Christine

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Tim Mahoney

Tom Rosso — have read — distribute to private sector group — please. I've made extensive marginal comments. D

ECONOMIC POLICIES OF DEVELOPING COUNTRIES

THE ROLE

OF

PUBLIC SECTOR POLICY AND FINANCE

IN DEVELOPMENT

I think another revolution in thinking is needed — like the one which demonstrated that farmers are rational — presumably, governments are rational — a lot of misguided + inappropriate policies are due to the constraints of a political economy — a better insight leads us to a better understanding — rather than narrow condemnation —

Constantine Michalopoulos
Chief Economist

A.I.D.

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August 1981

ECONOMIC POLICIES OF DEVELOPING COUNTRIES

THE ROLE OF PUBLIC SECTOR POLICY AND

FINANCE IN DEVELOPMENT

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ECONOMIC POLICIES OF DEVELOPING COUNTRIES: THE ROLE OF PUBLIC SECTOR AND POLICY AND FINANCE IN DEVELOPMENT

I. INTRODUCTION:

In the last few years, traditional thinking on macro-economic policy in the U.S has come under increasing scrutiny and criticism. In particular, excessive government spending and regulation have been extensively criticized because of their impact on hampering private sector initiative and impeding long-term growth in productivity, output and income.

These considerations have formed the core of the new thinking about economic growth in developed countries that has come to be referred to as "supply side economics." While the complex macroeconomic model underlying this thinking may not be applicable to the different conditions prevalent in developing countries, some of its critical components are relevant: (a) the fundamental determinants of long-term economic growth in these countries seem to also be primarily supply variables and (b) economic policies of developing countries' governments have frequently been ineffective and sometimes seriously damaging for the promotion of long-term development.

The purpose of this paper is threefold: (a) to summarize briefly the role of supply and demand variables in promoting self-sustaining economic development; (b) to review, in general terms, developing country policies as they pertain to the role of government and incentives to the private sector, and draw the implications of these policies for long-term development; (c) to explore what the U.S. can do through its bilateral assistance programs to promote improved developing country policies with a view to increasing the effectiveness of our assistance programs in supporting long-term development.

This paper attempts to combine some familiar aspects of economic development thought with some of the new ideas and observations on developing country policies that have emerged in recent years. It is not intended to be an exhaustive and systematic analysis of these policies. It is based on evidence developed in the course of A.I.D.'s regular involvement in a large number of developing countries.

II. SUPPLY AND DEMAND DETERMINANTS OF GROWTH

A strong case can be developed that the fundamental determinants of long-term economic development are on the supply side. In a very general sense, economic growth in developing countries can be shown to be dependent on two key variables: the rate of domestic investment in physical and human capital and the rate of productivity growth of factors of production.

The key to development policy is how to affect these variables so as to stimulate rapid expansion in the production of goods and services and a pattern of income distribution that does not limit the benefits of development to only a few. Keynesian policies of increased government spending aimed at stimulating income growth by raising demand are ineffective, because growth in developing countries is typically constrained on the supply side by inadequate infrastructure and institutions, lack of complementary inputs, unskilled and low productivity labor, etc. Given these constraints, increased spending only tends to result in persistent inflationary pressures -- which themselves may lead to weakening the domestic propensity to save and thus ultimately undermine one of the most important sources for long-term growth.

A. Demand Factors

Demand stimulation gained popularity in Western economic thinking because of a fundamentally different set of economic circumstances. In developed economic settings, it has been argued that spending stimuli can generate noninflationary growth because there is economic slack in the form of unused capacity--both in the form of industrial plant and equipment as well as of a trained but unemployed labor force.

And yet, such eminent economists as Albert Hirschman and Hans Singer convincingly argued, almost a generation ago, that this is not the case in developing countries. We need to recognize anew their valid insight into the importance of factors of production, technology, institutions and organization in the development process.

