PRELIMINARY ASSESSMENT OF THE STATE OF THINKING AND RESEARCH ON CREDIT AUTHORITY

PREPARED FOR
THE BUREAU FOR PRIVATE ENTERPRISE

PREPARED BY
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INTRODUCTION

The Bureau for Private Enterprise (PRE) is interested in conducting a study to examine the issues underlying the use of credit versus grants, and in what cases each of these modalities is most appropriate for development assistance. PRE is currently exploring the idea of working with a notable think-tank or research institution to conduct this study. Before selecting an institution to do the study, PRE requested that Coopers & Lybrand conduct preliminary research to assess the state of thinking and research on the use of credit authority. This report summarizes the findings and conclusions of this preliminary research.

The research involved two primary activities: (i) contacting a number of the leading think-tanks and universities to discuss whether they had conducted research on credit authority, and if so, what were their conclusions; and (ii) conducting a literature search on the use of credit authority in development assistance programs. In carrying out the first task, Coopers & Lybrand contacted 13 of the leading think-tanks and universities. These institutions include the following:

- American Enterprise Institute
- The Brookings Institution
- Carnegie Endowment for International Peace
- Cato Institute
- Center for Strategic and International Studies
- The Heritage Foundation
- Institute for International Economics
- Overseas Development Council
- Rand
- The Urban Institute
- MIT
- Harvard University
- Stanford University

C&L's discussion with each of these institutions focused on the following questions:

1. Has the institution conducted research or published studies on the use of credit authority, and if so, has it developed a specific position on the use of credit versus grants?

2. Who are the key individuals within the institution familiar with credit authority and/or development finance issues? What kind of research have they done on the issue and what are the key conclusions of their research?

3. Will foreign assistance be a significant part of the institution's "agenda for the next administration?"

This report is comprised of three parts: (i) a summary of findings and conclusions of the preliminary research; (ii) a series of one-page descriptions of C&L's discussions with each of the institutions contacted; and (iii) an annotated bibliography of publications that examine the use of credit authority.

SUMMARY OF FINDINGS AND CONCLUSIONS

1. There has been very little research done on the use of credit versus grants in the context of development assistance. Some reseachers have looked at credit authority with respect to U.S. domestic programs and often have strong views on the use of credit for development assistance. In general, they are not supportive of the use of credit to finance development assistance.

2. None of the think-tanks or the universities that we contacted have developed a specific position on the use of credit authority. As a Senior Fellow at the Brookings Institution noted, it is unlikely that a think-tank would take an "institutional position" on an issue like credit authority. However, many of the institutions do have a position on foreign assistance more broadly.

3. Two individuals who have examined credit issues extensively are Barry Bosworth and William Gale at the Brookings Institution. Their research on credit issues has focused on U.S. domestic credit programs. Both Bosworth and Gale were skeptical, at best, on the use of credit authority for development assistance. Bosworth thought that credit programs to promote economic development would be a "bad mistake".

4. The responses of individuals at the other major research institutions fell into essentially four groups:

    a. Representatives of the Overseas Development Council and the Center for Strategic and International Studies (CSIS) noted that they had not examined the use of credit versus grants. Nonetheless, they thought it was an interesting question and one that warrants consideration. Ambassador Ernest Preeg of CSIS was particularly interested in the study because of his interest in seeing USAID finance capital projects. However, as noted by Ambassador Preeg himself, CSIS has limited in-house expertise on development policy issues; indeed, he is the only individual in CSIS with such expertise.

    b. Representatives of the Heritage Foundation and the Cato Institute expressed negative views on foreign assistance in general. They believe that foreign aid has been ineffective, if not counterproductive, in promoting economic development. Whether aid is provided in the form of a loan or a grant is of little significance in their view.

    c. Neither Rand nor AEI have focused on development policy issues in recent years, and hence, would probably not be appropriate institutions for carrying out the credit authority study. A few scholars at AEI have looked at foreign aid more broadly and are critical of its impact.

d. The development finance specialists at both the Institute for International Economics and the Urban Institute have been away over the past two weeks. Hence, it is too early to come to any firm conclusion on these two institutions.

