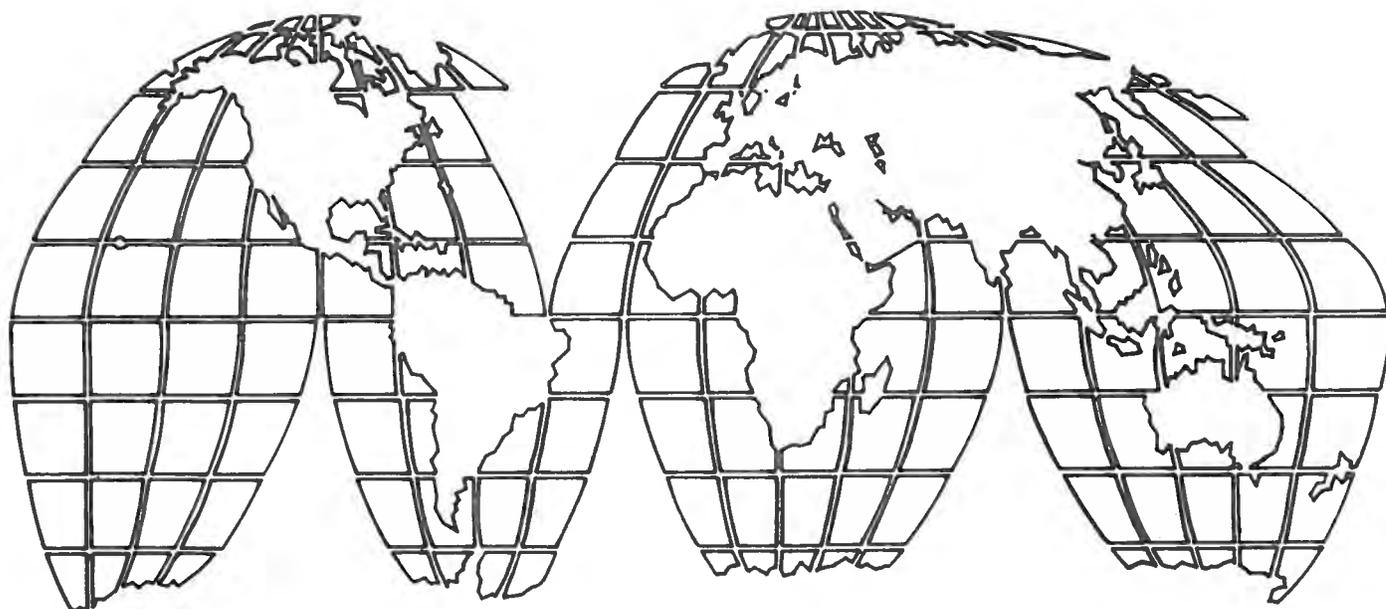


A.I.D. Program Evaluation Discussion Paper No. 16

The Private Sector, The Public Sector, And Donor Assistance In Economic Development: An Interpretive Essay



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THE PRIVATE SECTOR, THE PUBLIC SECTOR, AND DONOR ASSISTANCE
IN ECONOMIC DEVELOPMENT: AN INTERPRETIVE ESSAY

A.I.D. Program Evaluation Discussion Paper No. 16

by

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U.S. Agency for International Development

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The views and interpretations expressed in this essay are those of the author and should not be attributed to the Agency for International Development.

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I. THE VARIETIES OF ECONOMIC EXPERIENCE

A. Study Purpose

This paper is intended to provide to the Agency for International Development a retrospective view of the ways in which the public policy of host countries coupled with the actions of donors have led to the growth of a vital private enterprise economy in less developed countries (LDC), and how that private enterprise economy has affected the overall level of development and, in particular, the quality of life of the people of those countries.

Of necessity, our review could not be both broad and deep. Accordingly, we have concentrated our efforts on examining the recent (20-year) development history of four countries--Malawi, Cameroon, Thailand, and Costa Rica--which we believe are representative of the broad but limited range of countries which have dramatically improved the standard of living of their people. In order to provide a broader context, we will draw, from time to time, on other cases and on the existing literature.

We have consciously decided to examine success rather than failure. In part, this decision was taken because we felt that it was more important to learn what works than what does not work; in part, because we believe that there are many more roads to success than there are to failure; and in part because the paths to success are more subtle and more interesting than the paths to failure.

Representing success, the countries we have chosen to study are in a sense unique, since in large measure the economic history of Third World countries in the last two decades has not been a happy one. Nowhere has failure been more endemic than in sub-Saharan Africa, and thus the experiences of Malawi and Cameroon are particularly unusual. According to the World Bank, the median rate of growth of real per capita income among sub-Saharan African countries between 1960 and 1979 was 0.7 percent. The rate of growth of per capita income for Malawi and Cameroon was 2.9 percent and 2.5 percent, respectively.

Malawi's growth has been, perhaps, the most remarkable of all. To be small, poor, and landlocked are almost insurmountable hurdles for a new country to overcome. Worldwide, the average rate of growth for economies with this set of characteristics was .5 percent per year for the period 1960 to 1979. Malawi's growth record of almost 3 percent, despite these obstacles, despite having no natural resources besides relatively good though not abundant agricultural land, and despite an

almost total dearth of physical and human capital at independence, is a success story of the first magnitude.

Cameroon's record has been less spectacular, but nevertheless noteworthy. Surrounded by the Marxist regime in Congo-Brazzaville; the ethnic turmoil and violence in Nigeria; the untrammelled spending in Gabon; the maniacal regimes, until recently, in the Central African Republic and Equatorial Guinea; and the chaos in Chad, Cameroon remains an island of calm in a tempestuous sea. Progress may have been more tortoise-paced, but it has been steady and peaceful.

Costa Rica's growth experience between 1960 and 1979 was average for a country of its income level, 3.4 percent per capita. That growth, however, has taken place in a peaceful democracy, proud of the fact that it has more teachers than soldiers, in an area of the world in which peace and democracy have historically been rare. Costa Rica's development has been accompanied by a substantial improvement in the quality of life of its people (life expectancy has risen from 62 to 70 years; infant mortality has been reduced from 80 per 1000 population to 28; the literacy rate is 90 percent; food availability is 114 percent of average requirements).

The rate of growth of per capita income in Thailand has been the fastest of all--4.6 percent between 1960 and 1979. This growth has been associated with a steady reduction in poverty, improvement in an already relatively equitable distribution of income, and stability in an area of the world beset by war and insurrection.

The story of these four countries' economic and political successes forms the core of this study. What follows is an attempt to blend these stories into a coherent and unified whole. We will probably raise more questions than we answer, but we hope that the result will be to challenge the reader's preconceptions, stimulate curiosity, and sustain interest.

B. The Process of Development

It is easy to describe the mechanics of economic growth. GDP, gross domestic product, the total sum of goods and services produced in the economy, is a function of the amount of inputs available. These inputs are primarily land, labor, and capital. All things being equal, the more input, the more output. Of course, all things are never equal, and the level of output also depends fundamentally on the way in which inputs are used--the efficiency of input use and the level of technology (i.e., production information) available. Output then is a function of the level of inputs, the level of technology, and the efficiency of resource use.

In any given country, land is fixed. While in all less developed countries the labor supply is growing, increases in the general welfare imply increases in output per head, that is, increases in labor productivity. Thus economic growth is a function of increases in the capital stock, improvements in the productivity of that capital stock (i.e., technological change), and increases in the efficient use of those new investments. A simple measure of the latter concept is the Incremental Capital-Output Ratio (ICOR), which measures the ratio of changes in capital to changes in output. The larger that ratio, the more new capital is necessary to generate a given increase in output and, consequently, the less efficiently is capital being used. Table 1 presents comparative data on the rate of growth of capital stock and the ICOR. As expected, the growth success of the four countries we are studying is reflected in their ability to increase their capital stock rapidly, and the efficiency with which that capital is used.

Table 1. The Growth of Investment and ICORs
in Selected Countries, 1960-1979

Country	Investment Growth (annual percentage change)	ICOR (changes in gross capital/change in gross output)
Malawi	9.0	3.8
Cameroon	8.6	4.4
Thailand	11.9	3.0
Costa Rica	7.6	3.9
36 Low-Income Countries	6.7	5.1
60 Middle-Income Countries (excluding major oil exporters)	6.7	4.3

Source: Calculated from IBRD, World Development Report.

But how were these countries able to mobilize investments and use them efficiently? Do their growth histories reveal any pattern that will enable us to develop general rules for growth and prosperity? Let us examine the macroeconomic data to see if these questions can be answered.

1. Initial Structure

In 1960, these countries were at radically different levels of development from each other (see Table 2). Malawi was clearly among the poorest countries in the world. Over 90 percent of its population was engaged in agriculture, domestic savings were negative, and life expectancy was a mere 37 years. Cameroon and Thailand were already in the group of countries beginning the transition to middle-income status.¹ While GDP per capita was 40 percent higher in Cameroon than in Thailand, all other indicators (secondary school enrollment, life expectancy, share of labor force in agriculture) show Thailand had a much firmer basis for its subsequent growth. Costa Rica was already an upper-income country, with almost half of its labor force engaged in nonagricultural pursuits, and a life expectancy not very much lower than that of the developed countries. Moreover, except for the relatively high level of social indicators in Thailand, each of these countries was below the mean level of performance (in terms of social indicators) for its income group. In 1960, there was no reason to believe that Malawi, Cameroon, Thailand, and Costa Rica would be development success stories.

2. Structural Change

The pattern of structural change in the economies of the four countries of our sample is compared in Table 3 to the mean patterns of structural change of LDCs as a whole. The most interesting result evident from this table is that the patterns of structural change are similar even when the growth experience is different. Thus, between 1960 and 1980, the share of agriculture in GDP and of the agricultural labor force in total labor force declined for economies with both fast and slow rates of growth. Similarly, the role of international trade, the importance of the service sector, the share of GDP devoted to public consumption, and the share of manufactured products in total exports rose for our country sample (with the exception of Cameroon) and for LDCs as a whole--low, middle and upper income.

¹For the purpose of this study, LDCs are divided into three groups: low income, middle income, and upper income, with per capita income cut-offs (in 1979 dollars) of \$375 and \$1,035 between the lower- and middle-income groups, and the middle- and upper-income groups, respectively.

Table 2. Initial Economic Structure, 1960

Category	Malawi	Mean Low Income ¹ (34 countries)	Cameroon	Thailand	Mean Middle Income ² (28 countries)	Costa Rica	Mean Upper Income ³ (32 countries)
Population (millions)	3.3	12.1	5.5	27.2	8.4	1.2	12.5
GDP/Capita (1979\$)	116	171	350	251	376	964	957
GDP (billions 1979\$)	0.38	2.06	1.93	6.83	3.17	1.16	11.96
Share of GDP in							
Public Consumption	16	11	10	10	11	10	11
Gross Investment	10	10	15	16	18	18	20
Exports	21	14	29	17	23	21	28
Gross Domestic Savings	-4	8	14	14	15	13	17
Agriculture	58	52	35	40	33	26	22
Manufacturing	6	9	8	13	13	14	18
Primary Products as % of Total Exports	98	94	96	98	94	95	84
Share of Labor in							
Agriculture	92	79	87	84	67	51	46
Industry	3	8	5	4	12	19	22
Life Expectancy	37	41	37	51	45	62	66
Secondary Enrollment	1	6	2	13	10	21	23

¹Countries with per capita incomes below \$375 in 1979.

²Countries with per capita incomes between \$375 and \$1,035 in 1979.

³Countries with per capita incomes above \$1,035 in 1979.

Table 3. Structural Change, 1960-1980
(changes in percentage shares)

Category	Malawi	Mean Low Income ¹	Cameroon	Thailand	Mean Middle Income ²	Costa Rica	Mean Upper Income ³
Agriculture/GDP	-25.9	-26.9	-8.9	-35.0	-19.4	-26.9	-41.8
Manufacturing/GDP	+100.0	0	18.5	+46.2	+35.4	+35.7	+57.8
Ag. Labor Force/Labor Force	-6.5	-12.9	-4.5	-8.3	-14.9	-41.1	-34.8
Ind. Labor Force/Labor Force	+66.7	+37.5	+40.0	+125.0	+57.4	+21.2	+25.9
Man. Exports/Exports	NA	+83.3	0	+1150.0	+125.0	+480.0	+115.8
Exp-Import/GDP	+3.5	+43.3	-9.9	+47.2	+22.9	+46.7	+21.5
Public Consumption/GDP	+6.3	+9.1	+40.6	+20.0	+36.4	+80.0	+42.7
Services/GDP	+19.4	+11.4	-21.4	+12.2	+6.2	+1.9	-3.4
Labor in Services/Labor Force	+80.0	+46.2	+25.0	+16.7	+37.5	+56.7	+35.9
Memo Item							
Growth GDP/Capita	2.9	1.8	2.5	4.6	2.1	3.4	4.1

¹Countries with per capita incomes below \$375 in 1979.