Unemployment in developing countries is not of a cyclical nature. The main problem is underemployment or employment at very low productivity. Underutilized industrial capacity, which is common, is not traceable to demand insufficiency, but rather to incorrect decisions about the appropriate capital intensity of production, the management of foreign exchange, or government interference in the market. It is, of course, theoretically possible to increase capacity utilization in some sectors by stimulating overall demand but, in view of the uneven incidence of excess capacity, this inevitably generates serious shortages in other sectors and has major inflationary results. And underutilization of land is related more to ineffective management or organization (sometimes due to land tenure patterns that do not favor intensive cultivation) than to insufficiency of demand. Thus, whether or not demand stimuli do promote steady economic expansion in a developed country setting, they are unable to provide the answer in the developing countries since the underlying situation is quite different.

Earlier thinking on development had suggested that increased international demand for exports - demand stimulus -- has been and can be an important engine of long-term growth. The current OPEC experience has been cited as recent evidence in support of this argument.

Clearly, possession of a valuable resource such as oil whose international demand is rising fast can be a powerful stimulus to growth. However, it can also be argued that: (a) most countries cannot expect to rely on such stimuli; (b) many of the gains of OPEC members resulted not from rising demand, but from their actions to restrict growth of supply; and (c) studies of individual developing countries show close association between good long-term export and GNP growth on the one hand and effective foreign exchange, trade and domestic pricing policies even in the face of stagnant international demand. Taiwan and Korea are classic examples of this experience. William Branson in a recent AID-sponsored study argued that in the 1970s sluggish growth in developed countries did not materially affect the growth of several middle-income developing countries which are well integrated in the international trade and financial markets. His explanation is that the availability of bank credit, in combination with its reasonably productive use, permitted significant growth of certain developing countries in spite of slow growth in the West.

One should not read into these remarks the implication that demand considerations--especially on the external side--are irrelevant to the development process. Indeed, it is a well-known economic axiom that neither demand nor supply alone are sufficient; they are both ~~necessary to~~ jointly determine economic outcomes. Yet, if domestic policies are not conducive to productivity and output expansion, strong external demand is not likely to be beneficial; conversely, dynamic domestic policies can produce growth even when overall world demand is stagnant. However, too much attention has been placed in the past on the role of demand in development, and rigorous analysis as well as sound policy requires correcting that imbalance. At any rate, supply improvements come closer to being a sufficient condition for economic development in the long-run especially in developing countries at lower levels of development than does demand expansion.

B. Investment and Productivity

Turning then to the key determinants of growth on the supply side, the rate of capital formation is affected by a variety of factors. Among the most important are: (a) profitability of private sector investment; (b) the rate of private domestic savings; (c) entrepreneurship and risk-taking; and (d) government policies.

-- Profitability of private investment depends on the availability of infrastructure, labor skills, income levels, as well as or a ~~variety~~ of government fiscal and other policies, which affect the overall private investment climate.

-- The rate of private savings is affected inter alia by the level of income, the rate of interest, the existence of adequate savings institutions--as well as by government tax and monetary policies which determine the levels of disposable after-tax income, the rate of inflation and the structure of credit.

-- Joseph ~~Schumpeter many decades ago stressed~~ entrepreneurship as an essential ingredient of any investment decision. It is hard to pinpoint the source of entrepreneurial "spirit" but it certainly requires, at the very least, the existence of an economic and political "climate" favorable to its exercise.

-- Government policy is also important, both in terms of its impact on private sector investment decisions and in terms of the allocation of public funds between consumption and investment.

Productivity growth in developing countries depends on another set of complex variables. The most fundamental is the rate of technological improvement which results from the introduction of new processes, techniques or equipment as well as from better labor skills. In addition, because of specific shortcomings present in developing countries, productivity can be increased significantly through improvements in the management and organization of production, in the effectiveness of operations of institutions and in the efficiency of resource allocation. Total productivity could also be increased by overcoming particular sectoral constraints which may be inhibiting production growth, e.g., lack of basic infrastructure, specific skills, etc.

Policies of developing countries which have a bearing on these factors will be important determinants of developing countries' performance. In particular, policies and government expenditures which increase productivity through various means such as the introduction of appropriate technology, institution building, development of human resources or overcoming sectoral constraints work essentially on the supply side of the macroeconomic picture. On the other hand, the efficiency of resource allocation will be determined primarily by how efficiently free markets operate and whether government policies which interfere with the private sector and the free market result in economic distortions, or correct for imperfectly functioning markets.