5. An issue that emerged during our discussion with the Brookings Institution was that it is extremely rare for a major research institution to be a sub-contractor to another organization. The major think-tanks value their autonomy, and hence, rarely enter into sub-contracting agreements. A more typical scenario is for a Research Fellow from a think-tank to take a leave of absence to participate on a study under contract to a firm.

6. Many individuals in the academic community were also difficult to reach due to vacation schedules; however, we did talk to professors at MIT, Harvard University and Stanford University. Again, none of them were aware of any major research on the use of credit versus grants for development assistance. Their thoughts on the issue varied and did not represent an "institutional position" of the university.

7. With respect to the literature search, we identified eight publications that examine credit versus grants to some extent, often in the context of domestic programs. None of the publications specifically address PRE's questions, but some provide useful background information for the study. These publications are described briefly in the Annotated Bibliography attached to this report.

* * * *

In summary, there has been very little research or serious examination of the issues underlying the use of credit versus grants in development assistance. The individual that was most receptive to examining the issue was Ambassador Ernest Preeg of the Center for Strategic and International Studies. The Overseas Development Council also thought the credit authority issue was interesting, but had not conducted any research in this area.

SUMMARIES OF DISCUSSIONS

WITH LEADING RESEARCH INSTITUTIONS

AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH
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CONTACTS

- Herb Stein, Senior Fellow

- Allen Meltzer, Visiting Scholar
  Professor of Economics and Public Policy, Carnegie Mellon University

- Nicolas Eberstadt, Resident Scholar

- Tom Skladony, Public Affairs Department

SUMMARY OF DISCUSSION

- AEI has not conducted any research on the use of credits versus grants, and according to Stein, has not conducted any work on foreign assistance for a long time.

- The two individuals that have examined development issues at AEI are Allen Meltzer and Nicolas Eberstadt. Both appear to favor trade, in lieu of aid, to promote economic development. In an AEI conference on assistance to the former Soviet Union held in April 1992, Meltzer and Eberstadt argued against providing aid to the Newly Independent States, believing that the region would be unable to make good use of U.S. assistance.

- Neither Meltzer nor Eberstadt have looked specifically at the question of credit authority in their work on development assistance. However, in his book *Foreign Aid and American Purpose*, Eberstadt notes that there is little evidence that soft loans have any merit in promoting development. He argues that projects should be funded by either outright grants or market-rate loans, in lieu of the concessional terms offered by many development institutions.

- AEI generally does not produce an agenda for the administration following a presidential election. However, in a sense, all of the papers produced by its economic advisors are oriented toward Congress and the administration. AEI will be holding a major conference in January 1993, which may result in something like an agenda for the next administration. The conference will be broad in scope, covering issues of foreign, social and economic policy.

CONCLUSION

- AEI has not conducted any work on credit authority, and according to Stein, AEI has conducted little work on foreign assistance issues. None of the individuals contacted expressed much interest in discussing the issue.

THE BROOKINGS INSTITUTION
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CONTACTS

- Henry Aaron, Director of Economic Studies
- Barry Bosworth, Senior Fellow, Economic Studies
- William Gale, Research Associate, Economic Studies
- Susan Collins, Senior Fellow, Economic Studies

SUMMARY OF DISCUSSION

- The Brookings Institution does not have a position *per se* on the use of credit versus grants to finance development assistance. There are several individuals that have looked at federal credit programs, most notably, Barry Bosworth and William Gale.

- Barry Bosworth co-authored *The Economics of Federal Credit Programs*, a Brookings Institution book described briefly in the attached annotated bibliography. Bosworth has looked at credit issues in the context of domestic programs. Nonetheless, he had strong views on the use of credit for development assistance. He thought that using credit for development assistance would be a "bad mistake" for several reasons.

    -- Bosworth believes that the U.S. government should provide credit only when there is a failure in capital markets, as is the case in student loan programs and some housing loan programs. The reason capital does not flow to developing countries is not due to imperfections in the credit markets, but rather, because there are real risks in lending to most developing countries.

    -- Credit would be a mistake from an economic development perspective. Credit programs require a level of discipline which is not present in many developing countries. The history of the debt crisis provides ample evidence of this fact. The benefit of grants is that they entail no future repayment obligations which could potentially inhibit the growth of developing countries.