²Countries with per capita incomes between \$375 and \$1,035 in 1979.

³Countries with per capita incomes above \$1,035 in 1979.

The similarities are much more striking than the differences. It is only in the area of investment and savings that the performance of our sample differs markedly from the general performance of LDCs. For Thailand, Malawi, and Cameroon, the investment rate is both substantially higher than average and has increased faster than average. Only in Costa Rica, with its average growth performance, has investment behavior not been striking. Equally interesting, all of these countries, except for Costa Rica, have substantially increased their domestic savings rates (see Table 4). However, in all these countries, one variable looms larger than all the others--the ratio of foreign savings to GDP, i.e., the degree to which external capital is being used to stimulate economic growth. In Malawi, foreign savings are 60 percent higher (as a percentage of GDP) than for low-income countries as a whole; for Cameroon, four times as high; for Thailand, twice as high; and for Costa Rica, four times as high. There is, of course, a real chicken-egg question here--is good economic performance caused by large capital inflows or are large capital inflows caused by good economic performance? (It should also be noted that such economic disasters as Chad, Upper Volta, the Congo, Somalia, Benin, Mauritania, and Madagascar also have high rates of foreign capital inflows.) A breakdown of these foreign flows by type shows that in Malawi, concessional assistance is predominant, while in Thailand, Cameroon, and Costa Rica, concessional and nonconcessional flows are equally important.

We have seen a partial answer to our question. Increasing the rate of investment may depend very heavily on having access to foreign capital, either through concessional assistance or commercial borrowing.

But how does a country increase the productivity of its investment? How do culture, politics, public policy, donor activities, and the international economy interact to affect resource mobilization and resource use? How does a country get access to foreign capital? Answering these questions, the "how" questions of resource mobilization and resource use, is fundamental to understanding the process of economic development. The answers are complex and elusive. Let us begin with a closer examination of the nature of the private sector.

II. UP WITH THE PRIVATE SECTOR, BUT WHICH PRIVATE SECTOR?

A. Search for an Organizing Principle

One of the most dramatic findings of the four country studies is the existence of an enormous range of enterprises flourishing in the developing countries, including parastatals,

Table 4. Saving and Investment Behavior, 1960 and 1980
(percentage)

Year/Category	Malawi	Low-Income Countries	Cameroon	Thailand	Middle-Income Countries	Costa Rica	Upper-Income Countries
<u>1960</u>							
Dom. Sav./GDP	4	8	14	14	15	13	17
For. Sav./GDP	14	4	1	2	5	5	3
Investment/GDP	10	12	15	16	20	18	20
<u>1980</u>							
Dom. Sav./GDP	13	15	10	21	17	13	24
For. Sav./GDP	16	9	15	7	4	12	3
Investment/GDP	29	24	25	28	21	25	27

public finance corporations, transnational giants, family-owned firms, and "micro" firms, as well as any number of hybrid forms. A few quick examples will illustrate this point. In the area of financial intermediaries, the various studies discuss the following types of institutions:

- Development banks and finance companies, such as COFISA in Costa Rica, INDEBANK and MDC in Malawi, BCD in Cameroon, and IFCT in Thailand. These are institutions owned and operated by a mixture of international donor institutions, LDC governments and government entities, and private banks.
- Commercial banks which are either privately owned (as in Thailand and Cameroon), completely nationalized (as in Costa Rica), or owned by a combination of public entities and private firms (as in Malawi).
- Informal private credit institutions such as the pia huey in Thailand or the tontines in Cameroon.

In general, all of these types of enterprises, large and small, formal and informal, public and private, domestic and foreign, will be present in the same economy, providing highly differentiated goods and services to different clienteles.

With so many types of organizations, the distinction between the public and private sectors becomes very tenuous. Does the private sector include Press Holdings Ltd., the Malawi conglomerate which is owned by the Life President, Dr. Banda, in trust for the people of Malawi? Does it include IFCT in Thailand, a development bank with shareholders representing the Government of Thailand and several donor nations, as well as the World Bank and several privately owned firms? Does it include those firms partially owned and subsidized by SNI, Cameroon's National Investment Corporation? Does it include the Commercial Bank of Malawi, owned jointly by two Malawi parastatals, Press Holdings Ltd., and the Bank of America? Surely excluded from the "private" sector are the nationalized banking system in Costa Rica (Case 1), the Government-owned sugar factories in Thailand, and the primary school system in Cameroon.

At its simplest, the notion "private sector" means what it says, i.e., those firms which are privately, as opposed to publicly, owned. By such a definition, it is simple to categorize most enterprises in LDCs; however, difficulties arise in the case of hybrid firms, those firms owned by both public and private interests. Does "private" mean majority ownership by private interests, controlling ownership by private interests, or complete ownership by private interests? Or perhaps the notion of ownership is not the only variable which is important

in distinguishing between "private" sector entities and public sector ones.

Case 1: A Nationalized Banking System: SBN (Costa Rica)

The financial sector of Costa Rica is dominated by Sistema Bancario Nacional (SBN), the nationalized banking system, made up of four banks, each of which concentrates to some extent in different sectors of the economy. Two independent studies over a 10-year period have characterized SBN as slow, excessively conservative, inefficient in its lending policies, and unable to generate local savings. Thus while COFISA, a private development bank, was growing rapidly during the boom years of the Costa Rican economy, SBN's total loan volume grew slowly, and in some instances declined in real terms. This process was aggravated by the "freezing" of a significant proportion (perhaps up to 50 percent) of delinquent loans which were almost always automatically reextended without a new disbursement of funds. The failure to generate internal savings meant that by 1980, 27 percent of all credit in the economy had been raised from external sources. The failures of the SBN are in large measure a causal factor in the sudden downturn in Costa Rica's economic fortunes since 1979.

No commercial bank or profit-oriented firm could have survived the inefficient practices of the past. The lack of competition allowed SBN to slog on--a dinosaur living in the age of mammals.

Another dimension along which enterprises might be classified is the degree to which they are market oriented, the degree to which making profits is essential to the success of the firm. Thus, privately owned enterprises such as PVOs, trade associations, religious organizations, etc., would fall into the nonmarket-oriented group, while most others would be classified as market oriented. Similarly, most publicly owned enterprises (public schools, ministries of works, some parastatals) are not market oriented, although others are.

This two-dimensional classification scheme is illustrated below, along with some examples found in the four country studies. It is clear that those firms in the upper right-hand box of the diagram below are clearly private enterprises. Do the enterprises in this category have more in common with those in the box below them (privately owned, nonprofit-making firms) or those in the boxes to their left (publicly owned, but profit-making enterprises)? By almost every economic category, in particular in terms of efficiency of resource allocation and resource use, market-oriented firms are more alike than privately owned firms. Consequently, this study will investigate the behavior of all market-oriented firms, whether they are publicly or privately owned. These market-oriented firms make up the "private sector" in this study.

Market Oriented	Electric Power Commission in Malawi SODECOTON in Cameroon	Commercial Bank in Malawi IFCT in Thailand	Micro Firms Private Banks in Thailand Medium-size Enterprise in Costa Rica
Non-market Oriented	National Banks in Costa Rica State Enterprise in Thailand		Mission Schools in Malawi Chamber of Commerce in Thailand
	Publicly Owned	Hybrid	Privately Owned

B. A Taxonomy of Enterprise Types

Having defined what is meant by "private sector," it is useful to distinguish among the various types of private sector entities. We will briefly examine three private sector enterprise types: the proprietorial firm, the entrepreneurial firm, and the managerial firm.

1. Proprietorial Firms: Profit-Maximizing, Owner-Operated Enterprises

The private sector landscape, in almost all LDCs, is dotted with proprietorial firms--peasant farms and "micro" enterprises--producing a wide variety of goods and services (Case 2). From the coffee farmer in Costa Rica, to the money lender in Thailand or the tailor in Cameroon, these proprietorial firms are marked by small size, the importance of family labor, the low level of capital employed, and the limited demands made on the owners' managerial ability and technological expertise.

For the most part, proprietorial firms supply small local markets with valued goods and services; they tend to be labor intensive with low levels of labor productivity. Thus, in Nigeria, entrepreneurial firms may produce only 5 percent of manufacturing output, but employ 90 percent of the labor force in the manufacturing sector. More broadly, while proprietorial firms, be they farms, industrial firms, or service enterprises, may produce only a small share of total GNP in any LDC, they do provide a livelihood for the majority of the people.

These firms represent the prototype of the competitive firm, responding to market incentives, economizing on scarce resources, and having free market entry and exit. Because the

technology is simple (in industrial and service establishments), or because land markets are rudimentary (for agricultural enterprises), there is little scope for expansion of individual firms. The industrial sector (e.g., tailoring) may expand or contract in response to market forces, but rarely do individual proprietorial firms expand.

Case 2. The Proprietorial Firm: Malawi Tailors

Tailors in Malawi are representative of the micro firms which are a prevalent feature throughout the Third World. Tailors, generally men, own their own machines, tailor cloth bought by their customers, and rent space from small shops in both urban and rural areas. The entire capital costs are tied up in their treadle-powered sewing machines; overhead is limited to \$6-\$12 annual rental fees; supplies, to thread and replacement of needles.

There is a substantial, though indirect, body of evidence that indicates that despite increases in income (and thus changes in tastes), despite expansion of the medium-size modern garment manufacturer, and despite a Government tariff policy that puts a duty on imported cloth which is not processed by a modern garment firm, the number of tailors in Malawi has steadily grown to around 25,000, one for every 240 people. (In urban Lilongwe, based on a tabulation at city council, licenses indicate the ratio is one for every 150 people). In any case, there are probably 10 tailors for every employee in the formal garment industry.

Because these firms are labor intensive and because the opportunity cost of labor is very low in Malawi, tailors can produce clothes at a lower cost than the medium-scale garment industry, even with a tariff policy that penalizes them by 30 percent. Contrast this with a developed country where labor costs are very high and hand-tailoring is a luxury for the rich rather than a necessity for the poor.

2. Entrepreneurial Firms

The economic history of the West, particularly of Britain and the United States, is dominated by the entrepreneurial firm, the owner-operated firm rapidly expanding in response to a new technology or a new market opportunity. The Industrial Revolution is thought of in terms of men such as Richard Arkwright, Eli Whitney, and James Watt. The entrepreneurial firm has thus been considered as the backbone of industrialization and modernization--the institution which converts savings into new, risky, and productive ventures--the engine of growth.

In fact, however, as Gerschenkron points out (Case 3), the latecomers to the Industrial Revolution depended less on the entrepreneurial firm than on the large managerial firm (see below), usually developed through a partnership of government and private interest, the outstanding example being the Zaibitsu of Japan. The role of the entrepreneurial firm today in the Third World depends on historical circumstances. For instance, in Malawi, there are virtually no indigenous

entrepreneurial firms; in Cameroon, there are a small number; in Thailand, entrepreneurial firms are largely owned by the Chinese minority; in Costa Rica, indigenous entrepreneurial firms dominate the economy. One of the key problems facing donors working in the private sector is developing the assistance package needed to transform a proprietorial firm into an entrepreneurial firm (Case 4). However, even without an entrepreneurial class, even without the entrepreneurial firm, the private sector can be dynamic and can be the focus of growth as a result of the third type of private enterprise--the managerial firm.

Case 3. A Gerschenkron Model of Economic History

The evolutionary model of development works particularly well when applied to the economic histories of the first countries to undergo the industrial revolution--particularly Britain and the United States. However, the economic historian, Alexander Gerschenkron, noted that the pattern of economic development changed in a predictable way as latecomers to economic growth--Germany, Russia, and Japan--began to undergo their own entry into the industrial age.

For a number of sensible economic reasons, the size and thrust of development changed--economic units became larger and tended to dominate the economy. A partnership arose between the government and large industrial and commercial firms which did not mirror the more laissez-faire attitudes of the earlier industrial nations. In terms of our study, the latecomers skipped over the entrepreneurial stage, and large-scale managerial industries were developed by government and a few large-scale firms.

Today's LDCs often find themselves in a position to choose one of two paths--an evolutionary path echoing that of Britain, or a revolutionary, big-push path like that of Germany. (Japan seemed to have done both at the same time--the small-scale, labor-intensive textile industry was largely entrepreneurial, while the large-scale steel, shipbuilding, and railroad industries developed with close Government involvement.) For small countries, the big-push strategy is not available; markets are too small. Nevertheless, the availability of expatriate capital and skills allows the country to jump over the whole stage of developing indigenous entrepreneurial talent. Certainly this is what has happened in Malawi and Cameroon. For larger countries like India and Nigeria, the big-push option is available, but given the weaknesses of government administration, the result is frequently unsatisfactory.

3. The Managerial Firm

Most modern economies are dominated by large corporate firms which separate ownership from management and institutionalize decisionmaking. This is certainly true of most LDCs, where the managerial firms may be locally owned (Case 5), owned by foreign interests, owned by a combination of foreign interests and the government, or publicly owned.