III. DEVELOPING COUNTRIES' POLICIES AND THE PRIVATE SECTOR

Any broad view of developing country policies that affect the private sector and long-term growth must recognize at the outset that developing countries are a very diverse group. The main characteristics which are common to these countries are relative poverty in income and accumulated capital, and less advanced technology and institutions when measured by Western standards. They differ widely in institutional arrangements, in natural resource endowment, as well as in level of overall development. The economies of Argentina, Brazil or Korea may have more in common with the economies of Italy and Spain than with Bangladesh or Chad.

Developing country perceptions of the role of government in the economy vary from the highly centralized and controlled systems of Tanzania, Somalia, and Guinea to varying blends of mixed economies in which the role of government in the economy is relatively restricted to key sectors such as in Kenya, Ivory Coast, Thailand and Malaysia. In some, free enterprise is provided wide latitude. In others, there are pervasive intrusions by government.

Thus, by necessity, the generalizations offered in this review have to be interpreted with care. They may not apply in individual countries. But they occur frequently enough to warrant our attention.

Developing countries' policies which affect private sector incentives and long-term development prospects can be divided into the following major areas:

(a) Public sector intervention through either direct state production or distribution of goods and services, or through regulation of prices and quantities of outputs and inputs;

(b) Fiscal and monetary policy;

(c) Foreign trade and exchange policy.

These are discussed in detail below.

A. Public Sector Intervention

Historically, developing country governments have preempted the production and distribution of goods and services in a broad range of sectors which could have been undertaken efficiently by private enterprise. A common economic justification for this preemption has been the existence of market imperfections.

Free markets in many developing countries do not generally work as well as in the developed countries. Sometimes this is due to their general state of underdevelopment. Product markets are frequently segmented because of inefficient transportation or information systems--giving rise to local monopoly or monopsony situations. Capital markets are not developed and labor markets are segmented with significant urban-rural wage differentials that do not reflect productivity differences.

Sometimes government actions are themselves responsible. For example, licensing or import controls or some types of labor legislation create market imperfections. No matter what the cause, in many developing countries the typical response to market imperfections has been to opt for public sector production of goods and services or regulation rather than to try to improve the functioning of the market. Examples abound:

1. In industry, production is frequently in government hands in a variety of sectors--varying from basic Industries such as steel or fertilizer to more ordinary consumer goods. The evidence for several countries, notably in Egypt, Tanzania, Turkey, Ghana, Senegal, and Sudan is that these so-called "parastatal" organizations or public enterprises are, on balance, a considerable drain on national resources.

Sometimes the "parastatals" intentionally subsidize product prices, for example, of fertilizer in order to (a) promote its use by farmers as part of the introduction of new high yielding varieties or (b) to offset, at least in part, disincentives introduced by the establishment of subsidized prices of food; sometimes both objectives are present. But the subsidization of fertilizer usually continues on an indefinite basis and does not apply only to the new users. Its only real reason frequently is the existence of other subsidies in the system, i.e., subsidized food prices for urban consumers.

J. Bhagwati and T.N. Srinivasan presented a well-documented case of the effects of licensing of industrial enterprises in conjunction with import quotas in India in the late 1960s. The combined effects of the regulation were both to increase inefficiency as well as to favor larger enterprises which were the only ones with the capacity to develop specialized expertise on how to deal with the bureaucracy. (Incidentally, a similar problem and a similar response has developed in the Soviet Union.)

2. In agriculture, the marketing and distribution of food is usually at least in part in government hands. Moreover, most export crops are within the jurisdiction of marketing boards or parastatals. The initial intent was to overcome infrastructural constraints in transportation and storage which impeded the establishment of a national food market. However, given the inflationary conditions in many developing countries, the system frequently serves to provide subsidized food prices to urban centers. It is, of course, true that developing country governments are subject to internal political pressure in the direction of establishing, or maintaining, these subsidies--as much as and in many cases much more than are developed country governments. But recognition of these political realities does not in the least alter the fact that these subsidies are inimical to long-term development.