    -- One of the perceived benefits of credit programs is that they provide government agencies with increased leverage. However, according to Bosworth, the desire to leverage funds in and of itself is not a sound rationale for pursuing credit authority. He is concerned that federal agencies will underestimate the risk inherent in credit programs; this is particularly true in the case of foreign assistance where the credit risks and the probability of default are difficult to assess.

-- Bosworth favors increased foreign assistance. Nonetheless, he would prefer to see our program remain small and grant-oriented, than carry the risks inherent in lending to developing countries.

- William Gale has also done considerable research on U.S. credit programs. His greatest concern regarding the use of federal credit is that, in the end, loans often become grants. The U.S. government does not have a good track record in collecting its loans, hence over the long-term many loans become in effect grants. This has been the case in agricultural lending programs in the U.S., as well as student loan programs. Gale has also carefully examined credit reform issues.

- Susan Collins noted that the issue of credit versus grants was raised during a conference on a series of papers produced for *The Brookings Papers on Economic Activity*. Jeremy Bulow, a professor at the Stanford Business School, and Kenneth Rogoff, a professor at Princeton's Department of Economics presented a paper on providing credit to the former USSR. The authors came out in favor of grants over credit. This in turn sparked debate in the conference on the most effective modalities for providing assistance.

- Henry Aaron raised an important point in noting that it is <u>extremely rare</u> for an institution such as Brookings to be a subcontractor to another firm. In the few cases that it has been a subcontractor, Brookings has insisted on retaining complete control over the content and the publication of the document; these conditions are unacceptable to most prime contractors. A more typical scenario is that a Brookings Fellow might take a leave of absence to participate on a particular study under contract to another firm.

- The Brookings Institution has an on-going series of publications called *Setting National Priorities*, which provide policy recommendations to Congress and the administration. As part of this series, Brookings intends to release a book entitled *Setting Domestic Priorities* on September 14. As its name implies, the book will focus exclusively on domestic issues and will not touch foreign policy considerations.

<u>CONCLUSION</u>

- The Brookings Institution clearly has the expertise to undertake PRE's study. Brookings is the sole institution we contacted that had in-house expertise on credit authority. Both Gale and Bosworth have published numerous articles on credit authority. However, it is also quite clear that they are not supportive of the concept of using credit to finance development assistance.

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CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE
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CONTACTS

- James Clad, Senior Associate

SUMMARY OF DISCUSSION

- No one at the Carnegie Endowment for International Peace has look at the question of credit authority. Mr. Clad suggested contacting other institutions.

- The Carnegie Endowment for International Peace is not planning to published an agenda for the next administration following the election. However, the Carnegie Endowment National Commission recently published a book entitled *Changing Our Ways: America and the New World* (August 1992). The Commission makes the following points regarding economic development and foreign assistance:

  -- The United States will be a major beneficiary as growth spreads among developing nations. The U.S. is in a particularly strong position to meet the needs of developing countries for capital goods and equipment.

  -- The prosperity of the United States will be affected by the economic and social development of developing countries. Developing countries are also central to resolving global issues of the environment, energy, food, health, population growth, drug trafficking, refugees and illegal immigration. These issues all require early attention and resources to forestall much heavier costs in the future.

  -- There is little domestic support for foreign aid. U.S. foreign aid amounts to less than 0.2 percent of GDP, a smaller percentage than at any time since World War II and the smallest percentage among industrial countries. The United States should as a matter of self-interest bring its aid budget into line with those other industrial nations.

  -- The Commission believes that AID is in need of fundamental reform, but that it should not be scrapped. AID has developed valuable programs and skills which will be needed in future aid efforts.

CONCLUSION

- The Carnegie Endowment has not looked at the issues surrounding credit authority.

THE CATO INSTITUTE
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202-546-0200

CONTACTS

- Brink Lindsey, Director of Regulatory Studies

- Ian Vasquez, Assistant Director, Project on Global Economic Liberty Program (Cato Institute's specialist on aid and development)

SUMMARY OF DISCUSSION

- The Cato Institute has not done any studies related to credit authority.