While there may be little difference in behavior between the entrepreneurial and the managerial firms, the differences in organization and style imply differences in constraints. For instance, entrepreneurial skills--mobilizing capital,

Case 4. Entrepreneurism at the Brink:
The Lorena Stove in the Philippines

The Lorena stove is a stove designed to economize on wood consumption. It turns out to be most efficient when substituted for natural gas or when used on a large scale as in restaurants. As part of a Peace Corps project, Lorena stoves were built by mathematics teachers at a university in the Philippines. While the teachers demonstrated little interest, a janitor at the university saw the possibility of introducing the Lorena stove into the restaurant business (there are over 100,000 cafes and restaurants in the Philippines).

Together with his sons, the janitor went into business producing Lorena stoves and marketing them to restaurants near and far. (To date, they have sold 30 stoves including one to a large, modern inn 150 km from their home.) There is no doubt that the idea is a sound, profitable one. (The stoves, which last three years, pay for themselves in fuel savings within two months.)

However, the stove cannot be patented. If the entrepreneur is to be able to meet what could be a very large market demand, he needs to build a factory, obtain credit, develop a sales network, keep accounts, etc. The janitor had the creative idea--taking the new technology to the restaurant trade. But does he have the organizational and managerial skills necessary to create a managerial organization able to meet market demand?

Case 5: Transformation of Entrepreneurial Firms Into Managerial Firms:
The Overseas Chinese in Thailand

Perhaps the most salient feature of the business community in Thailand has been the central role played by overseas Chinese. The Chinese have a long and somewhat checkered history in Thailand. By 1857, there were already an estimated 1.5 million Chinese living there, and in the ensuing century, the number has more than doubled. As of 1965, 70 percent of ethnic Chinese were engaged in commerce, and an additional 16 percent in industry. With the rapid development of the Thai economy, the larger Chinese trading organizations have evolved into industrial and banking conglomerates.

There is a considerable degree of concentration in the banking industry, with the share of the five largest banks making up almost 80 percent of total assets. In 1980, 9 of the 16 Thai commercial banks had fewer than 10 major shareholders controlling 50 percent of the shares. Historically, the banks have been family owned and operated, as have been the large businesses. Bank loans were made more on the basis of family and kinship ties than on objective criteria. (Nevertheless, loans were not made if repayment was in question.) Thus, for most of the recent past, the financial and commercial sectors of Thailand have been controlled by large family-owned (and largely Chinese) conglomerates. Recently, rapid growth has necessitated organizational changes, and in more and more of these organizations, operational control is passing on to managerial types as the owners become more separated from day-to-day operations.

perceiving bold new opportunities, and taking daring risks--are different from managerial skills--organizing, calculating the benefits from different management choices, and managing cash balances with a sharp pencil. The critical managerial decision is expansion; the critical entrepreneurial decision is establishment. Generally, given their existing resources, managerial firms have an easier time obtaining capital than entrepreneurial firms. In any case, donor programs aimed at entrepreneurial firms may not be effective in removing constraints inhibiting the growth of managerial firms, and vice versa. The question which donors must always ask themselves is which private sector do they wish to promote.

C. Private Sector Vitality

A taxonomy of organization types tells us little about the determinants of birth, growth, decay, and death of these organizations; of the ways in which these organizations interact to form an economy; of the ways in which the economy (and the various enterprises which make it up) grows or stagnates; or of their responses to changing exogenous variables.

What follows is a set of observations on the ingredients necessary for a healthy, vital economy.

1. The Variety and Coexistence of Organizational Forms

In all of these economies, from the simplest to the most complex, the variety of forms that productive units can take is remarkable. In Malawi, for example, an economy barely the size of an American city of 100,000, (e.g., Bridgeport, Connecticut), one can find smallholders, plantations, and medium-size farms; village beerbrewers and Carlsberg Brewery, Ltd.; tailors operating on a store porch; garment manufacturers with 100 employees; and the giant David Whitehead textile mill (Case 6), employing over 2,000 workers, owned in part by a British transnational firm, a Malawi Government parastatal, and a large holding company owned by the president in trust for the Malawi people. Malawi parastatals take all forms, from the more typical Electric Power Commission and Blantyre Water Board, to the marketing and investment giant, ADMARC (Case 7). Similarly, the large, managerial firms are, in general, neither privately owned nor publicly owned, but a hybrid of the two. Education is largely a province of the Government, but there are many private training schools and much training is done on the job. Credit is provided by the commercial banks (themselves owned by both public and private interests), building societies, an insurance company, small moneylenders, and the borrower's cousin. In short, wherever a supportive environment exists, some economic life form will fill it.

Case 6. The Managerial Firm: David Whitehead (Malawi), Ltd.

David Whitehead, Ltd., an old established English textile firm (later bought out by an aggressive transnational, Lonrho, Ltd.) opened a textile mill in Malawi in 1967, designed to serve the market with 100-percent cotton cloth. David Whitehead used its own assets to finance 51 percent of the original investment, and borrowed from the Malawi Development Corporation (MDC) and the Commonwealth Development Corporation (CDC) for the balance. MDC is a Government finance corporation established to provide equity and loan finance to new firms. Shortly after start-up, CDC sold its holdings to Press Holdings Ltd., a Malawi private holding company, owned entirely by Malawi's President Banda in trust for the people of Malawi.

Whitehead's growth has paralleled that of Malawi. The original plant consumed 3,000 bales of locally produced cotton; and in four years this measure increased to 12,000 bales. Initial production was of drills and denim. Poplin was added in 1968 and dress prints in 1972. In 1977, a major expansion, financed partly by the International Finance Corporation (IFC) of the World Bank group, was undertaken. By 1977, consumption of cotton had expanded to 24 million bales, almost the entire domestic crop. A new expansion costing \$20 million is planned to develop a poly-cotton capability. This new expansion will again be financed in part by IFC (25 percent). Employment--800 at the start--is projected to increase to 3,350 once the new plant is built.

Because of Malawi's land-locked position, transport costs are high and the import-substituting industry receives natural protection. Despite this protection, despite the fact that it has something of a monopoly position, and despite the fact that it is partly owned by Press Holdings, David Whitehead has been an efficient, profit-making enterprise. Its growth has been linked to increased demand (fueled by Malawi's general economic growth), low wages which tend to keep costs competitive with imports, and excellent management, provided by Lonrho, Ltd.

Case 7: A Successful Government Marketing Authority: ADMARC

ADMARC, the Agricultural Development and Marketing Corporation of Malawi, was established in 1971 as a successor to the Farmers Marketing Board. ADMARC is a parastatal ("statutory body" in Malawese) with primary responsibility for marketing agricultural inputs to and outputs from the smallholder sector. The most important of ADMARC's marketing function involves the purchase and export of dark, fire-cured tobacco, of which Malawi is the world's leading exporter (about 30 percent of world trade). Largely because of this market domination, ADMARC has acted to restrict domestic output in order to keep world prices high. Consequently, prices to producers were never allowed to reflect world prices, thus discouraging output. It is not clear whether this policy maximized export revenues; it certainly acted to augment the trading margins of ADMARC, which between 1972 and 1977 averaged K16 million (U.S. \$18.5 million).

By the end of 1980, ADMARC had fixed assets of K39 million, current assets of K12 million, investments in subsidiary firms of K29 million, and loans of K143 million, for a total net worth of K223 million. By the end of 1980, ADMARC owned 19 estates, had investments in 27 agro-industrial firms, and had provided loans to 34 other companies. In 1978, ADMARC was earning 15.4 percent profits on its equity, had 11.9 percent annual growth of assets, was saving five times what it was investing (thus providing needed resources to the private sector), had a debt-equity ratio of 0.2, and a current ratio of 5.0. By every conventional financial measure, ADMARC was a dramatic success.

2. An Enterprise Will Survive Longer If It Is Adaptable to Changing Environmental Conditions

No matter how dominant an enterprise, its survival depends on its flexibility. Like the dinosaurs, economic organizations that are highly specialized or highly rigid will die out when economic conditions change. For the economy, too, flexibility is vital. Flexibility will be more likely if the economy is complex and large. In such a case, there are many ecological niches available, and a downturn in an industry's fortunes need not have a substantial adverse effect on the rest of an economy.

1. Corollary 1: Diversification of firm and economy will enhance the prospects of survival.
2. Corollary 2: An economy is often healthier when the inefficient enterprises are allowed to disappear.

The success of the entire economy is not linked directly to the success of its individual components. Inefficient firms, like Thai State Enterprises (Case 8) or Spearhead in Malawi (Case 9), should be allowed to die when they prove to be inefficient. The resources which they waste can be more effectively used by more successful enterprises.

Case 8. An Alternative to Divestiture: State Industry in Thailand

In its first Development Plan, published in 1960, the Government of Thailand stated:

It is believed that in Thailand increased output will be most rapidly secured through the spontaneous efforts of individual citizens, fostered and assisted by Government, rather than through Government itself entering directly into the field of production.

Nevertheless, by 1960, the Government of Thailand owned between 60 and 100 enterprises. According to a 1959 IBRD report: "In practice, all of the state industries, except the monopolies, have proved unprofitable by commercial standards." In 1965, USAID provided a consultant to advise the Government on how to divest itself of some of these enterprises. In practice, due to opposition from bureaucratic, political, and labor groups, little divestiture occurred. However, since public firms were inefficient, the private firms grew while the public firms stagnated. Gradually, the state enterprises became a less important actor in the economic scene. Today, their only importance is in the funds they drain from the public treasury, sinecures for the feeble, the aging, and the moribund-but-as-yet-unburied.

Although Thailand was unable to divest itself of its state industries, it avoided deep trouble by allowing nonpublic firms to compete. Thus, given the inefficiencies of its state-run firms, private firms were able to grow and dominate the market. In small economies, where market size is too small to allow more than one firm in many sectors, this alternative is not viable.

Case 9. Allowing the Inefficient Enterprise to Disappear:
Spearhead Ltd. (Malawi)

In 1968, the Malawi Young Pioneers (a youth group with paramilitary and political overtones) undertook responsibility for running a petrol station in a remote corner of Malawi when no private operator could be found. This first venture into commercial activities was followed by others as a means for fulfilling the objectives of the organization to train young people in modern methods of agriculture and husbandry. By 1978, Spearhead Enterprises, Ltd., the commercial arm of the Young Pioneers, owned 20 tobacco estates (over 100,000 acres), a tea estate, a coffee estate, a cattle ranch and dairy, a garment factory, an air charter business, an entertainment center, a large transport fleet, a commercial garage, and numerous properties.

All of these operations were funded by the dubious procedure of bank overdraft under Treasury guaranty. Owing to questions of the legality of this mode of operation, Spearhead Enterprises was incorporated in 1978, and Treasury guaranties were withdrawn. Because of the lack of equity capital, the increasing politicization of management, a decline in tobacco prices, and some poor investment decisions made on the basis of prestige rather than profit, financial problems became acute. Finally, the Life President, Dr. Banda, sole trustee and owner of the firm, decided that Spearhead should be treated according to the normal practices of the commercial world, and on April 11, 1980, Spearhead was placed in receivership. The receiver, Price Waterhouse, is trying to sell off potentially profitable operations; the rest will be allowed to close down.

For an economy, diversification and flexibility are the basis for survival. Any economy that, through policy or circumstance, finds its activities concentrated in one sector can be devastated by an unfavorable change in the economic climate. Malawi, with its dependence on tobacco, tea, and sugar, and Cameroon and Costa Rica, with their dependence on coffee, are in grave danger of being held completely hostage to the decline in world commodity prices.

Equally important, an economy must be able to learn from its past mistakes, to understand when a particular opportunity has been foreclosed (import substitution in Costa Rican textiles, for example), and to turn away from practices that have been shown to be ineffective. For example, while the Government of Thailand was unable to divest itself of its state enterprise, the Government avoided undertaking new activities--a decision that many other countries failed to take. In Thailand, as a result, the state enterprise sector shrank as a percentage of the total economy. When management problems threatened the survival of Malawi's public holding companies--Press, ADMARC, and MDC--management was replaced. When several publicly owned firms in Malawi proved unprofitable, they were closed and their assets were sold.

3. The Principle of the "Tortoise Walk"

Because economic survival requires flexibility, adaptability, and diversification, prudence suggests an incrementalist approach to development--an avoidance of large-scale projects intended to make a large impact on growth. These high-risk, high-gain activities are too vulnerable to a capricious environment. Far better, to take small steps, to move slowly, to avoid the pitfalls.

It should be noted, however, that incrementalism is no guarantee of success. Costa Rica is faced with bankruptcy because of a series of incremental steps that increased its dependence on the international capital market and increased its debt repayments, until, with world recession and inflation, the slow build-up of debt broke the camel's back. In this case, it was the increased dependence on international borrowing, in a time when credit was becoming increasingly expensive, that brought Costa Rica to the brink of disaster.