Where government food distribution systems operate alongside with private distribution, over time they have tended to account for a decreasing market share because prices offered to farmers are relatively low. There are several cases in which the low prices to farmers have served as disincentives to production; thereby creating a need to import additional food. Recent reviews showed this to be a problem in several countries, notably Egypt, Sudan, Bangladesh, Jamaica and Liberia.

Excessive prices on the other hand have led to unwanted surplus and in turn a burden on public revenue. In Turkey recently such price policies led to unsaleable stocks of tobacco, tea and cotton. The same can be said for Tanzania where excessive surplus supplies of minor cereals and beans were accumulated, necessitating extensive government financing. In some countries, ineffective policies have led to surpluses and deficits of particular products in successive years.

Apart from assuring orderly marketing of agricultural exports, parastatals or marketing boards have been found to be convenient devices to capture the foreign exchange earnings that arise from such sales, as well as a means of generating revenue for the public treasury. A common problem that has occurred under such circumstances is that prices paid to producers by these government entities have not kept pace with domestic inflation. As a result there is a disincentive to produce for export and producers switch to crops that offer better relative price terms. This price disincentive is of course compounded to the extent that the foreign exchange rate is overvalued, as has often been the case.

In Ghana the support price of cocoa has not kept pace with inflation and farmers have switched to maize and rice where they receive full market prices or in some cases moved out of agriculture altogether. The same effect can be seen in Sudan where cotton is taxed the full cost of water allowing other crops a free ride. In Indonesia support prices below world market prices for crude palm oil have diverted the commodity to the domestic market where a full price can be obtained for the refined product at the expense of exports and investment in plantations. A support price for wheat in Morocco at double the world market level has resulted in some land better suited for specialized fruits and vegetable crops for export being diverted to small grain production. In all of these countries the tampering with input/output price relationships has led to falls in their major export crops. All with the exception of Indonesia, which is benefitting from oil exports, and Morocco, where the effect is not very large, are suffering from serious balance of payments problems at present.

3. <u>In services</u>, a variety of activities are performed directly by the government, ranging from health and education to insurance, banking, transportation, etc. Some of these activities are similar to public sector involvement in developed countries, others are not.

Inefficiencies or inequities resulting from pricing policies are a problem here, too. For example, the provision of universal free education (in some developing countries through all levels of education) and of free health services clearly represents a drain on public revenue--since many in developing countries who can pay for such services do not. This is, of course, also true of the free provision of public services in developed countries. But in developing countries, where poverty is the norm and starvation all too frequent, the economic and ethical justification of free provision of public services to all comers, regardless of ability to pay, is indeed weak. In addition, when such provisions are not accompanied by the real economic resources needed to make them a reality (as in the case of Jamaica during the 1970s) they are little but a source of understandable popular frustration and discontent.

4. <u>In the capital and labor markets</u>, government policies affecting the cost and allocation of capital and labor frequently introduce distortions in the efficient utilization of resources. Interest rates in the monetized

sector are usually quite low and frequently negative in real terms--in the sense that they are lower than the rate of inflation. This is in part due to a desire to keep interest costs low to the government and public enterprise sector. Whatever the motivation, this policy has a variety of adverse effects.

-- It tends to promote a heavier than appropriate capital intensity of production, and capacity underutilization. This in turn has adverse effects on employment, an important concern in labor abundant developing countries.

-- It adversely affects domestic saving rates--thus undermining the capacity of the country to rely over time more heavily on its own resources for development.

-- It introduces distortions in the allocation of credit. Since credit is cheaper than the opportunity cost of capital, demand for it exceeds supply and credit has to be rationed. This leads frequently to favoring the government sector and large scale industrial enterprises, at the expense of the private sector in general and of smaller scale enterprises which are typically more labor intensive. At the same time interest rates in the informal money lending sector are typically extremely high, reflecting the scarcity of investable capital and the inadequate development of capital markets. These excessive interest rates in turn inhibit private investment for those individuals or enterprises which have not been able to obtain the cheap rationed credit.

