprises; and third, deficits may reflect heavy government spending on free or subsidized services.

A heavy debt service burden also tends to retard growth because higher payments mean greater diversion of domestic resources and foreign exchange earnings from other uses that could contribute to output. Large debt-servicing requirements accentuate the scarcity of foreign exchange. Developing countries usually allocate foreign exchange to such priorities as food imports and public sector needs. This results in a shortage of raw materials, spare parts, and underutilization of the more productive sectors. Also, because most foreign debt is publicly guaranteed, most of the loans are used primarily to finance government programs and secondarily to finance those of indigenous, large-scale private enterprises. Small and medium-sized firms, which are more efficient and dynamic, have restricted access to such credit and are often the last to be considered.

Foreign Assistance

A final point has to do with the effect of foreign assistance on growth. Although independent evaluation of some aid programs has shown positive results, other macroeconomic studies indicated weak relationships between aid flows and economic growth.[4] Critics suggest that this is because much aid ends up in government hands and government uses the funds ineffectively—or even harmfully. However, the research does not demonstrate that aid bolsters domestic policies that impede development and growth. It should be noted that these findings apply not only to U.S. assistance programs, but to all developed country programs.[5]

What has not been satisfactorily tested is the effect of assistance programs aimed directly at the most productive sector of developing countries—private enterprise. Development practitioners should be encouraged to design new assistance programs, which have policy orientations geared to creating more favorable environments for private enterprise, finding new ways to encourage training through private corporations, or devising legitimate credit schemes that enhance the effectiveness of private enterprise. This more direct approach to the broad private sector, with private enterprise itself as the primary target, has not been widely tested in development assistance.

Appendix

U.S. ECONOMIC ASSISTANCE POLICY

U.S. Foreign Assistance Act and Historical Trends

Organization

Assistance programs have been important to U.S. foreign policy since the end of World War II. Initial resources were directed toward rebuilding West European economies devastated by the war. The Marshall Plan (1948-1952) was the primary vehicle for U.S. reconstruction assistance. It was designed economically to reestablish industries and markets and intended politically to shield against and contain Communist expansion. Another example, the P.L. 480 program (Food for Peace) has provided agricultural commodities to needy developing countries as grants and under long-term concessional sales agreements since 1954. This program helped to develop new commercial markets for U.S. agriculture.

It was not until 1961 that the U.S. Government separated economic and military assistance programs. U.S. assistance programs were unified prior to that time, despite continuing debate about the different objectives of the two types of assistance. The 1961 Foreign Assistance Act provided for the creation of the Agency for International Development to handle nonmilitary assistance.

Since then, there have been few fundamental changes in the organization of U.S. assistance programs, though economic programs are now divided into bilateral and multilateral assistance. This is partly due to the rapid expansion of multilateral development bank activity.

Concern for improving the coordination among economic assistance programs, which were spread throughout the U.S. Government, prompted the establishment of the Development Coordination Committee in 1974. In 1979 Congress mandated the creation of the International Development Coordination Administration (the umbrella organization for AID), the Overseas Private Investment Corporation, and the Trade and Development Program.

Coalition or constituency building for support of development assistance was also an important concern. A commission was established in 1983 to look at U.S. assistance activities. Chaired by Frank C. Carlucci, the Commission on Security and Economic Assistance found several factors accounting for a decline in support. These included the perception that relative U.S. influence in the Third World has diminished; the persistence of seemingly intractable economic, political, and social problems in many developing countries; and a sharpening of the differences between supporters of economic assistance and military assistance. The commission concluded that the inability to build a congressional coalition, as these factors indicate, poses problems of resource allocation, program design, and foreign policy formation.

Overview of Programs

U.S. economic assistance programs derive, in part, from an economic philosophy of free trade in goods, services, and technology; unrestricted capital movements; and open market systems. U.S. assistance efforts have contributed significantly to growth and development in the Third World by channeling resources and know-how to host country institutions capable of generating growth or by helping to establish the conditions for growth to occur.