- Whether foreign assistance is extended in the form of a loan or a grant is a moot point. According to the individuals contacted at Cato, foreign assistance is ineffective, be it in the form of a loan or a grant.

- The Cato Institute has conducted studies of the impact of foreign assistance on developing countries, and overall, is highly critical of aid programs. The Institute believes that the record of foreign assistance has been very poor and that, in general, foreign assistance has not met its goals and in some cases has been counterproductive.

- The Cato Institute usually publishes a book following a presidential election which provides policy suggestions to the new administration. The Institute has already begun to outline a book to be published in early 1993. The preliminary table of contents includes a chapter on multilateral assistance, specifically World Bank and IMF activities. At the point, it does not appear to address bilateral assistance programs. Both Lindsey and Vasquez noted that the chapter is likely to reflect the Cato Institute's highly critical views on foreign assistance.

CONCLUSION

- The Cato Institute is highly critical of foreign assistance in general, be it in the form of credit or grants.

CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES
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CONTACT

- Ambassador Ernest Preeg
  William M. Scholl Chair in International Business

SUMMARY OF DISCUSSION

- Ambassador Preeg was not aware of any major research or publications on the use of credit authority. He noted that some of his articles touch the issue, particularly in the context of project finance and infrastructure development. He strongly believes that there is an important role for use of credit in AID-financed activities and suggests that many technical assistance activities should probably be financed with loans in lieu of grants. This is particularly true for feasibility studies for infrastructure projects.

- Ambassador Preeg thought that the most thorough studies on the use of credit authority would have been conducted by the Organization for Economic Cooperation and Development (OECD), the World Bank, or one of the regional banks.

- Ambassador Preeg noted that CSIS, as an institution, has little in-house expertise to undertake the kind of study PRE is considering. Indeed, Preeg is the only individual in the institution that has a policy-orientation on economic development and finance issues.

- CSIS does not plan to develop a comprehensive "agenda" following the presidential election, as it did in 1988. However, it may do a few small pieces. For example, Preeg is currently completing a piece on the trade versus aid debate to be published in *The Washington Quarterly* in early December 1992; this article will be somewhat of an "agenda" for the foreign assistance program.

- In addition, CSIS is just about to complete a major research project which looks at the relationship between economic aid and non-economic objectives (such as political and security objectives) in four developing countries.

CONCLUSIONS

- Ambassador Preeg is not aware of any prior research in this area, but believes that a study exploring the use of credit versus grants would be extremely valuable. Ambassador Preeg would no doubt be a valuable resource in conducting PRE's study. Other than Preeg, CSIS has little in-house expertise to bring to the study.

HERITAGE FOUNDATION
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<u>CONTACTS</u>

- Edward L. Hudgins, Director, International Economic Studies
  Center for International Economic Growth

- Bryan T. Johnson, Policy Analyst, International Economic Studies
  Center for International Economic Growth

<u>SUMMARY OF DISCUSSION</u>

- The Heritage Foundation has not looked at the question of using credit versus grants to finance foreign assistance activities. According to the individuals contacted at the Heritage Foundation, all foreign assistance is "bad". In their own words, the question is whether one form of assistance might be worse than the other. Hudgins speculated that grants might be less harmful than credit because they have fewer market distortion effects.

- According to both Hudgins and Johnson, there is no link between increased foreign aid and economic growth. Rather, existing evidence proves the opposite. As examples, he cited reports from the GAO, the Inspector General's Office and the Woods Report, which purportedly conclude that foreign assistance is ineffective in promoting economic development and may even hinder development. Many poor countries have become "addicted to loans and aid, while refusing to reform their own economic environments" (*The Heritage Foundation: Backgrounder*, July 1991). In doing so, they discourage foreign investment, and hence, economic growth.

- One of the concerns Johnson raises with respect to credit is that loans have already "drowned countries in a sea of debt." Moreover, according to Johnson, governments that are not willing to commit themselves fully to comprehensive and consistent free market reform should not qualify for loans. Such loans do not help developing countries and often remove the pressure to make fundamental changes.

- The Heritage Foundation usually produces a book or a report following the presidential election entitled *Mandate for Leadership*, and foreign assistance is often an important issue in these reports. Thus far, Heritage has produced three of these reports, the most recent following the 1988 election.