On the labor side, developing country wage policies have also frequently had adverse effects on employment and on absorbing the large number of new entrants to the labor force. These policies range from general minimum wage policy, to government policy on salaries and wages of public sector employees, to cases of labor legislation restricing layoffs.

-- Minimum wage legislation in cases where there are abundant labor supplies of unskilled labor tend to fix wages at rates exceeding labor productivity. This in turn makes it appear more profitable to adopt capital intensive methods, with adverse repercussions on employment growth.

-- Fast-rising salaries and wages of government employees have adverse effects on the total wage structure leading to increases in other sectors in excess of productivity growth. This has adverse effects on the profitability of the private sector and tends to fuel inflation as well. This phenomenon has been especially prevalent in oil exporting countries.

-- A classic case of legislation forbidding layoffs existed a few years back in Peru. This induced private entrepreneurs to constantly reorganize firms as a means of laying off even a small number of workers--or to pay higher cost overtime wages rather than hire new workers when demand rose.

5. <u>Summary: The Role of Government in Production and Distribution</u>

In sum, the key conclusion is that permitting market forces to work more freely would tend by and large to increase efficiency of production, and raise output, income and employment. Many developing countries have tended to aggravate imperfections in product and factor markets through policies that have emphasized public sector production and regulation of market forces. The problem is especially acute in the many countries where comprehensive planning is attempted through a weak and ineffective administrative apparatus. Finally, policies that have favored capital over labor have inhibited the adoption of more efficient labor intensive technology or the expansion of the more labor intensive sectors of production--thus aggravating the problem of underemployment.

This conclusion should not be interpreted to mean that governments of developing countries can or should play a totally passive role in development. Advocating such a passive role would, in any case, fly in the face of political and economic realities in most countries. Among the realities is the imperative of assuring national stability and cohesion by influencing the geographic distribution of income to prevent regional disparities from endangering the political fabric of the country--particularly when its independence is relatively recent. Among the economic realities is, for many developing countries, the need for government action to keep the income of some groups from falling below biological subsistence levels, both on clear humanitarian grounds and, again, for preserving national cohesion. Private enterprise cannot and, many thoughtful observers have argued should not be expected to, include such considerations in its decision-making.

In addition, developing countries' governments need to take into account the following considerations in determining their role in the market process.

-- The time dimension relevant and appropriate to private economic decision-making, particularly in the area of investment, is generally shorter than the time dimension relevant to decisions affecting long-term national development; when this is so, the government has a legitimate role, perfectly consistent with the functioning of free markets, to directly or indirectly correct the natural private tendency to reach decisions mainly on the basis of short-term costs and benefits.

-- The calculation of costs and benefits which is appropriate from a private point of view may sometimes not correspond to the economic costs and benefits for the country as a whole, even when the time dimension of decision-making is the same. This is the well-known result of the existence of (a) externalities, favorable or damaging or (b) economies of scale that cannot be exploited by the private sector. Thus, there is a proper government role in helping build institutions, in promoting research, and in stimulating productivity growth through improved technology and human resource development--all of which may generate important externalities--but not by preempting private initiatives in these areas. Similarly, there is frequently a proper government role in helping develop physical infrastructure when there are significant economies of scale not exploitable by the private sector. But in both cases, there is a need, to the extent possible, to defray the full cost of the goods and services provided.

-- Finally, there is a proper government role to intervene to improve the functioning of imperfect markets, but not create or worsen other imperfections in the process.

B. Fiscal and Monetary Policies

1. Expenditures

Developing countries' government spending policy has a significant impact on private sector investment and on the total development effort. Most developing countries have two budgets -- an ordinary one and a development one. The latter is intended to promote investment. The former is designed to meet recurrent expenditures. A fundamental tenet in most developing countries is that the public sector has a responsibility to stimulate aggregate investment, particularly public investment in infrastructure. Because of this perception, the development budget is typically maintained irrespective of revenue levels.

At the same time, there is pressure to maintain ordinary expenditures, in order to finance the persistently large recurrent outlays on social services, subsidies arising from pricing policies, and the necessity to make transfers to unprofitable public enterprises. The net effect is that developing countries often operate at total expenditure levels that are incompatible with their ability to raise government revenue through taxation.