It was in the 1950s that U.S. economic assistance programs began to expand in scope to include the Far East, Latin America, and Africa. With the passage of the Foreign Assistance Act of 1961, the U.S. Government committed itself to assisting economic growth in the Third World through the "trickle down" approach to development. The private sector was both a target as well as the frequent vehicle for the delivery of assistance programs.

In the 1960s, comprehensive country programs were developed and growth became the major aim of U.S. economic assistance. During this period, major programs were undertaken by U.S. universities to provide technical assistance and to cooperate in establishing counterpart universities and other institutions in developing countries.

In revising the Foreign Assistance Act in 1973, Congress mandated a shift from a "trickle down" approach to a basic human needs approach. Termed "New

Directions," this policy shift focused on the poorest people and selected sectors in targeted developing countries, with the aim of adding equity to growth objectives. The New Directions policy required AID to focus much of its development assistance activities on meeting the basic human needs requirements of countries where AID was active. Still in effect today, specific goals of this policy include increasing productivity through small-scale, labor-intensive activity (tenets of "appropriate technology" advocates), more equitable distribution of income, reduced underemployment and unemployment, and others.

An outgrowth of earlier security supporting assistance, the Economic Support Fund was established in 1978 as a means of rapidly and flexibly providing resources on a concessional loan or grant basis to priority countries for a variety of uses—commodity import programs, development projects, or general crisis management—in support of U.S. political interests.

The Reagan Administration's "Private Sector Initiative," created in 1981, is based on the belief that greater reliance on private enterprise, individual initiative, and free competitive markets is essential for sustained, equitable growth in the Third World. While this initiative is the most explicit and comprehensive statement in support of private enterprise development, it is also consistent with nearly 40 years of U.S. foreign assistance programs.

It recognizes the difference between utilizing private enterprise, both U.S. and host country, as a vehicle in meeting basic human needs and other U.S. program objectives, and specifically supporting private enterprise development. This distinction is important. In an analysis of the intent and effectiveness of U.S. development and assistance programs, the Carlucci Commission found (out of 13) only one U.S. bilateral program had private enterprise support and development as its primary intent. This program is the Trade and Development Program. Three additional bilateral programs, as well as the multilateral development banks, have secondary effects related to private enterprise development. Also, many nonprofit volunteer organizations, such as the International Executive Service Corps, Technoserve, and others receive funding from AID to support private sector activities in developing countries. The Bureau for Private Enterprise was created and housed in AID to devise and implement comprehensive programs to support and enhance private enterprise development in the Third World.

Almost every U.S. Government economic development assistance program is motivated to some degree by a combination of humanitarian concerns and economic growth considerations, and provides political support for policies consistent with U.S. interests. The P.L. 480 Program, indicative of the multi-purpose nature of U.S. assistance programs, has been an integral part of U.S. economic assistance for 30 years. Capitalizing on the strength of U.S. agriculture, the program addresses varied developing country food needs, promotes the adoption of market-oriented agricultural policies, and supports U.S. market development and political objectives.

Growth in Development Assistance

At face value, foreign assistance programs increased by about 50 percent, from an average of $7 billion in the 1968-1972 period, to $11 billion in the 1978-1982 period. But, when adjusted for inflation and expressed in constant 1982 dollars, the level of real assistance actually declined by 18 percent from the 1968-1972 period to 1983. At the same time, the U.S. share of total official development assistance provided by the world's major donors fell from 37 percent in 1970 to 22 percent in 1982. Measured by the Carlucci Commission, this downward trend reflects the factors cited earlier that have caused an erosion of U.S. positions in the Third World.

Economic assistance has increased as a percentage of total assistance to 61 percent in 1983 from 52 percent in 1968-1972, if ESF is included. If it is excluded, then economic assistance has declined over the same period from 44 percent to 40 percent. However one defines economic assistance, the United States has increased dramatically the amount of funding to the multilateral development agencies and ESF, and has decreased real amounts for development assistance programs.