4. Linkages Among Enterprises

Symbiosis is one key to economic progress (Case 10). The more linkages there are among various enterprises, and the more symbiotic these linkages are, the greater the chance that growth of any one enterprise will lead to growth rather than decay of others. (Of course, the converse is also true. The more interdependent an economy, the more vulnerable it is to unfavorable events in any one sector.)

As an example, when Sears, Roebuck began development of its retail chains in Peru, it actively established linkage with local producers of every ilk--small- and medium-size firms, micro firms, and skilled craftsmen. As Sears grew, the share of its merchandise produced locally also grew. The phenomenon is illustrated over and over again--in the sugar industry in Thailand, linking smallholders and factories; in Cameroon, with garment manufacturers processing local cloth which, in turn, is made from smallholder cotton. The links may also be between public activity in education or infrastructure development and the ability of private firms to produce more cheaply and at lower risk.

Of course, parasitism is also possible. In Costa Rica increasingly large budget deficits led to the Government's starving the private sector of credit. In Malawi, ADMARC generated large trading margins by not passing onto producers increases in international prices, particularly in groundnuts and cotton. In East Africa, Lonrho wanted to begin the production of Chibuku

beer (a local product made in the villages). After it captured the market by using penetration pricing, Lonrho ensured its market position (following a rise in prices to reflect its real costs) by sending thugs into the villages to break up the beer-making equipment of the women brewers.

Case 10 Symbiosis--The Parastatal and the Smallholder:
SODECOTON (Cameroon)

SODECOTON, the Societe de Developpement de Coton au Cameroon, was established in 1954 as a parastatal to take over operation of the French parastatal CFDT. SODECOTON, owned 70 percent by the Government of Cameroon and 30 percent by CFDT, is a vertically integrated organization producing, ginning, and marketing seed cotton. CFDT acts as SODECOTON's marketing agent and has a technical assistance contract providing key personnel. In fact, SODECOTON is one of the least "Cameroonized" of the large parastatals, with about 75 expatriates accounting for more than one-third of total labor costs.

During the early years of cotton growing in Cameroon, output growth was generally associated with increases in acreage, and yields remained low. The Sahelian drought brought pressure to increase food production, and cotton acreage began to decline during the early 1970s, although world cotton prices were favorable. SODECOTON then embarked on a program of increasing yields by intensifying production using the applied research results of the French cotton research institute in Cameroon (IRCT).

The CFDT-SODECOTON system is based on 140,000 planters each cultivating, on the average, less than half a hectare. The system is based on tight supervision of farmers (the French word is "encadrement," which is the term for officering in the military). With a force of 800 Cameroonian "moniteurs" (one for every 175 farmers), SODECOTON distributes seed, fertilizer, chemicals, and farm equipment on credit. SODECOTON then purchases all the cotton after subtracting the costs of inputs.

Between 1969 and 1970 (a good year) and 1980 and 1981, hectares planted to cotton declined from 108,194 to 65,044, while output decreased from 91,346 tonnes to 84,344 tonnes. Yields increased by 53 percent over this period. SODECOTON is praised from all quarters, including the World Bank, for its managerial competence. It would not be too far from the truth to say that in the North (the Sahelian region of Cameroon) SODECOTON works, while not much else does. Equally important is the slow development of a local capacity to take on some of SODECOTON's functions. For example, SODECOTON has started setting up pre-cooperative village groupings which will gradually take over SODECOTON's seed cotton purchasing operations. As a result, peasants are developing the skills to effectively manage cash cropping, marketing, inputs, and credit. It should be noted, however, that this development is the result of 30 years of activity.

5. Different Growth Stages Will Lead to Different Configurations of Production Organization

At the early stages of growth, when labor is plentiful and capital scarce, when markets are small and the possibilities for large-scale production are limited, the small, proprietarial

firm will be ubiquitous and efficient. As growth progresses and new opportunities emerge, some of the more successful proprietary firms will accumulate capital and expand production--particularly in the nonmanufacturing sectors of trade, transport, and finance. (Since proprietary manufacturing is limited to skilled artisan work, success is generally linked to the owner's skills, which are not easily expanded.) In some instances these firms become entrepreneurial, grow into new areas, diversify, and expand, until they become too large to be managed as they were in the past, and they emerge as managerial firms.

6. Conclusions

As we have seen, an economy is a set of productive organizations. Some of these organizations are constrained by market forces while others are not. Among economic organizations, there exists a variety of linkages--competitive, symbiotic, and parasitic. The soundness of the economy is linked to the soundness of its economic organizations; however, new economic enterprises are constantly being born, others are expanding, some contracting, and some failing completely.

This constant flux is regulated by the workings of the market which determine success by making profits. When profits are large, firms expand; when they are small or negative, firms contract; where there are continual losses, firms fail. Profits, in turn, are determined by the efficiency of the firm in converting inputs into outputs (use efficiency) and the value the society places on those outputs (allocative efficiency). Thus, the market is constantly weeding out the inefficient and promoting the efficient.

In general, an open and competitive market system operates to ensure economic vitality; to allocate resources efficiently; to respond to changes in tastes, technologies, or resource availabilities; and to reward individual creativity. Of course, such a system does not work when firms are insulated from its strictures, or when markets are not open and competitive.

The next section discusses the role of markets in development and the limitations of purely market-determined strategies.

III. UP WITH MARKETS, BUT HOW FAR?

Economists since Adam Smith have asserted that the working of the market is not merely a positive principle--the principle by which economic activity can be understood--but a normative one, a mechanism which leads to an optimum, efficient allocation of productive resources. This eighteenth century, mechanistic view of the economic world has remained a fundament of economic theory for two centuries. However, the theoretical model is based on some very stringent assumptions. How does the market work (or not work) in a world where those assumptions do not apply? Let us examine the way in which factors of production--labor and capital--are allocated and augmented in the four countries we have studied.

A. Capital Markets

The function of financial institutions is to channel savings from one segment of the economy to investors in another segment. The price of credit (the interest rate) is the variable which equates the opportunities for investment with the availability of savings. In an efficient economy, the interest rate will equate the rate at which current production can be transformed into future production (the rate of return on an investment) with the rate at which consumers are willing to forgo current consumption in favor of future consumption. Thus, if an investor expects to earn 20 percent on his investment, and a saver is willing to give up consumption today for 20 percent more consumption tomorrow, financial markets work so as to channel the savings to the investor.

It is frequently asserted that two problems plague credit markets in LDCs: (1) a lack of savings due to low incomes, and (2) an excessively high cost of administering credit because of the high risk and small size of loans. In fact, however, evidence seems to show that (1) the market, through small-scale, informal mechanisms, can provide small loans to prospective investors in an efficient manner, and that (2) savings are available when the return is sufficiently high. (There is, for example, a very high level of investment in family farms, family businesses, and in human capital.)

While large-scale, formal credit systems provide the bulk of the credit for managerial firms, the entrepreneurial and proprietorial firms are unable to depend on the formal system for their credit needs. Given the small size of the latter firms' loans, the lack of collateral, and the problems with record-keeping, the costs of servicing these loans with highly trained personnel is prohibitive (even where government interest rate

ceilings do not act to restrict these loans). Accordingly, the informal credit network, widely spread throughout the rural and urban-informal sectors, has grown up to fill the gap (Case 11).

Case 11. Informal Credit in Cameroon

In Cameroon, there are two categories of informal savings institutions--those which charge interest and those which do not. Those savings systems, called "tontines," are voluntary organizations made up of from 10 to 30 members, who make contributions varying between \$10 and \$200 per month. Sometimes funds are hoarded; sometimes they are placed in a bank. In those tontines without interest rates, proceeds are allocated by a random drawing to one member at a time (although other arrangements, such as one based on need, are possible). Where interest rates are regularly charged, members may borrow from the tontine if they have the guaranty of one or more members. Interest rates are usually very high (between 30 and 60 percent), and the maximum loan term is usually one year.

Loans are used both for investments and for purchase of consumer durables. Frequently, loans are used for celebrations such as weddings, as insurance to pay for hospitalization, or to pay tuition. Most artisans and a number of small enterprises rely on tontines to finance their activities. Most urban artisans and, according to hearsay, a majority of Government employees, are members of such associations. One important advantage of linking credit functions with the social purposes of the association is the personal relationship existing among members. This allows for intangibles such as trustworthiness, honesty, and hard work to be used as collateral for loans--which is rarely the case when dealing with a commercial bank or other formal financial intermediary.

A further note: An AID project with a private voluntary organization in Malawi, the MUSCO project, has as one of its goals the creation of an institution in Malawi similar to the Cameroonian tontine.

There are two important aspects to credit markets--mobilizing savings and allocating loanable funds to their most profitable uses. Similarly, there are two important attributes of well-functioning capital markets: (1) a set of institutions that provide capital of various types--short term and long term, equity and debt--to investors of differing industries and size; and (2) a set of policies that encourage the efficient operation of these markets.

1. Institutions

In almost every LDC, one finds the following types of financial institutions:

- Central bank
- Commercial banks
- Development bank
- Finance corporation

- Agricultural bank
- Savings and loan

The participation of government in these institutions varies. All central banks are government owned and operated, although the degree of independence that they possess varies. In Cameroon and Thailand, the commercial banks are private, in Malawi they are hybrid, and in Costa Rica they are governmental. Most savings and loan institutions are private. The development banks in Malawi and Thailand are joint ventures of the government and the donor community; COFISA in Costa Rica is private, while the BCD in Cameroon is wholly publicly owned. The nationalized banks in Costa Rica are clearly failures, while the private financial institutions in that country seem to perform quite well, given the constraints of economic policy. Of interest, however, is the relatively effective performance of IFCT in Thailand and INDEBANK and MDC in Malawi, organizations with governmental ownership, but run along market lines, again underlining the critical importance of the market vs. nonmarket distinction to success.

Despite the relative effectiveness of most financial institutions in our study, the inability of the formal credit sector to provide credit to small and medium enterprises (SMEs) may be a problem area. However, in most of our countries, particularly Cameroon and Thailand, it is not the lack of credit that constrains SME development, but lack of managerial and technical expertise. We will return to this issue later.

2. Financial Policies

The Mobilization of Savings

The idea that low-income countries cannot generate savings has no empirical basis. Indeed, low-income and middle-income developing countries as a whole had a higher rate of savings in 1979 than did the industrial market economies. Some of this savings is generated by government, other from households, but the bulk is provided by private firms from their retained earnings. High levels of profit thus generate future capital as well as providing a demand for that capital.

In Malawi, improved fiscal management moved the Government from a position of net borrower to one of net saver; high profits in the managerial sector and in the smallholder cash economy provided substantial savings, accruing both to expatriate firms and to Government parastatals. These profits were largely reinvested. In Thailand and Cameroon, the same situation pertained. Fiscal probity, coupled with positive real

interest rates and high levels of profit, generated savings for the managerial firms.

Only in Costa Rica, where a combination of administered interest rates, budget deficits, and an overvalued currency led to capital flight, were Government policies detrimental to domestic capital formation.

Allocating Capital

As long as interest rates are allowed to serve as the price of credit, and as long as the market signals represented by profitability reflect national as well as private interest, the market allocates capital efficiently (Case 12). When, as in Costa Rica, credit is rationed, or when prices are distorted through tariff and nontariff policies to favor import-substitutions over exports (as in Costa Rica and Thailand), then decentralized investment decisions no longer allocate capital efficiently. While to some extent all four economies have manipulated prices through tariff protection, only in the case of Costa Rica was the policy so pronounced, consistent, and continuous as to substantially distort the pattern of investment.

Case 12. Aboveboard Subsidies: Cameroon's SNI

Cameroon's principal public agency for equity participation in private enterprise is the National Investment Corporation (SNI).

SNI was established in 1964 as a fully state-owned company to promote development in industry, agriculture, and trade. Its objectives are to mobilize national savings; to make or finance project studies; to finance investments through equity participation, loans, or guarantees; and to manage the direct investments of the state and of the public institutions. As of June 1981, SNI's portfolio was valued at about \$63 million in participations and \$40 million in loans. SNI has a competent staff, many with graduate school training from the United States. The GURC guarantees borrowing by SNI; the subsidy element is thus embodied in the lower interest rate.

SNI has mostly channeled funds into large-scale Government-promoted projects; support to small-scale enterprise has been minimal. In principle, SNI participation is governed by efficiency and commercial profitability criteria--either current or anticipated after an initial transitional period. SNI insists that it is interested in protecting the financial integrity of the institution. However, in practice, SNI has participated in a of commercially unprofitable ventures. Occasionally, the GURC pushes SNI to invest in a particular company for other than commercial profitability reasons. In these cases, SNI management says that it explains to the GURC the costs of such investment and requests a specific subsidy schedule to cover its anticipated losses. This has the considerable advantage that subsidies are explicit rather than hidden--and thus much more carefully granted.