The overall deficits thus incurred, given the early stage of development of their money and capital markets, have been usually financed by central bank borrowing, thereby increasing the money supply. More often than not, this expansion in the money supply has not been closely followed by an increase in output, as government investment, for example in infrastructure, tends to have a long gestation period. This leads to increased demand for imports, since domestic supply tends to be rather inelastic, along with substantial inflation.

A not unusual policy prescription by developing countries governments under such circumstances is the extension of price controls, and the introduction or expansion of import licensing, in which government and other public enterprises and entities are accorded preference. Vivid examples of this pattern can be seen in Tanzania and Ghana.

The private sector, in the absence of foreign capital inflows, is thus often faced with an inflationary situation accompanied with a shortage of foreign exchange allocations and uncertainty about future direction of government policy. Under these circumstances the incentive to invest in productive activities is diminished. Funds tend to be diverted to more speculative or less productive allocations such as in real estate, or black- market purchases of foreign currency or gold.

2. Taxes

The tax policy of developing countries has an effect on the private sector through its impact on personal and business savings and thus on funds available for investment, as well as through the differential treatment of profits in various sectors or various types of enterprises. The focus on this discussion is on the aggregate savings and investment rates.

The tax burden in developing countries is low compared to that in developed countries. Thus, for 16 of the largest recipients of U.S. bilateral assistance through

FY 1982 (accounting for over three quarters of such assistance in that year), the ratio of tax revenue to Gross Domestic Product averaged only about 14 percent.

Developing countries tend to collect the bulk of their tax revenue through indirect taxes which for the most part are regressive. In 1972-76 indirect taxes accounted for about two-thirds of total tax revenue in 63 developing countries, about double the percentage accounted for by such taxes in developed countries. On the other hand, some developing countries do have personal income taxes that are steeply progressive, and with relatively low threshold levels. In addition, businesses in some developing countries are subject to high nominal rates of taxation.

The effect of progressive personal income taxes on savings in these countries is difficult to assess realistically because of the generally high degree of avoidance and evasion made possible by manpower and administrative deficiencies. Moreover, a wide range of allowances and deductions is usually permitted, and must be taken into account to determine effective rather than nominal rates of personal income taxation. It is in any case clear that effective taxes are far lower than nominal tax rates. It is also generally agreed that the brunt of personal income taxes in developing countries, even more than in developed countries, falls on wage and salary earners of record where the tax can be withheld.

One important question is whether lower income taxes would be consumed or saved. Given the relatively low average levels of incomes in these countries, the prevalence of avoidance and evasion, and the early state of development of financial intermediaries, these are reasons to believe that the bulk of the marginal income not taxed would go to consumption rather than savings.

To a high degree, self-employed and other professionals through various devices are probably able to avoid the brunt of high marginal rates. In the usual inflationary environment in developing countries and given negative interest rates and the desire to maintain assets in an unrecorded form, their tax savings are likely to be used up in higher consumption, and speculative uses.

In turn, public intervention to restrict these uses would inevitably generate its own inefficiencies. On the other hand, it is not clear that effective taxation of that income would result in additional investment which would be highly productive. In summary, for this group the largest adverse impact on the savings rate probably comes from inflation, with high marginal tax rates having some additional impact on the allocation of savings to different types of investment.

With regard to corporate taxation, it is difficult to determine whether high nominal tax rates depress private sector capacity to invest. A major problem in this regard is again the administrative capacity of developing countries' governments as against the various devices available to business, such as transfer pricing and dual recordkeeping to avoid or evade taxes. The attempt to measure effective rates of business taxation in these countries is further complicated by the differing and broad range of investment incentives widely provided by developing countries' governments~~. Moreover~~, it is a somewhat difficult task to determine the extent to which businesses in general, and in particular sectors, are able to shift the impact of their tax burdens to consumers. However, in cases where high rates of business taxation are combined with a pervasive system of price controls on business products and services, and rising costs of production, one would certainly expect to find also significant disincentives to private sector investment in productive activities.