- In *Mandate for Leadership III*, the Heritage Foundation concluded that U.S. foreign assistance program should flow only to those countries that can best use it. The Foundation proposed the development of an "Index of Economic Freedom," which would measure the degree of freedom from government intervention and control in an economy. It would measure protection of private property rights, free pricing systems, tax rates, government regulation of the economy, free trade policies, and private sector involvement in the financial sector. The index was intended to encourage the development of economic systems based on free market principles and private sector development. It was also hoped that this index would be the economic analogue of Amnesty International's index of political freedom.

- The Heritage Foundation is unlikely to produce a new *Mandate for Leadership* this year unless there is a change in the administration. In lieu of a comprehensive report, Heritage may produce a series of papers on "what to do now." Johnson noted that, if Heritage were to produce a paper on foreign assistance, the paper would probably recommend abolishing the U.S. foreign assistance program. Hudgins agreed, but added that abolishing foreign assistance would be unlikely -- particularly in a Clinton administration. In this case, Heritage would probably try to "neutralize the damage" of foreign assistance programs and steer them toward doing something good, that is, helping to create popular free markets in developing countries.

CONCLUSION

- The Heritage Foundation is also very critical of foreign assistance. Regarding credit versus grants, the question would be which form of assistance is less harmful; one researcher speculated that grants are probably less harmful than credit because they have fewer market distortion effects.

INSTITUTE FOR INTERNATIONAL ECONOMICS
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CONTACTS

- Jeffrey Schott, Research Fellow

SUMMARY OF DISCUSSION

- The Institute for International Economics has published a series of monographs on development finance issues. While none of these publications specifically address the issue of credit versus grants, some do examine options for providing finance to developing countries.

- The Institute for International Economics has a number of individuals that have done notable work on development finance issues, including Fred Bergsten, John Williamson and William Cline. Unfortunately, none of these individuals have been in the office these past two weeks.

- The Institute for International Economics only produces an agenda for the next administration if they feel "it is worthwhile." The Institute published such an agenda in 1988, but has no plans to do so this year.

CONCLUSION

- Too early to make any conclusion. Need to contact additional individuals when they return from vacation.

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CONTACTS

- Jonathon M. Friend
  Assistant to the President for Institutional Relations

- Christine Contee, Fellow

SUMMARY OF DISCUSSION

- The Overseas Development Council has not looked at the issue of credit versus grants to finance development assistance; nor has the ODC looked at the role of the private sector in developing countries *per se*. The ODC tends to focus on the social and economic situation in developing countries, as well as the interdependence between developing countries and the United States. Nonetheless, both Friend and Contee thought the question of using credit authority was an interesting one. Moreover, many of the other think-tanks/universities pointed to the Overseas Development Council as an appropriate institution to look at such an issue.

- The Overseas Development Council recently published a report entitled *Challenges and Priorities in the 1990s: An Alternative U.S. International Affairs Budget, FY 1993*. The Alternative International Affairs Budget recasts the U.S. government budget accounts in terms of U.S. foreign policy objectives appropriate to the post-Cold War era. This report does not directly address the question of credits versus loans, but does look at the role of foreign economic assistance, as well as that of USAID. A few of the major conclusions include the following:

  -- Bilateral aid need to be redesigned to meet global challenges more effectively. "USAID cannot meet today's development challenges and should no longer monopolize the distribution of U.S. bilateral assistance."

  -- The report proposes the creation of a Sustainable Development Fund (SDF). The Fund would be a source of funding for global cooperation, not an operating agency. "By introducing competition into U.S. bilateral development programs and channeling its resources through other U.S. government agencies, private and voluntary organizations, multilateral institutions, and other entities, the SDF will dramatically increase the effectiveness of U.S. bilateral aid efforts."

-- By the mid-1990s, the proposed Sustainable Development Fund should be the major vehicle for U.S. bilateral assistance. USAID would continue as a delivery agency, but would have to compete with other organizations for SDF funds. Accordingly, the resources directly appropriated to the agency by Congress should gradually be reduced by $3.1 billion between FY 1993 and FY 1997.