B. Management and Skills Training

The role of public and private institutions in the development of human capital, the acquisition of the skills necessary for economic development, is a very complex process. In general, governments have provided the institutions for general education--literacy and arithmetic competence. Private, market-oriented institutions become more important at higher levels of training, where skills are more specialized and where there is a shorter gestation period, a quicker connection between the investment and the return.

A number of points should be made.

1. A stock of literate, arithmetically competent workers is fundamental to economic success (studies show that the social rate of return to primary education in LDCs averages 24 percent).
2. There are very different training needs among the different enterprise types described above. For example, proprietorial firms may need simple bookkeeping; entrepreneurial firms, a variety of technical and financial skills; managerial firms, specialized skills and MBA-type training.
3. Key skill shortages can be addressed through the importation of expatriates, although this is costly. (For a long while it was too expensive to import any but the highest level of management; recent increases in international mobility have made it possible for middle management, artisans, and skilled workers to become temporary migrants.)
4. On-the-job training is important; the more specific the skill and the less likely the trainee is to be bid away by another company, the more willing are private firms to train their own personnel.
5. Training in many countries tends to be conducted in public or parastatal institutions. There seems to be room for the development of more private educational and training enterprises in LDCs.

C. The Dangers of Ignoring Market Information

In general, market-oriented firms respond to market signals. If those signals are distorted, the firms will be led into production of the wrong goods by the wrong methods. Thus

government fixing of sugar prices in Thailand, coupled with a controlled international sugar market, has led to substantial excess capacity in the Thai sugar industry. Excess protection coupled with an over-valued exchange rate has led to the growth of inefficient import-substitution industries in Costa Rica. Taken to its extreme, a policy of ignoring market signals--for example, an exchange rate that is out of line by a factor of 10, as in Ghana--can lead to unmitigated disaster and a complete breakdown of the formal market economy (Case 13).

Case 13. Killing the Golden Goose: Cocoa in Ghana

In the past 15 years, Ghana has seen a dramatic and steady decline in cocoa production, from a peak of 566,000 metric tons in 1965 to 249,000 metric tons in 1979. Ghana's share of world production has shrunk from one-third in the 1950s and 1960s to one-sixth in 1979; from being the world's leading cocoa producer, Ghana has fallen to third place. The basic reason for this depressing performance is the tax, both explicit and implicit, placed on cocoa producers. Between 1963 and 1974, the price index for consumer goods rose to 22 times its initial value; food prices rose at about the same rate and the price of cocoa in neighboring countries rose by 36 times its initial value. In contrast, the cocoa price to producers is only six times what it was in 1963. Two predictable responses occurred: farmers neglected their cocoa trees and began expanding into food crops, and a considerable amount of cocoa has been smuggled into neighboring countries. Thus, the economy suffers from a foreign exchange shortage while its most important resource--cocoa trees--lies neglected.

In Ghana, two economies arose: an official economy where goods and services were bought and sold at official prices, and a parallel, black-market economy where goods and services were sold at a price reflecting their opportunity cost. Since the official market generally undervalued goods, a rationing process developed which led to generalized corruption, because rationed goods could be resold on the black market at enormous profits. Few economies have experienced the total breakdown that Ghana has, but even the generally market-oriented economies we have been studying here have not avoided the temptation to ignore the strictures of the marketplace and, as a consequence, have recently found themselves in great difficulty.

The Costa Rican economy grew in an environment in which market signals and allocations were consistently ignored. Protective tariffs, low interest rates, high rates of domestic inflation, and an overvalued domestic currency all acted together to favor import-substitution over export promotion, and foreign borrowing over domestic savings. The impact of these policies had been cloaked by a coffee boom, but when commodity prices began to decline, the underlying weakness of the entire system became obvious. By the beginning of 1982, Costa Rica had an immense debt (over \$4 billion, or about \$2,000 per capita), excess installed capacity, significant capital exports,

little foreign equity, and a public service that employed 20 percent of the labor force (Case 14).

Case 14. COFISA--A Success Becomes a Failure

COFISA (Costa Rican Industrial Financing Corporation) was instituted in 1963 with the assistance of a \$5 million AID loan. COFISA was created as a private development finance company to help meet the capital requirements of the private industrial sector. By 1968, COFISA had established itself as a successful lending institution, granting a total of 333 loans of both fixed investment and working capital, for a total of \$6.9 million.

COFISA secured a second \$5 million AID loan in 1969. 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). A 1978 AID financial study showed COFISA to be a healthy lending institution with "good management and consistent profitability." It was recommended that AID permit COFISA's debt-equity ratio to rise to 10:1.

The onset of Costa Rica's financial crisis affected COFISA as heavily as any institution in Costa Rica. By mid-1981, COFISA's borrower delinquency and default rate was on the increase, and new lending had dropped and was limited almost exclusively to short-term uses. In July 1981, the Supreme Court of Costa Rica decided that it was legal for debtors to service or pay off their dollar-denominated debts in grossly inflated colones (Costa Rica's currency). The result was a loss equal to almost twice the corporation's stock value. As a result of an Arthur D. Little study, COFISA has been working out debt rescheduling with its creditors.

Thus, despite excellent management and a history of success, COFISA found itself hostage to Costa Rica's macroeconomic policies. In particular, an overvalued currency led to the flight of domestic capital and a consequent dependence on foreign borrowing. That same borrowing on an economywide scale led to massive debt and a continuously weakening colone. It was a formula for disaster. COFISA's management was as incapable of stopping the ensuing flood as King Canute was of stopping the tide.

Thailand's recent difficulties have not been as severe as Costa Rica's, although they have necessitated a large structural adjustment program with the World Bank and an Extended Fund Facility (EFF) from the IMF. The increase in oil prices in 1973 and the associated turmoil in the international economy presented serious problems for the Thai economy--both in terms of the balance of payments and domestic inflation. At this point, it appears that the Government chose to try to insulate the economy from the inflationary effects of the oil price hike, to proceed with new social projects, and to continue its import-substitution policy. Energy prices were sharply out of line, and by 1979, energy consumption was growing twice as fast as GDP. As a consequence, the Government began to run

substantial deficits in its budget as well as in the balance of payments, and was forced to resort to heavy borrowing. By 1980, inflation reached 25 percent, and the system of price controls introduced to mitigate inflation was increasingly out of line. These structural problems became obvious as a result of a downturn in export prices. However, in 1979, energy prices were allowed to rise to reflect their real cost. The structural adjustment agreements with the World Bank look toward rationalizing the price systems in agricultural, energy, and trade policy, and shifting tax policies away from favoring capital-intensive industry. With these reforms and the influx of IMF and World Bank assistance, Thailand should be able to straighten out its economic affairs.

Malawi's recent problems come not so much from distorting current prices as from misestimating future prices, particularly those of tobacco. Because of the close link between the Government and the commercial banking system, the latter was pushed into concentrating its loans in a dramatic expansion of tobacco acreage without normal collateral (because of land tenure arrangements in Malawi). When tobacco prices fell and management turned out to be ineffectual, the banks found themselves with a substantial amount of bad debt. The contraction of domestic credit, an over-ambitious development program, and a continual erosion in the terms of trade has led to two years of no-growth.

D. Why Do Governments Intervene If Markets Work?

In the natural world, an omnipotent God created the universe in such a way that the laws of natural selection remain inviolate. When the dinosaurs fall prey to the ice age or the snail darter to the developers, God refuses to intervene. The natural law is the only standard that applies; life forms either adapt to their environment or die.

The deus ex machina of the economic world, the government, is not typically content to stay in heaven. It is consistently interfering with the market--fixing certain prices, distorting others, applying taxes and subsidies with equal abandon, and creating institutions that are not responsive to market forces. The result, as discussed above, is frequently chaotic. Firms that can't stand the heat are insulated from the sun. Others are allowed to grow in a hothouse, incapable of withstanding the rigors of their natural habitat. Despite all the evidence that interfering with markets can be disastrous, laissez-faire market systems are almost nonexistent.

A basic question that needs to be answered is, why does the government consistently intervene with the workings of the market? A number of possible answers suggest themselves:

- Sometimes markets don't work
- Governments don't believe markets work
- There are more important goals than economic efficiency

These three motives--market failures, ideological predispositions, and noneconomic objectives explain a large number of government interferences in the market.

1. Market Failures

The economic literature contains a widely accepted set of instances where markets do not work so as to allocate resources efficiently. Markets only work when the underlying assumptions on which they are based are fulfilled. There is, for example, a spectrum of goods known as public goods, which, for a variety of reasons, are better produced by organizations (usually government) which are not profit oriented. These include, among others, defense, administration of justice, a lighthouse, public health, a portion of education, and certain types of infrastructure. The exact list of public goods may be open to discussion, but not the fact that public goods cannot be provided efficiently by the market.

There are other types of market failures as well. Not all markets are free and open, and the existence of a true monopoly--a firm with substantial control over the production of a product and its substitutes--will lead to inefficiencies. Thus, monopolies are either regulated or owned and run by public authorities.

There are, in addition, external effects of production and consumption which the market cannot deal with. An example is the problem of common resources such as fisheries. Each individual fisherman has as his goal maximizing his catch given his costs. Unless they can agree on a method for maintaining the resource, decentralized decisions could lead to overfishing and decreased profits for all fishermen.

Another area where markets fail is with respect to time horizons. Few firms have the luxury to wait 80 years for a teak tree to grow. Consequently, activities with extremely long gestation periods are better undertaken by a public authority with a long time horizon (Case 15).

Most important, markets do not necessarily lead to equity, however measured. This problem is so central to an understanding of the reasons for government intervention that we need to discuss it in greater detail.

Case 15. Time Horizons, Economic Commons, and the Market:
The Thai Furniture Industry

The Thai wood-furniture industry is an example of a putting-out type of organization that was prevalent just prior to the industrial revolution. Carvers at the village level produce furniture at piecework rates for larger firms which then market the furniture around the world.

A major constraint to expansion of the industry is the virtual depletion of teak forests in Thailand, although some teak has been smuggled in from Burma. Since forests are not privately owned, there is no incentive to hoard or self-regulate the cutting of trees. Even were forests private, however, the 80 years needed for a tree to grow to maturity would mitigate against teak planting.

Thus, a Thai parastatal, the Forest Industry Organization (FIO), was developed to regulate deforestation and plant new trees. The FIO has clearly been much more successful at the latter task than the former. Laws regulating the harvesting of trees are honored in the breach. An unregulated industry has destroyed the resource on which it is based.

a. Markets and Equity

It should not be surprising that the market system in itself is no assurance of equity. Indeed, the lesson of the market system is that the strong survive and the weak perish-- which may make great sense for impersonal organizations, but is clearly offensive when applied to individuals. Nevertheless, the market rewards individuals impersonally on the basis of the quantity and scarcity of the assets (be they physical or human) they possess and the efficiency with which these assets are employed. If the distribution of assets is unequal, then the distribution of incomes will be unequal (Case 16).

In LDCs, where a large portion of the population earns its income from agriculture, the distribution of land ownership is a prime determinant of the distribution of income. Incomes will tend to be very unequal if land is primarily owned by large landholders while peasants are forced into small infertile plots, wage labor, share cropping, or tenancy. This is the case in much of Latin America, parts of India, and in a few other scattered areas of the world. In each of our four countries, land is distributed reasonably equitably (peasants have access to sufficient land to maintain themselves and earn a small cash income) and, consequently, rapid growth has meant an increase in the incomes of the people at the bottom.

Since skills are a scarce resource in most LDCs, they tend to be very handsomely remunerated if markets are allowed to function. Thus, in Malawi, where civil service salaries reflect opportunity costs, employees at the top of the wage scale are earning 20 times the salary of those at the bottom of the scale. (A casual glance at the GS wage schedule will indicate

that in the United States the ratio is closer to four to one). Therefore, providing access to skills is not only fair, but it allows the society to expand its quantity of scarce inputs while narrowing the wage differential between skilled and unskilled workers.

Case 16. The Concept of Equity

The whole question of equity can get buried in unhelpful semantic discussions. We are clearly not advocating equality in the Vonnegut sense (in a short story, Kurt Vonnegut describes a society in which equality is mandated by forcing individuals with a superior genetic inheritance to wear millstones around their necks, thus handicapping them in the same way horses are handicapped in a race). Equity, as defined here, must mean equality of opportunity, in a very broad sense.

Thus, how broad is access to education? This need not mean equal educational opportunities for all students. There will undoubtedly be differences between rich and poor, urban and rural. Rather, equity means that the poor, as a group, or a given ethnic or regional group is not excluded from the opportunity to go to school, even if the country can only afford to educate 60 percent of its school-age population. Similarly, equity in land distribution need not mean that every farmer has two acres of land, but rather that large numbers of the rural population are excluded from land-owning when large tracts of underutilized land are not available.