3. <u>Monetary Policy</u>

The monetary policy of many LDC governments is circumscribed by the persistent requirement to finance large government deficits. This has been at least a major contributor to an inflationary process that necessitates in turn a tight credit policy for the rest of the economy. As a result credit allocations, differential interest rate practices, and quantitative or qualitative credit controls have evolved, with the private sector generally, on the short end of the stick. Past experience in Ghana, Turkey and Senegal, among others, illustrate this point.

Perhaps the sharpest impact on the private sector from these practices is an acute shortage of medium and long-term credit compatible with private investment requirements. The co-existence of low and frequently negative real interest rates in lending to official institutions, with extremely high interest rates in the informal money lending market, tends to discriminate against the private sector, particularly against smaller enterprises. In addition, it undermines the ability of banking institutions to mobilize domestic savings.

The net effect of fiscal and monetary policies taken together is to discourage private sector mobilization of resources for long-term investment, to reduce, in many cases, the aggregate rate of domestic investment and to contribute to an inflationary climate.

C. Trade Policy

The trade policy of many developing countries is characterized by the use of numerous policy instruments including tariffs, subsidies, differentiated credit and interest rates, import prepayments, and quantitative and foreign exchange restrictions. In line with their pursuit of industrialization, the combination of policy instruments applied by many developing countries tends to provide a substantial amount of effective protection to the manufacturing sector (particularly in consumer goods) and to favor the import of capital intensive technology in the face of labor surplus.

These policies are often justified on the infant industry argument. Aside from the merits of this argument, it has been amply demonstrated in numerous studies that in practice the bias of developing countries' policies towards import substitution has resulted in significant resource misallocation and waste. Indeed, protection of existing capacity and the prevention of entry to new entrepreneurs, with the resulting monopolistic implications, can have some of the most pernicious long-term effects on development.

Finally, the efforts to simulate industrialization through protective trade policy in developing countries, is also often at the expense of the agricultural sector in the form of lower product prices and higher input prices. This in turn has serious deleterious effects on increasing food production and addressing the problem of rural poverty.

IV. SOME IMPLICATIONS FOR U.S. ASSISTANCE POLICY

The previous section offered a depressing litany of well intentioned policies often gone awry. The most critical policy problems would differ by country, but frequently the problem is systemic. Worthwhile objectives are being pursued with incorrect and ineffectively applied instruments which in turn give rise to the need for further policy distortions that feed on each other.

The desire to stimulate growth through government investment and the related lack of faith in the free market system often lie at the core of the problem. They may lead to an increased government role in direct production or regulation. This in turn may give rise to inefficient government enterprises inflationary tendencies, squeezing of private sector investment, reducing savings, etc. The thrust to industrialize through import restrictions is another general issue leading to diverse problems of low productivity, excessive capitalization, discrimination of agriculture and so on. It is frequently hard to break through these cycles by focusing on one policy issue alone, as we have found in several countries, notably Egypt.

On the other hand, it is clear that many developing countries are moving away from this pattern. Sri Lanka is an obvious case that has made great progress in recent years through systemic reform. Sudan, Egypt, Turkey and other countries are making hesitant progress away from heavy government control after lengthy bouts with centralized patterns of production. One of the most difficult issues in these cases is the pace and particular patterns of policy reform that would ease the transition to a more market oriented economy. One of the challenges of the U.S. assistance program is how best to encourage and support this process away from heavy government control, which holds promise for more rapid development.

Indeed, the importance of supply factors and of the role of the market has been to an extent recognized within A.I.D. for years, and in some countries the U.S. has played a positive role in inducing some desirable reforms. With respect to interest rates, for example, the successful South Korean reform of the mid-1960s is a particularly notable case. We have also had a positive influence on interest rate reforms in some Latin American and Caribbean countries. The question is then how to reinforce these efforts within A.I.D., at the same time as we try to encourage developing countries' moves toward liberalization.

In light of the primacy of the developing countries' own policies for accomplishing their own development objectives, it is extremely important to take such policies into account both in allocating assistance among countries and in designing assistance programs. Following are some general implications for A.I.D. policy.