- With respect to an agenda for the next administration, the Alternative Foreign Affairs Budget discussed above is a first step toward providing policy recommendations regarding future directions for foreign assistance. In addition, ODC plans to issue a report in January 1993 on aid reform. In 1988, the Overseas Development Council published *Campaign 88 - Briefing Paper for Candidates: The U.S. Economy & Developing Countries*. The aim of the document was to assist candidates during the 1988 election campaign. A specific section of the document focused on foreign assistance.

CONCLUSION

- The Overseas Development Council has not considered the question of credits versus grants to fund development assistance, but thought the question was interesting. ODC would no doubt have the capability to conduct a major study along the lines of PRE's thinking, but it is not clear what conclusion they might come to on the issue of credit versus grants.

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CONTACTS

- Richard Neu, Associate Corporate Research Manager
  International Policy Department

- Jess Cook, Public Affairs Division

SUMMARY OF DISCUSSION

- Rand has done very little work on economic development policy in recent years, except in the context of China, Eastern Europe and the former Soviet Union.

- Richard Neu was not aware of any research that looks specifically at the use of credit versus grants. Nonetheless, he had strong views on the use of credit authority. He believes that it would be a "big mistake" if AID were to enter the credit business. If a country is a good credit risk, it should borrow from private capital markets. If it can't borrow from private capital markets, it probably is not a good credit risk, and hence, should not receive loans from the U.S. government. Loans to such countries will most likely be rescheduled and/or written off. Neu says let's not fool ourselves by calling such loans "credit", when they are in fact grants in the end. He commends AID for resisting the use of credit and hopes that it will not follow the same route as the World Bank and the major regional development banks.

- Rand is not planning to issue any major publication following the presidential election in November.

- Rand held a major conference on August 3 called "Rethinking International Economic Institutions." The conference focused on new directions for the major multilateral institutions, including the World Bank, the International Monetary Fund, the GATT and others, in the post-Cold War era. There was no explicit attention devoted to the role of bilateral assistance programs. Rand intends to publish a major paper to summarize the proceedings of this conference. It may also publish a series of smaller papers on themes or issues discussed in the conference.

CONCLUSION

- Richard Neu is the only individual we were able to contact that had considered credit-related issues. As noted above, he is clearly quite skeptical of the use of credit in development assistance programs.

THE URBAN INSTITUTE
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CONTACTS

- George Peterson, Senior Fellow

SUMMARY OF DISCUSSION

- Peterson has not done any research on the issue of loans versus grants within the context of development assistance. He focuses primarily on finance issues within developing countries themselves, such as lending from the central bank to local organizations and parastatals.

- The Urban Institute has looked at the use of housing guarantees in developing countries. (Note: Peterson will try to send additional information).

CONCLUSIONS

- No conclusions yet. We are trying to contact another individual at the Urban Institute who works on development finance issues. He is currently on vacation.

UNIVERSITY PROFESSORS AND RESEARCHERS

1. *MASSACHUSETTS INSTITUTE OF TECHNOLOGY (MIT)*

Professor James Peturba, Professor of Finance
Professor Peturba has not looked at the issue of credit versus grants; nor did he know of anyone that has looked at this issue carefully. He suggested contacting two professors at the Woodrow Wilson School at Princeton University.

2. *HARVARD UNIVERSITY*

Professor Robert Lawrence, John F. Kennedy School
No knowledge of credit authority; focuses primarily on international trade issues.

Professor Phillip Wellons
Professor Wellons was unaware of anyone who has looked at credit authority issues. He thought the best sources of information would be the World Bank (specifically, policy papers underlying the creation of the World Bank).

Dwight Perkins, Director, Harvard Institute for International Development (HIID)
According to Dwight Perkins, HIID tends to focus on country-specific or sector specific problems in economic development. HIID has not addressed broader issues such as mechanisms for financing development. Perkins knew of no one at HIID who had conducted researched on credit authority issues; nor was he aware of any other institutions which had examine the use of credit versus grants.