Equity, as defined here, is less concerned with income at the top than income at the bottom. Absolute notions such as standard of living are of greater interest than relativist ones such as the ratio of income of the top 10 percent to the bottom 40 percent. All of this is vague and somewhat unsatisfactory. Nevertheless, in practice, it is not difficult to determine that growth in Korea has been equitable while growth in Brazil has not been.

Finally, a wage policy that resists increases in wages above a market-clearing price leads to greater efficiency, equity, and savings rates. High wages lead to unemployment and a greater differential between urban and rural incomes. Market-clearing wages in labor surplus economies spread the benefits of modern sector employment more widely and keep urbanization from occurring too quickly.

For the most part, Thailand, Costa Rica, Malawi, and Cameroon demonstrate this same case forcefully. In all four countries, land is reasonably widely distributed, access to education is fair and broad, and wage rates reflect the opportunity cost of labor. Consequently, at least for the three countries for which we have data (Malawi, Thailand, and Costa Rica), income distribution compares favorably with other countries of the same region and income level, particularly for the bottom 40 percent (Case 17).

Case 17. Equity and Growth

Simon Kuznets, in a seminal article, noted that European economic history suggests that at the early stages of development, income distribution worsens as growth proceeds, bottoms at some level of income, and then improves. Most cross-sectional studies of contemporary economies confirm Kuznets' observation, now elevated in economics to a "Kuznets curve." However, a recent AID study looking at the limited time series evidence available for LDCs suggests that the Kuznets curve does not hold for half of the countries studied.¹

Examination of World Bank data reveals the following norms:

Average Income Share Going to Bottom 40 Percent of Population

Category	Africa and Asia	Near East	Latin America	Average
Low Income \$380 per capita	15.6 (4)	18.8 (2)	--	16.7 (6)
Middle Income \$380-\$1,390	13.9 (3)	11.4 (1)	7.2 (2)	10.1 (6)
Upper Income \$1390	16.9 (1)	--	11.1 (6)	11.9 (7)
Average	15.1 (8)	16.3 (3)	10.1 (8)	13.2 (19)

Note: Numbers in parentheses refer to number of observations.

Two general observations seem clear: (1) on a cross-sectional basis the Kuznets curve seems to be validated; (2) income distribution in Latin America is generally worse than anywhere else. There are income-distribution figures for three of the countries we have been studying. Looking at the share of income going to the bottom 40 percent, we find that for Malawi that share is 21.5 percent; for Thailand, 17.0 percent; and for Costa Rica, 12.0 percent--all values greater than the mean for their income level and region.

Given the outstanding growth performance of these three countries, the share of income going to the bottom 40 percent would have had to decrease by 42 percent for Malawi, 58 percent for Thailand, and 47 percent for Costa Rica, in order for the poor not to benefit from this growth. Such disparities in income distribution are unlikely, and it is highly probable that real incomes of the poor have grown substantially between 1960 and 1979; however, given the absence of time series data, the actual changes are not calculable.

¹See Crosswell, M., Growth, Poverty Alleviation, and Foreign Assistance, AID Discussion Paper No. 59, 1981.

2. Ideology

All four of the countries which we have examined are predisposed in favor of the market system. Nonprofit-oriented enterprises are the exception rather than the rule. Governments in these countries tend to look toward market signals to allocate resources. Most prices are market determined. This perception of the world is not typical in LDCs. For a number of reasons, which we need not go into now, LDC governments tend to distrust decentralized market systems. This inherent distrust has become an image, a filter which distorts the perceptions of those looking through it.

Once an ideology becomes prevalent in an organization, all information is filtered through it. Those pieces of data which are in conformity with the ideology are allowed to pass through and reinforce the image; conflicting information tends to be discarded. Thus, an ideological view of the world tends to be self-reinforcing. In time, if the ideology does not allow the real state of events to be observed, it becomes increasingly disfunctional, and more and more messages are received which indicate the vulnerability of this image. Eventually, the weight of evidence is so great that the image cracks, and a new one is built based on all the new information. Ideologies consistently distort perceptions of reality and thus lead to bad decisions. Ideologies are the antithesis of pragmatism. The four countries we have examined have been, in general, pragmatic--searching for what works and discarding what doesn't work. More often, governments reject the pragmatic for the doctrinaire.

Ideologies not only affect the way in which the ideologue views the world, but also the way in which the world views the ideologue. For example, Malawi is widely believed to be a capitalist country, yet the Government has effectively nationalized or obtained a large ownership share of most large-scale enterprises in the country. Both the transnational firms and the Government are satisfied with this "partnership" arrangement. Such an arrangement--private foreign investment coupled with Government participation--would be ideal in Zimbabwe. But in Zimbabwe it would be called "socialism" and the rhetoric, if not the substance, would probably scare off potential investors.

3. Markets and Politics

Ultimately, economic objectives are not the most important considerations faced by the political leadership. For most politicians, the top item on the agenda is to stay in power. This objective is closely followed by a set of subobjectives

intended to ensure the survival and vitality of the nation-state both with respect to foreign enemies and internal political threats. Adam Smith himself had occasion to say, "Defense is more important than opulence." One may rephrase this dictum for today's developing countries as "national integration is more important than maximum efficiency."

For the newly independent, uncertain, heterogeneous states of Africa, nothing is more important than forging political unity and respect for the new political institutions. To achieve this goal requires ensuring relatively equal regional and ethnic development. Even in the older states of Latin America and Asia, centrifugal forces coupled with a tradition of violent changes in government are prevalent, and political stability is the paramount objective.

To be sure, political stability is linked in some rather complicated ways to economic progress. A failure to provide demonstrable economic progress in an era of rising expectations is destabilizing; however, so is rapid growth from which certain populations are excluded. Growth does not need to be equal, it needs to be perceived as "equitable." People need to feel that they will be able to better their lot, that the fruits of growth are not being denied them on the basis of group affiliation. In particular, people need to perceive the possibility of progress. Exclusion of an ethnic group, a region, or a class will lead to great political tension.

Thus, governments frequently make decisions to interfere with market outcomes in order to achieve some political objective. One common example is the need to distribute economic activity more broadly geographically, counter to the normal market tendency to foster geographic concentration of investments. For example, Cameroon, Malawi, and Thailand all have policies to encourage private investment in the poorer regions of the country.

As in any polity, decisions are often taken which benefit a particular, powerful group rather than the nation as a whole. Since urban workers are more politically powerful than peasant farmers, LDCs frequently distort markets by subsidizing the urban proletariat (high wages, food subsidies, subsidized housing, etc.), despite the unfortunate effects of such a policy on rural income and on the growth of slums and urban squalor.

Finally, politicians, like the rest of us, are strong believers in Keynes' epigram, "In the long run, we are all dead." Consequently, many decisions are taken to achieve short-run goals, even when long-run prospects are thereby threatened. Thus, a short-run policy to finance fiscal or balance of payments deficits is undertaken, even if the long-run debt burden increased thereby becomes unmanageable.

Thus far, our examination of the private sector in economic development has led us to the following conclusions:

1. There is a wide variety of economic organizations that act as productive units in LDCs.
2. A distinction between market-oriented and nonmarket-oriented enterprises is more meaningful than between private and public.
3. Markets are, in general, efficient mechanisms for allocating resources, and failure to heed market signals can lead to economic crises.
4. Nevertheless, governments frequently distort or ignore market signals, either because of ideology, market failure, or superseded political reasons.
5. When public intervention corrects or offsets market imperfections it can improve economic efficiency and growth; when public intervention worsens market imperfections or creates new uses, it tends to impair the functioning of the economy for the benefit of most people.

It seems that our study must turn to the place where the first economists started the relationship between politics and economics--political economy.

IV. THE POLITICAL ECONOMY OF DEVELOPMENT

A. Political Systems

Historically, liberal democracies and laissez-faire market systems have tended to go hand-in-hand. The pluralism of the market reflects the pluralism of democracy. However, despite the clear sympathetic resonances between the two systems, a democratic political process is neither a necessary nor sufficient condition for the existence of a market system. Of the four countries we studied, Costa Rica is the only one that can be labeled a democracy; by almost any measure, Costa Rica's democratic heritage is one of the strongest and oldest in the world. Yet of all the countries we studied, Costa Rica has moved away from market solutions more fundamentally than any of the others. This is not to say that the Government is more pervasive in Costa Rica than elsewhere, only that the particular political choices that were made have distorted market signals in one vital area--the relationship between domestic and foreign prices--and thus distorted the resource allocation process throughout the economy.

Conversely, the political regimes in Cameroon and Malawi (Case 18) are authoritarian, with power in each country concentrated in the hands of one man. Despite a very centralized political structure and the pervasiveness of Government influence throughout the economy, both countries have generally followed market-oriented policies and have countermanded the dictates of the market only where market failure was obvious. The resultant centralized allocations were not pervasive enough to distort economic allocations throughout the economy. Small inefficiencies are acceptable for political reasons; it is the large inefficiencies that must be avoided.

Case 18: The Benevolent Autocrat: Ahidjo and Banda

The political strengths of Malawi's Life President, Hastings Kamuzu Banda, and Cameroon's President, Ahmadou Ahidjo, are very similar, not only to each other, but also to other autocrats past and present such as Ataturk of Turkey and Prime Minister Lee of Singapore. Both Banda and Ahidjo stand at the pinnacle of power (Banda has four ministerial portfolios in addition to the Presidency) and both intervene in decisions large and small. Both have expressed a coherent political philosophy, and both have consistently pursued their goals despite internal and external opposition.

Ahidjo's Cameroon is made up of over 100 diverse ethnic groups with two distinct colonial heritages and three religious backgrounds. Therefore, the primary objective had to be the creation of a nation-state and the forging of loyalties to the nation-state. Ahidjo's task was no less than legitimizing the very existence of Cameroon. The political strategy for achieving that goal was to spread development evenly (especially among ethnic and regional groupings), promote order and discipline, extend political control to the economic sphere (when necessary), and to move slowly when major decisions were being made (the "tortoise walk").

Malawi was a much more homogeneous society. Its major problem was development in a region that was suffering from the conflict of nationalist and colonial ideologies. Southern Africa, after all, has been the major battlefield of decolonization in Africa. Banda's response was to reject ideological posturing and to put Malawi's development before vague anti-imperialist ideologies. He has said that he would deal with the devil to further the interests of his people. In many eyes, he has done just that. Not only are the pariah embassies of South Africa, Taiwan, and Israel welcome in Malawi, but he has felt no compunction in using expatriate capital, skills, and technology when he felt they were necessary to economic development.

Neither Ahidjo nor Banda have an ideological commitment to the market or private enterprise. Their economies are mixed in almost every sense. Where market solutions conform to their purposes, they let markets work; where market solutions might be politically unacceptable, then markets are put aside, and centralized decisions are made. Since markets more often work than not, their economies are largely market oriented, but out of pragmatism, not ideology. The results could offend the market purist, but they generally work.

-- democracy does not necessarily lead to the legitimacy of market systems, neither does it imply constant political interference in economic decisions. Indeed, one of the strengths of the democratic system is its ability to transform itself from one set of belief systems, or ideologies, to another. Sri Lanka and Jamaica, like Costa Rica, are representative of democracies which have paid great attention to equity and to the welfare of the people at the bottom. In both Sri Lanka and Jamaica, this equity orientation was accompanied by a socialist ideology which led to a number of unfortunate economic decisions. In both of these countries, despite violence and civil disorder, the democratic system was strong enough to change the fundamental direction of the economy, to replace doctrinaire socialism with a more pragmatic market orientation, and, it was hoped, to move back from the brink of disaster.

Similarly, autocracy without both benevolence and wisdom is a formula for disaster. The various authoritarian regimes in Ghana, Zaire, Guatemala, and Bolivia, for example, have combined the power to make unsound decisions with the ruthlessness to make inequitable decisions based on a fundamental ignorance of the relationship between the decisions they make and their likely outcomes. Sometimes, of course, ignorance and malevolence work at cross-purposes. More often, the result is disastrous.

Consequently, it seems that the type of political system is not a good predictor of the success of economic decision-making. If substance is not predictive, perhaps style is.

B. Political Style

If political systems do not determine political behavior, then they are not useful guides for distinguishing between polities. Are there other, more useful measures? We will discuss three such distinguishing features--image, confidence, and authority--and group them under the category of political style. It is this set of characteristics which explains the success of the disparate regimes in Malawi, Cameroon, Thailand, and Costa Rica in promoting economic development.

1. Image Strength

We have already discussed the question of the effect of ideology on economic decisionmaking. The variable being considered here is the strength of the leadership image--the degree to which ideological beliefs are held so strongly that new information is screened or rejected. Thus, a strong "image"

means a strong ideology and vice versa. Ideology, of whatever stripe, is the enemy of pragmatism, and pragmatism is the key factor in effective policymaking. To a large extent, all four of the countries we studied were pragmatic in their approach to public policy.