1. The capacity of the U.S. to induce or support developing countries' macroeconomic policy changes which result in improved resource allocation and a favorable climate for private sector growth through pricing, tax or other reforms is affected by a number of considerations. Perhaps the most important condition is that we have something useful to say. In all countries in which AID operates, missions must be familiar with the implications for long-term development of government policies which directly or indirectly affect the private sector. This may sound like an obvious and unnecessary recommendation, were it not for the fact that in the recent past AID mission interest and capacity to analyze developing country policies in general, and those macro

policies that impact on private sector initiatives, have by and large been inadequate. Government policy and its implications for long-term development should be an important factor in our analysis of the country's economic prospects and therefore the determination of the aid level to individual countries.

2. A second condition is the existence of a receptive environment in the recipient government. This is a function of a number of factors--overall political relations, as well as the nature, quality, and manner in which the dialogue is carried out would affect the willingness of the recipient to participate. A major potential asset in inducing developing country governments to follow policies more conducive to economic efficiency and long-term development is our physical presence in the country: the availability of a knowledgeable, respected, trained field staff, capable and willing to engage host country officials in the kind of policy dialogue which, along with a flexible policy of assistance to the individual country, can make a significant impact on country policies. It is, of course, essential that our advice in this direction be sympathetic, pragmatic, and knowledgeable. Any perceived arrogance, unfamiliarity with local conditions, insufficient economic training, or ideological inflexibility is certain to diminish the probability that the host government will in fact undertake a significant policy shift toward greater economic efficiency and reliance on the market.

Another factor, sometimes overrated, is the size of our assistance (including DA, ESF, and PL-480) which is viewed by the recipient as essential to its development progress. There are only a few countries, perhaps ten or so, where this is the case. Moreover, in most of the cases where assistance resources are substantial, we have a variety of important foreign policy and security interests which have often inhibited us from engaging in as full a policy dialogue as would have been desirable.

Despite the size and foreign policy constraints there is probably room for doing more in this area in a number of countries without compromising our other foreign policy objectives. Indeed, the achievement of our long-term foreign policy objectives in these countries may be compromised if, because of their appropriate economic policies, there is little long-term development progress. While it is probably true that in countries where our aid involvement is miniscule, it is difficult to engage in policy discussions, the most serious constraint at present derives from staff inadequacies at the field level which do not permit us to engage in a serious dialogue in more than a few countries.

3. Aside from the above general considerations, we need to coordinate our efforts with other multilateral donors and international organizations, especially the IMF and the IBRD, to help move countries in desired directions. In many countries, where our assistance does play a significant role

at the sectoral level, especially in agriculture, the combination of PL-480 and development assistance or economic support funds makes it possible for us to engage in a meaningful dialogue on such issues as pricing of agricultural products and inputs (e.g., fertilizer); the effectiveness of marketing and distribution systems (e.g., the role of government parastatals, marketing boards, etc.); incentives toward private rural savings and investments; or the development of agri-business. Our programs will need to take advantage of all opportunities to support and encourage developing country policies in this area.

4. The nature of the policy dialogue evolved with developing countries will naturally vary depending on the circumstances of the case. In general, experience suggests that we should rely more on persuasion, on demonstration of the worth of our ideas and economic advice, and on strengthening those elements in the government and institutions which are supportive of our approach, rather than on strict conditioning of assistance when the conditions do not have the full support of the recipient government.

5. In our strategy of project design we need to develop activities which strengthen private sector institutions in developing countries and increase reliance on the market mechanism. We must be cognizant, however, of the danger that specific projects supportive of particular private

entities or institutions may not prove successful if the overall policy environment in which they function is inimical to private enterprise.

6. Finally, we need to support and enhance developing countries' efforts to raise the productivity of domestic resources, and thus promote their long-term development. Again experience as well as economic common sense suggest that the most cost effective way of doing this is through: (a) the promotion of technological improvement and adaptation; (b) through the establishment and strengthening of effective institutions that will disseminate the technology and improve the organization of production and distribution as well as policy development; and (c) through increased emphasis on training and other measures to promote human resource development.