3. *STANFORD UNIVERSITY*

Jeremy Bulow, Professor, Stanford Business School
Professor Bulow knew of no major research on the issue of using loans versus grants. He is skeptical of the use of credit. He believes that, in most cases, loans to developing countries become grants due to debt renegotiations, rescheduling and outright forgiveness of debt. He believes it would be more straight-forward to provide grants in the first place, rather than convert our loans to grants over the long term.

Clark Reynolds, Food Research Institute
Clark Reynolds has not specifically focused on credit authority issues. Most of his research focuses on how to enact non-distorting credit allocation policies. He has no specific position on the use of credit versus grants, but believes the issue is an interesting one. The potential leverage gained by using loans seems fiscally attractive, but he also acknowledges the problem of potential defaults.

ADDITIONAL CONTACTS

1.	John Sewell Overseas Development Council	On vacation; will return September 8.
2.	William Cline Institute for International Economics	On vacation; will return August 31.
3.	John Williamson Institute for International Economics	On vacation; will return September 1.
4.	John Makin American Enterprise Institute	Out of the office; will return August 27.
5.	Alice Rivlin The Brookings Institution	Out of the office; left message to return call.
6.	Robert Litan The Brookings Institution	On vacation; will return September 8.
7.	Michael Aho Director, Economic Studies Council of Foreign Relations	Out of the office; left message to return call.
8.	Richard E. Feinberg Inter-American Dialogue	Out of the office; left message to return call.
9.	Harry Cross The Urban Institute	Out of the office; left message to return call.
10.	Professor Anne C. Case Assistant Professor of Economics Princeton University	Not in; left message to return our call.

11.	Professor Timothy J. Besley Assistant Professor of Economics Princeton University	On vacation; will return on August 29.
12.	Professor Dutch Leonard John F. Kennedy School of Government Harvard University	Out of the office; left message to return call.
13.	Professor Gerald Meier Stanford University Business School	Out of the office; left message to return call.
14.	Professor Gary Hufbauer School of Foreign Service Georgetown University	Out of the office; will return September 1.
15.	Professor Jim Tybout Professor of Economics Georgetown University	Out of the office; left message to return call.
16.	Professor Dale Adams Ohio State	Out of the office; left message

ANNOTATED BIBLIOGRAPHY

Bosworth, Barry P., Andrew S. Carron, and Elisabeth H. Rhyne, The Economics of Federal Credit Programs (Washington, D.C.: The Brookings Institution), 1987.

This study details the major issues involved in benefit-cost analysis of federal credit programs. The study has three major focuses: an overview of the rationale for credit programs, their costs, and their likely economic effects; an examination of sector specific loan programs; and a proposal to clarify the costs of credit programs within the budget process. The first part -- the overview of the rationale for credit assistance -- is relevant for the purposes of this report.

The authors outline three key objectives of credit programs: correction of credit market imperfections; reallocation of resources toward activities deemed to have significant public value; and redistribution of income. Correction of market imperfections is the justification for government credit programs such as agriculture loans, small business loans, and student loans. Such programs do not normally require a subsidy.

Governments may also wish to devote credit assistance to encourage private involvement in activities that generate greater gain for the general public than for the private entity that undertakes the activity. Encompassing such areas as synthetic fuels programs, education credits, low-cost rental housing, and environmental waste treatment equipment, such assistance usually involves government subsidies.

Finally, governments may use credit programs in order to effect "the simple transfer of income to a specific class of borrower rather than [to] change ... economic behavior." Examples of these programs include the Veterans' Administration mortgage guarantee program, some programs of the Farmers Home Administration, and some types of disaster loans.

Brent, Robert J., "The Cost-Benefit Analysis of Government Loans", Public Finance Quarterly, Vol. 19 No. 1, January 1991, pp. 43-66.

A neglected area of cost-benefit theory is the evaluation of federal government loans to finance private investment. This article builds on a model by Feldstein (1973) which disaggregated public investment decisions into two parts: one is the expenditure on the good to be purchased by the loan, and the other is the loan itself. The result is that distributional consideration can be divorced from economic efficiency in making the first (expenditure) decision. Distributional factors are used to help determine the second (financing) decision. The two-decision framework is applied to FmHA loans made in New York State.

Edgerton, Russell H., The Creation of the Development Loan Fund, (New York City, NY: Columbia University), 1967.