2. Confidence

Too often, new, emerging LDC governments lack the confidence to shed ideology, nationalist images, and historical grievances, which limits the ability of the governments to take the actions necessary for success. These four governments have the confidence to limit the pace of localization to the development of local skills. Few governments are willing to shed their nationalist credentials and do business with the "devil itself" if necessary. Few governments are able to accept certain Western cultural attributes as vital to economic development.

Gustav Jahoda once did a study of racial attitudes in Ghana. He learned that the attitudes of Ghanaians toward Europeans took one of three forms:

1. A complete acceptance of everything white as successful (because whites were seen as representing a different level of humanity, given the magical tools they had).
2. A rejection of everything white (accompanied by self-loathing and deep feelings of inferiority).
3. An ability to synthesize what is valuable in European culture with what is valuable in traditional culture.

In general, these views were correlated with education--the poorly educated being in the first group, the partially educated in the second, and the fully educated in the third group. Nations, like individuals, have a set of attitudes ranging from awe to xenophobia to maturity. For each of the four countries examined, confidence is a hallmark of leadership style, and goes hand-in-hand with a weak ideology in forming pragmatic responses.

3. Authority

Governments may pursue the right policies, but they will be ineffective if they do not possess the authority to mobilize citizen action in support of development. Weak governments,

where tax evasion, corruption, and bureaucratic incompetence are pervasive, are not likely to be effective in implementing their policies. Strong governments require an efficient and competent bureaucracy as well as a political mobilization system that can translate moral suasion into citizen action (Case 19).

Case 19: The Art of Political Mobilization: The Malawi Congress Party

One of the most effective institutions for mobilizing local-level activity is the political party. In a one-party state, the party often rivals the government as both an administrative arm at the local level, and as a channel of communication between the people and its leaders. The Malawi Congress Party (MCP), together with the women's and youth organizations, is an extremely effective instrument for consolidating Dr. Banda's political power.

The party has three primary functions: (1) it mobilizes local resources behind self-help projects, political rallies, and consciousness-raising sessions; (2) it acts as an informal pressure device to ensure political conformity, suppressing political opposition and resistance to government policy; and (3) it channels grievances to the leadership, where, if possible, they are addressed and responded to.

The effect is striking. There are 1 million taxpayers in Malawi, most paying a head tax of \$5 per year. Price controls are enforced in rural areas. Most development projects in education and water have a local self-help component built in. National campaigns to plant trees or tend one's garden are successful. Grievances are responded to against individual politicians or unfair allocations. (For example, a corrupt politician in the Northern region was beaten by his constituents. This expression of displeasure led to his being removed from his post.) The virtues of hard work, discipline, loyalty, and obedience are widely accepted.

Of course, authority and performance go hand-in-hand. If the government is able to deliver on its promises, it is more likely to be able to generate public support. When a government's writ ends at the capital city limits, it is not surprising that policies are not implemented.

C. Exogenous Variables

If leadership style factors (image, confidence, and authority) are the primary determinants of political behavior, contextual factors help set the goals of political behavior. These contextual variables, the cultural, geographical, and historical heritage, are vitally important. In Cameroon, cultural diversity made national cohesion a vital goal. In Thailand, the external threat of Communist subversion has made development of the Northeast a vital factor. In Malawi, dependence on South Africa as a provider of goods and a market

for labor necessitated a pragmatic foreign policy and a resistance to doctrinaire nationalism. A homogeneous population and a democratic heritage led Costa Rica to follow a policy emphasizing equity and social programs.

D. Conclusions

Ultimately, political choices center about the way in which economic growth is to occur and the distribution of that growth among competing uses. In sharply heterogeneous societies, either with respect to class, region, or ethnicity, equity considerations are paramount. Any country in which groups of people are excluded from access to the benefits of growth is likely to exhibit political tensions that may undermine political stability. Thailand and Cameroon are examples of countries in which regional and ethnic equity form a major goal of public policy.

In Malawi and Costa Rica, the populations are more homogeneous. Malawi's endemic and widespread poverty led to concentration on growth rather than distribution. Costa Rica's advanced income level and broad middle class led to concentration on considerations of interpersonal (not intergroup) equity. For all four countries, growth was also a major goal.

In all of these countries, governments took actions which were counter to market principles--either to further regional integration (as in Cameroon), to increase the participation of the indigenous people (as in Thailand), to control an economy dominated by expatriate firms (as in Malawi), or to respond to the political power of import-substituting industrialists (as in Costa Rica). Sometimes these policies were effective, often they were not.

In order to control the direction the economy took, governments developed institutions to regulate, plan, and participate directly in the production process. In Thailand and Costa Rica, these state enterprises were almost always inefficient. However, in Malawi and Cameroon, the opposite was the case. By most measures, parastatals in Malawi and Cameroon were efficient, promoted growth, and allowed the Governments to ensure that growth followed the desired path. The difference between the two sets of countries seems to be the degree to which the parastatal was forced to face the music of the marketplace. On the basis of our study, there is no evidence that market-oriented parastatals perform any worse than private organizations.

However, the greater the degree of government involvement in the economy, the greater the danger of government participation in enterprise decisionmaking. In both Malawi and Cameroon,

parastatals are largely managed by expatriates. In Costa Rica and Thailand this is not the case. When Malawi moved to localize management, parastatal performance declined precipitously, not so much because Malawian managers were incapable as because they were more beholden to the political system for their positions. Consequently, decisions were taken for political rather than economic reasons, and the result was near disaster. It is another example of Malawi's flexibility and pragmatism that this trend was reversed and new management was put in place. This danger of politicization (which the political leadership sees as an opportunity) plagues parastatals in all economies.

In fact, in every society, economic decisions tend to be subordinated to politics. The more direct the involvement by the government in the economy, the more likely is it that this tendency will be translated into a pattern. It is less the politicization of economic choices that is dangerous than the substitution of a particular benefit over the general benefit, or the immediate good over the longer term good. Where the government is responsive to the national welfare, and where it is not constrained by a strong ideology, political interference is likely to be less harmful. Thus in Malawi and Cameroon, the coherent political visions of Ahidjo and Banda have led to Government actions which were measured and rational.

V. THE NATION STATE IN THE WORLD ECONOMY

For these four countries, as for the vast majority of LDCs, the international economic climate puts limits on the shape and pace of their growth. Two areas are particularly important--trade and capital markets. Being relatively small and largely underdeveloped, the countries of the Third World, with a few exceptions such as India, must rely on imports of key commodities which they do not produce themselves (Case 20). These commodities include raw materials, such as fuels and metals, and capital goods, which are produced primarily in the developed world. Without these imports, growth cannot proceed. In order to obtain the imports, hard currencies must be acquired, either through exports or through the flow of capital. Let us look at each of these possibilities in turn.

A. International Trade

For most LDCs, trade is a vital part of the economy. The four countries studied here export, on average, about 25 percent of what they produce. Despite progress in manufactured exports, agricultural products remain the most important export commodities in all four of them. The value of this trade depends on

their ability to produce exports in quantity and on the strength of the market for primary products in the developed world. In the last decade, the two oil price shocks of 1973 and 1979 have substantially destabilized the international economy.

Case 20. An Increasingly Interdependent World

Between 1960 and 1979, World Trade grew at an annual rate of 6.5 percent, while world production was growing at only 4.5 percent. As a consequence, 72 percent of the countries for which we have data show exports as a larger percentage of GDP in 1979 than they were in 1960. Moreover, an increasing proportion of exports from the Third World are in manufactures rather than primary products.

In 1970, the current account deficit of oil-importing developing countries was \$18.5 billion; by 1980 it had tripled to \$58 billion. Over the same period, total LDC debt had risen from \$50 billion to \$294 billion. In 1978, there were 13 countries, ranging from Upper Volta to Bangladesh to Yugoslavia, which were earning very substantial amounts of foreign exchange from workers' remittances.

As a result, an increase in interest rates in the United States has a profound effect on the economies of many LDCs. Conversely, a weakening in oil prices which reduces foreign exchange earnings in Mexico can have a substantial effect on financial markets in the United States. The two oil shocks of 1973 and 1979 caused large inflows of cash into the oil exporting countries, some of which was spent on increased imports, but most of which was recycled in world financial markets. That cash was then lent in large quantities to the LDCs to help pay for the oil. Since then, the pigeons have been coming home to roost as more and more LDCs find themselves with debts they can no longer service. The world has become very small and very interdependent. This has great advantages, as the specialization of labor is extended, but it also means that the LDCs are increasingly vulnerable to events in the industrial world over which they have no control.

In the first place, the price of oil increased by a factor of 10 over the last nine years. Since petroleum products are connected to all sectors of production, a secondary effect was to accelerate price increases everywhere. As the developed world slowed down its own economic growth to fight inflation, a recession ensued, and the world found itself beset by both a rise in prices and a decline in aggregate demand.

For the LDCs, the impact has been devastating. World inflation has raised the prices of their imports. Recession, by decreasing demand, has lowered the price of their exports. The result has been a serious downturn in their terms of trade--the quantity of imports they can buy for a given quantity of exports. There are no good estimates of the terms of trade losses faced by the LDCs as a whole, but declining terms of trade have had substantial adverse impacts on Malawi, Thailand, and Costa Rica. For each 4 percent decline in the terms of trade, real GDP declined by 1 percent (assuming exports and imports are 25 percent of GDP). In a given year, a 12 percent

inflation rate for imports coupled with a 15 percent decline in the average price of exports would mean a 6 percent decline in real GDP. President Reagan's statement that the most important thing the United States can do for the Third World is to get its own economy on track is profoundly true.

Not only do world recession and inflation lead to slower growth in the LDCs, but they create pressure for greater protectionism in the United States and elsewhere. The U.S. sugar quotas, imposed earlier this year, threatened to reduce the value of sugar exports from LDCs (Case 21). Malawi and Thailand are sugar exporters, and Malawi, in particular, feels it may be hurt by the new U.S. policy. While estimates of the quantitative impact of sugar quotas vary, there is little doubt that the loss of export earnings in Malawi offsets in large measure the \$8 million in U.S. concessional assistance.

Case 21: The World Sugar Market

There are currently three world sugar markets--the European Economic Community (EEC), the United States, and the rest of the world. Prices in the first two markets, due to restrictions on entry, are higher, perhaps double the price in the third market. Those exporters with access to the U.S. and EEC markets earn considerably more than those with more limited access.

Recently the United States restricted entry to a greater extent than previously, and also increased import duties. The restriction probably counteracted the increased duty, making the U.S. market as lucrative as previously. But the restriction in imports threw a great deal more sugar into the third market, thus depressing the price even further. The quantitative impact of this policy is not known and will vary from country to country. It is probably not large enough to dwarf concessional assistance flows, but does represent a significant counter-balance to them.

Perhaps the most important policy decisions LDCs take are in the area of trade and industrialization (Case 22). Policies which favor inefficient patterns of import substitution, particularly through the use of quantitative restrictions and overvalued exchange rates, have led to substantial inefficiencies. However, dependence on traditional exports, especially when the range of commodities is narrow, has not, in general, been successful in the long run. The fall in tobacco prices in Malawi, rice prices in Thailand, and coffee prices in Costa Rica has precipitated financial crises in all these countries. In Sri Lanka, dependence on tea, rubber, and coconut prices led to a situation in which terms of trade losses between 1960 and 1980 amounted to 38 percent of 1960 GDP. As a result, consumption per capita in Sri Lanka in 1980 was 11 percent lower than it was in 1960.

Case 22. Export Promotion vs. Import Substitution: The False Dichotomy

For years, economic policy in LDCs has been cast in terms of the choice between export promotion and import substitution. Raoul Prebisch, writing in the 1950s, suggested that for a number of reasons, the prices of primary products would tend to decline secularly over time vis-a-vis the price of manufactured goods. Consequently, LDCs would face continually declining terms of trade. Prebisch, writing as chief planner in the UN Economic Commission for Latin America (ECLA) was very influential. His dual policy prescription of import substitution and regional economic integration formed the basis of economic ideology of Latin America.

But the argument is incorrectly stated. The question is not import substitution vs. export promotion, but rather what type of import substitution and what type of export promotion. The growth of a manufacturing industry is vital for development. (Manufacturing grew at an annual rate of 6.7 percent in Malawi, 5.2 percent in Cameroon, 11.5 percent in Thailand, and 8.8 percent in Costa Rica between 1970 and 1979.) Manufacturing output is either exported or sold on the domestic market; i.e., either exported or used as substitutes for imports.

In the early stages of development, there are many industries in which efficient import substitution is possible. In Malawi, the range is greater due to the natural protection of inland transport costs. However, since manufacturing tends to grow faster than overall income, import-substituting possibilities tend to erode. This is certainly the case in the Costa Rica textile industry, while it is not yet the case in Malawi. It is when easy import-substituting possibilities are no longer available that important choices must be made: to continue import substitution by protecting industries, to attempt to increase the amount of processing in primary exports, or to move to develop exports of manufactured goods. It is the last choice which requires the most skill and offers the most promise.