The funding levels, variety, and long-term nature of U.S. assistance programs are as critically important today as they have been at any time in the past. The targeting of resources, the complementarity of funding and programs with other provider countries, and prudent approaches to support private enterprises in the Third World are required. The difficulty today of appropriating large increases in funding for economic assistance, no matter how useful, requires that current monies be effectively spent and that private sector resources be mobilized to assist in innovative ways.

U.S. INTERNATIONAL INVESTMENT POLICY

The flow of foreign direct investment by private entities into developing countries provides a source of capital, know-how, new products, and access to export markets. For decades, foreign direct investment has been an important activity for both home and host governments as well as multinational corporations and developing country firms. Because of severe constraints imposed on developing countries by the debt crisis and the related requirement to expand exports as a means of repayment, it is potentially even more important today. However, this need arises at a time when potential investors see greater risks in overseas markets as a result of developing countries' import, technology, and profit remittance res tions.

Current U.S. Government policy on international investment stems from the belief that an open international investment system that responds to market forces provides the best and most efficient mechanism to promote economic development. The U.S. Government further believes that government intervention in the international allocation of investment resources, except for matters related to national security, can retard or distort economic growth.

Central to the U.S. policy position is the national treatment principle, whereby foreign investors do not receive less favorable treatment than domestic investors. Related to this concept is the belief that foreign direct investment should receive fair, equitable, and nondiscriminatory treatment that is consistent with international law standards.

U.S. policy opposes practices that interfere with the market mechanism. These include government practices, such as trade-related or performance requirements (for example, local content, minimum export levels, and local equity requirements), as well as fiscal and financial incentives that distort, restrict, or place unreasonable burdens on direct investment.

Expropriations, when they occur, should be consistent with international law. U.S. Government policy is that no U.S. investment should be expropriated unless it has a public purpose, is carried out under due process of law, is nondiscriminatory, does not violate previous contractual arrangements, and is accompanied by prompt, adequate, and effective compensation.

In addition to the above principles of American international investment policy, the U.S. Government seeks to strengthen multilateral and bilateral discipline over government actions that affect investment decisions. Through cooperation among developed and developing countries, it also seeks to create an international environment in which direct investment can make a greater contribution to development and growth.

The U.S. Government undertakes a range of multilateral activities. These include a continued adherence to the OECD Investment Declaration related to national treatment, incentives, and disincentives as well as the Guidelines for Multinational Enterprises. Support and expansion of the OECD Code of Liberalization of Capital Movements is also advocated. Ways are continually being sought to extend the OECD principles to non-OECD countries, especially the newly industrializing countries.

Believing that the lack of adequate property rights and protection is a major obstacle to investment in manufacturing, research and development, and the transfer of technology, the U.S. Government also encourages adherence to the Paris Convention for the Protection of Industrial Property and the enactment of effective industrial property laws. These laws guarantee patent, copyright, and other industrial property rights.

The United States also supports U.S. investor access to third-party arbitration for the settlement of investment disputes through the World Bank's International Centre for the Settlement of Investment Disputes or similar agencies.

Further, the U.S. Government continues to promote the principles of its international investment policy on a bilateral, case-by-case basis. This is being done in several formal ways: through the relevant provisions of U.S. friendship, commerce, and navigation treaties; and through the negotiation of bilateral investment treaties with interested countries. This promotion also occurs on a continuing, informal basis through U.S. mission contact with host country government officials.

In addition, the U.S. Government provides various services to assist U.S. investors overseas. These include country assessments, market analyses, and the identification of development priorities and investment opportunities in developing countries. At the same time, the United States and developing countries continually explore appropriate ways to increase nonofficial capital flows.

The U.S. policy on international investment is an integral part of American foreign policy to assist growth and development in the Third World. The magnitude of U.S. direct private investment in Latin America alone, prior to the debt crisis, approached $40 billion net book value. Expanded opportunity for foreign private investment in debt-ridden countries is a sorely needed source of capital inflow. But it is also a source that requires an environment with reasonable risks and returns. The U.S. policy with respect to international investment is directed to improving the policy environment in developing countries so that private enterprise activity can take place efficiently across national borders and contribute effectively to growth and development.