The most successful LDCs have been those that have been able to develop nontraditional export industries. Between 1970 and 1979, total LDC exports grew at 5.2 percent while manufactured exports grew at 14.0 percent. The proportion of manufactured exports to total exports in Brazil grew from 8 percent in 1965 to 49 percent in 1981. Of course, it has been the middle-income countries, the gang of four (Taiwan, Hong Kong, Singapore, and Korea), and Brazil in which manufactured export growth has been pronounced. However, Thailand, Costa Rica, Cameroon, and even Malawi have prospects for increasing their nontraditional exports. To a large extent, future prospects for nontraditional exports in LDCs depend on access to industrial country markets. When a world recession threatens, the typical response is to restrict access rather than expand it.

B. Capital Flows

A second result of the oil shocks of the 1970s was to flood financial markets with petro-dollars. Banks were searching for borrowers. For most of the 1970s, real interest rates were low, given the high rates of inflation. The result was

massive borrowing by the oil-importing LDCs. Table 5 illustrates the dramatic changes in international capital flows over the last two decades.

Table 5. Composition of Real Net Capital Flows to LDCs, 1960-1962 and 1978-1980 (billions of 1978 dollars)

Category	1960-1962	1970-1980
Official Development Assistance	14.75	25.84
Other Official Nonconcessional	1.75	9.88
Private, Nonconcessional	8.50	40.28
Direct Investment	5.00	10.64
Export Credits	1.75	9.88
Financial Flows	1.75	19.76
Total	<u>25.00</u>	<u>76.00</u>

Source: Organization for Economic Cooperation and Development.

The tripling of capital flows into the LDCs has helped to offset the effects of the decline in the terms of trade, as well as the effects of bad economic policy. However, the increased borrowing in commercial markets at interest rates exceeding 15 percent is only tenable in a time of inflation. If export prices fall (as they have for most primary producers), the real resource cost of debt service rises, and the ability to import decreases. The result is slow or no growth. Consequently, there was a rapid rise in IMF financing arrangements, from 420.6 million Special Drawing Rights (SDR) in 1977 to 3,381.8 million SDRs in 1980, and an increase in the pressure for debt rescheduling, of which Costa Rica is only one instance.

C. Concessional Assistance and the Role of Donors

The importance of capital flows from the developed to the less developed world cannot be overstated. In 1978-1980, \$25 billion of capital, roughly \$3 per capita, were provided on concessional terms to the countries of the Third World. In

Malawi, which is an extreme case, concessional assistance, mainly from the United Kingdom, financed one-third of all investment as well as one-third of all imports. Without this volume of assistance, GDP per capita in Malawi would be roughly one-third less than it is today. While donors tend to concentrate on projects and technology change, the macroeconomic effects of capital flows of this magnitude are very important.

1. Donor Interventions in Capital Markets

Donors have helped to create investment-finance institutions in three of these countries. The history of these intermediary institutions is mixed. INDEBANK in Malawi has been a substantial success; COFISA in Costa Rica, a measured success hindered by bad macroeconomic policy; and IFCT in Thailand, a vital and imaginative component of the credit market (Case 23). The counterpart institution in Cameroon, BCD, which has had little donor involvement, seems to suffer from management problems and to be somewhat less effective in getting credit to where it is needed. It has apparently been the donor's expertise more than its credit that has been responsible for success.

Case 23. The Development Bank: INDEBANK and IFCT

The Investment and Development Bank of Malawi (INDEBANK) is a private development bank established by IFC, The Commonwealth Development Corporation (CDC), and the Dutch and German counterparts to the organization. Small, even by Malawi standards, its influence is much greater than the size of its portfolio, which in 1980 consisted of equity participation in 17 corporations and secured loans to 36 separate firms. INDEBANK's influence stems from its excellent management cadre--mainly British, German, and Dutch managers. The present general manager, originally seconded from CDC, has just been appointed head of troubled ADMARC, while the original general manager was recently asked to be acting general manager of Press Holdings Ltd., until a new manager could be found.

The Industrial Finance Corporation of Thailand (IFCT) is a development bank which was established in 1959. Its owners are the Thai Government and donors such as IFC, the Asian Development Bank, the German Finance Company, and the Japanese Import-Export Bank. IFCT makes loans of medium maturity to medium-scale industry. IFCT has subsidiaries which participate in capital leasing activities, and in 1975 it set up the Mutual Fund Ltd. to try to channel private savings directly into productive enterprise. The IFCT has been active in developing an underwriting industry, and it manages the billion baht Capital Market Development Fund designed to inject more capital into Thailand's stock exchange.

Less conservative than commercial banks, development banks are designed to take risks on the basis of expected future returns (collateral is not necessary). Thus, they are a source of finance for new ventures rather than expansion for old ones, and therefore aid the entrepreneurial firm.

In a well-functioning economy, credit gets channeled to where it is most productive. This is partly a function of good policy (let the market work) and strong institutions. However, as we've seen, informal credit institutions are particularly effective in most countries in meeting credit needs for borrowers at the lower end of the spectrum. If policy is correct and institutions are working, then capital provided by donors to a credit institution is no different from capital provided to the central bank or to the government. Increasing the flow of resources increases the amount of savings which increases the amount of credit.

Thus, the contribution of donor assistance for specific credit interventions would appear to lie in these areas: to help develop institutions, to reform policy, or to improve management. The financial assistance is less important than the other changes. The success of donor programs in capital markets is basically due to the high level of management skills provided.

Direct involvement in a particular firm can be successful. In most instances, the objective of donor assistance is to lower the risk by broadening the participation. After all, loans are available to financially sound investment prospects. Direct investment or loans by international financial institutions to firms in Malawi have, in general, been successful.

An examination of a successful international finance company, CDC (see Case 24) indicates that a donor agency such as USAID is not the appropriate place for the financing of private enterprise development. Rather, there are good reasons for the creation of a separate, autonomous agency which can lend at market rates, control its reflows, borrow from public and private sources, participate directly in the management of LDC firms, be freed from bureaucratic procedures designed to protect the taxpayer, and be isolated from foreign policy interests.

2. Donor Intervention in Skills and Management Training

Donor interventions in education, at whatever level, raise the stock of human capital, increase productivity and profitability, and increase equity. However, the labor market is as segmented as the private sector. MBA training is only useful in staffing large managerial enterprises. Providing simple training in accounting and inventory control will aid the proprietary end of the spectrum. Similarly, somewhat more sophisticated training in the area of production techniques, basic management, and cost accounting will be of use to the entrepreneurs.

Case 24. An International Finance Company: CDC

The Commonwealth Development Corporation (CDC) is the British parastatal devoted to promoting private enterprise in the Third World (originally in the Commonwealth). CDC was established with no funds, but with a writ to borrow from the British exchequer at rates somewhat below market rates. These funds were then reinvested or loaned to companies and financial institutions throughout the Third World. Working like a commercial firm, CDC tries to borrow low and lend high enough to assure a profit and an expansion of its portfolio, which is currently about \$1 billion.

CDC is active in all four of the countries we have investigated, but its range of activities in Malawi is broader than elsewhere. CDC has had an interest in INDEBANK; the sugar industry; David Whitehead textiles; the National Seed Company; Standard Tobacco Packers; Malawi Hotels; the Blantyre Water Board (a parastatal); Mandala Ltd. (a rubber plantation); the Electricity Supply Commission (another parastatal); and smallholders of tobacco, sugar, tea and coffee.

Technical assistance is provided by the British aid agency (ODA) with which they cooperate, and frequently personnel are seconded from one to the other. CDC's representative in Malawi is on the board of 23 corporations in both the public and the private sector, and has management responsibilities for a number of these enterprises.

It is not serendipitous that the British, like almost all donors, separate their aid agency from their private enterprise-development financial institutions. There are a number of compelling reasons for this separation:

1. The need to deal with profit-making institutions on commercial terms. Thus it is inappropriate to provide concessional assistance to private firms, to require aid-like documentation, or to commit them to tied procurement.
2. The need to disassociate donor governments from management decisions in private firms. It is appropriate for CDC, an autonomous parastatal, to be represented on the board of 23 Malawi companies; this would not be appropriate for a USAID Mission Director.
3. The need for the finance company to have control over reflows without treasury authority being required for new borrowings.
4. The need to be able to borrow from private sources if desirable
5. The need to be insulated from foreign policy interests.

In Thailand, which has a long history of U.S. influence, training degree students in the United States has had a profound influence on the basic outlook of key managers in the economy and must have had an impact on public policy. In Malawi, over the 1963-1969 period, the Peace Corps made up 70 percent of the secondary school staff.

There are no general rules relative to skills training. Skills of all kinds are in scarce supply (different scarcities

in different countries). Investments in training frequently have high payoffs, but each project must be examined on its own merits. The benefits of training and education are broader than their effects on labor markets. Changing values, broadening perceptions, and the development of an analytical approach are all impacts which can have a widespread effect on behavior and policy formation. If such changes are desired, it requires a long-term, consistent, and substantial program in particular institutions or sectors. USAID's agricultural education and research programs in India, and the influence of the University of California at Berkeley in Indonesia and the University of Chicago in Chile are all examples of successful, long-term, consistent training policies.

3. Donor Intervention and the Provision of Information

We generally lack information on donor interventions in the area of information. However, almost all the country studies point out the need for specific technical assistance in a broad range of organizations, particularly in financial intermediaries. Technical assistance of this sort has two functions: (1) it provides detailed and specific help in areas where such specialized knowledge is unavailable, and (2) it helps insulate indigenous managers from political pressures.

One area of special promise is promotion of nontraditional exports. In a reasonable policy environment, there are certainly manufacturing industries in which low-income countries have a comparative advantage. The need to improve the efficiency of production techniques and to develop export markets remains the main constraint. Technical assistance in these areas is not often available locally, and returns to such information could be very large.

VI. CONCLUSIONS

The four private sector evaluations undertaken by AID in Malawi, Cameroon, Thailand, and Costa Rica contain a great deal of information on the process of economic development, the role of private enterprise production activities in that process, the importance of free and competitive markets, and the possibilities of donor intervention to affect the speed and direction of economic development.

These studies have revealed that the "private sector" is a grouping that includes a wide variety of organizations and enterprises differing in degree of private ownership and indigenous participation, in size, and in organization. Not

surprisingly, these "private" enterprises have much in common with each other and much that is particular to the enterprise type. Consequently, public policies and donor interventions may have beneficial effects on one type of enterprise and harmful effects on other types. The issue then becomes, not "Up with the Private Sector," but "Which Private Sector?"

Secondly, the studies clearly point out that free and competitive markets are efficient institutions for allocating resources. In certain areas, particularly with respect to the prices of foreign exchange, labor, agricultural commodities, and credit, interfering with market signals can lead to profound misallocations of resources, with dire effects on outputs and incomes.

Nevertheless, governments frequently intervene in the working of markets--setting or controlling prices, imposing quantitative restrictions, subsidizing some activities and taxing others. In some cases, these interventions are consonant with economic theory which identifies numerous areas of market failure. At other times, goals other than economic efficiency are predominant in the government's political agenda. Sometimes, ideology or ignorance takes precedence over common sense.

In all of these countries, economic policy and economic ideology seem unconnected to the existing political system. Moreover, success was frequently the result of pragmatism, caution, and flexibility rather than the dogmatic adherence to a political or economic philosophy. In general, these countries followed policies that worked and were able to change or withdraw from policies that failed.

Three of the four countries found themselves tested by a downturn in their economic fortunes in 1979. In Malawi, Costa Rica, and Thailand, mistaken policy choices of varying severity were combined with a deteriorating international environment to create an economic crisis. In Costa Rica, the crisis threatens bankruptcy. In Thailand and Malawi, internal policy changes combined with substantial international assistance may avert disaster. In any case, the deteriorating international economy suggests the need to review policies that have worked in the past.

Donors wishing to encourage private sector growth find themselves in an anomalous situation. In the first place, market solutions imply that the only way to encourage private sector activity where it is lacking, given free and competitive markets, is by means of a subsidy. Does this undermine the very private sector we are trying to support? Second, any direct involvement with particular enterprises or institutions requires actions which a government body such as AID must be

cautious about undertaking directly (here the model of a separately financed institution is intriguing). Third, interventions need to be chosen to address constraints, and in most countries we know precious little about the constraints inhibiting the growth of proprietorial, entrepreneurial, and managerial firms. Fourth, interventions need to be targeted to that segment of the private sector we are interested in supporting.

Despite these caveats, there is little doubt that the private sector of most economies is the focal point of development. As a donor, our role should be to facilitate the expression of the creative energies within the private sector by working with host governments on ways to both provide needed help (infrastructure, human capital, credit institutions) and reduce unneeded hindrances to market activities. Frequently this means helping governments get out of the way, an unaccustomed role for a government agency.

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