U.S. TRADE POLICY

In the broadest sense, U.S. trade policy has been dynamic in its striving for the liberalization of the movement of goods and services, and the security of policies and practices that will allow trade to contribute to international growth and development. The General Agreement on Tariffs and Trade (GATT), to which the U.S. is a signatory, is the multilateral instrument that sets agreed rules for international trade among its 87 member nations and another 30 countries that accept the rules of GATT. For over 35 years, GATT has provided a code of rules and has functioned as a forum for countries to negotiate and resolve trade problems.

Since 1934, the President of the United States has had tariff-adjusting authority, with the power to renew such authority retained by Congress. The merger of congressional constitutional power to raise revenue and regulate commerce with foreign nations, and the President's constitutional power to make treaties with the advice and consent of the Senate, marked the beginning of the modern trade agreements program.

The importance of international trade to the U.S. economy was recognized by Congress with passage of the Trade Expansion Act of 1962. This act created the position of special trade negotiator to coordinate U.S. commercial interest in trade negotiations and to develop an international trade policy. The act also provided the legislative authority for U.S. participation in the Kennedy round of trade negotiations, which produced major cuts in tariffs, an antidumping code, and other results. The Trade Act of 1974 furthered these goals and gave the President authority to negotiate reductions in nontariff as well as tariff barriers to trade. The Tokyo round of trade negotiations, from 1973 to 1979, focused on nontariff barriers. It was also distinctive because it included many developing countries and Eastern bloc nations. The Trade Agreements Act of 1979 approved important nontariff trade barriers, made appropriate modifications in U.S. law to implement them, and extended the President's authority to negotiate agreements on nontariff barriers until 1987.

Woven throughout this history of liberalized trading policy is the development of protectionist movements abroad and in the United States. The reasons are universally the same: unemployment or underemployment; uncompetitive industries wanting reserved domestic markets; political pressures either to export at all costs, as in the debt-ridden developing countries, or to erect barriers to appease labor and other constituencies; and overcapacity due to poor planning and lagging economic recovery. In the case of the United States, one of the driving forces for protectionism is the 1984 forecast of a trade deficit approaching $130 billion. Despite the reasons (overvalued dollar, stronger recovery here than elsewhere), this staggering record alone encourages protectionist movements in the United States. The present proliferation of nontariff trade barriers—export restraints, orderly marketing arrangements, purposefully cumbersome import licensing requirements, and others—jeopardizes the benefits of free trade and requires international cooperation.

Industrialized countries have made special provisions to assist developing countries in accessing export markets. The United States participates with other industrialized countries in implementing the Generalized System of Preferences (GSP). The U.S. GSP is a system of nonreciprocal tariff preferences for the benefit of developing countries. It grants duty-free entry of imports from eligible countries as an incentive for diversifying their production and export base. GSP is not a permanent haven for developing countries, but a temporary mechanism to enhance developing country competitiveness.

The Caribbean Basin Initiative (CBI) is an example of a specialized U.S. development program that provides, *inter alia*, a "one-way free trade" advantage to encourage CBI countries to build outward-oriented economies by assuring them access to the U.S. market.

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Acknowledgments

The members of the President's Task Force on International Private Enterprise and Task Force Executive Director Christian R. Holmes gratefully acknowledge the outstanding contribution of Deputy Executive Director Richard M. Seifman for developing this guidebook. They would also like to recognize the fine efforts of Samuel L. Hayden, of Burkholder Wallender International, who served as principal consultant during the drafting phase.

Others who contributed significantly include Task Force staff members Van Dyne McCutcheon, Margery O'C. Kemper, and Birge C. Watkins; and Keith Marsden of the World Bank. Those who helped review this publication include AID Deputy Administrator Jay Morris and Frank B. Kimball, Edgar C. Harrell, and Marshall D. Brown of the Agency for International Development.

The Task Force would also like to express its gratitude to Anne C. Bradley, Lou Ann Baudrand, Betty Jane Burson, and Mary A. Heffren for their superb administrative and secretarial support during the preparation of this publication.

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