This case study of policy making in the American government was undertaken to produce some hypotheses about the requirements for policy innovation. The case involves a series of decisions made in 1957 which led to the creation of the Development Loan Fund (DLF), an institution for financing long term "soft" loans to developing countries. Sources for the narrative include published materials from offices in the Department of State, Bureau of the Budget, and Agency for International Development.

Frank Jr., Charles R., Jagdish N. Bhagwati, Robert d'A. Shaw, and Harald B. Malmgren, Overseas Development Council Studies - 1, Assisting Developing Countries: Problems of Debt, Burden-Sharing, Jobs and Trade (New York, Washington, London: Praeger Publishers), 1972.

The essays by Frank and Bhagwati in this ODC publication are the most relevant to the scope of this report. In Charles R. Frank Jr.'s essay "Debt and Terms of Aid" he presents arguments, pro and con, for soft as opposed to hard terms of assistance (Ch. 3). Despite the problems of debt servicing, arguments are sometimes made in favor of relatively hard terms. For example, it is argued that hard terms may be the only way in which large amounts of capital can be raised on the international capital markets, and that assistance on these terms can be justified if the expected rate of return on investment is taken into account.

On the other hand, relatively soft terms seem justified and indeed necessary, at least for some countries, when one takes into account the debt servicing problem. It is often difficult to convert domestic resources into assets which produce foreign exchange earnings at a rate rapid enough to provide funds to service a large and increasing volume of debt.

In "Amount and Sharing of Aid", Jagdish N. Bhagwati analyzes the growing crisis in levels, terms, and conditions of development assistance in the 1970s. More importantly, he examines the distribution of aid burden among donors and the aid benefit among recipients. The study looks at the volume and sharing of aid, as well as the pattern of distribution among recipients. It reviews past trends and discusses future prospects. In doing so, it explains the various ways in which resource flows can be measured and the real cost to donors.

Gale, William G., "The Big Debt Overhang", The Wall Street Journal, October 25, 1989.

Noting that the federal government lends almost as much as it borrows, this article discusses the size of federal lending programs and mechanisms to improve lending procedures. Of these improvements two are relevant for this report. In particular, Gale advises that the federal government "use credit to improve the operation of capital markets, not to provide subsidies." He stresses that:

> There is a fundamental conflict between providing a subsidy and maintaining the integrity of a credit program. If the program is meant to provide a subsidy, collecting the debt defeats the original goal. Thus, subsidized loans tend to turn into giveaway programs, with increasing subsidy and default rates over time. To avoid this problem, government should issue credit only if it intends to use every legal method to collect.

Gale also notes that providing better incentives could improve federal lending practices. Under current federal credit programs, both borrowers and lenders face distorted incentives. The government typically offers guarantee rates of 100%, giving lenders little reason to screen customers carefully. Similarly, borrowers face few adverse consequences should they default on their loans, since the government has a poor record of collecting bad debt and since borrowers can often obtain additional government loans even if they have defaulted on previous loans.

Gale concludes by making several pertinent general observations regarding credit programs. He advises that the administration of federal credit should closely parallel private lending practices, including the development of a loan loss reserve and regular outside audits. He also notes that the government should reform the way in which loans are documented in the budget and the way in which loans are accounted for. Without such reforms, Gales warns, credit programs will continue to be a large-scale, high-risk proposition for taxpayers.

Gale, William G., "Federal Lending and the Market for Credit", Journal of Public Economics, 42(1990), 177-193.

In this article, the author describes federal lending activities, develops the underlying model of the credit market (with and without credit programs), examines the effects of credit subsidies on investment and interest rates, and analyzes the welfare effects (meaning aggregate net wealth in the economy) of subsidized credit programs. The results of the third section are relevant for this report.

The effects of credit subsidies on interest rates and the allocation and level of investment are as follows:

- Unsubsidized credit policies have no effect on credit allocations or interest rates. Instead, in providing an unsubsidized direct loan, the government simply diverts deposits from the private financial system and lends the funds directly. The net effect of credit programs is simply a substitution of publicly-provided credit for private credit. Thus, credit programs have real effects only if they lose money.

- Interest subsidies are relatively less effective than guarantees in reallocating credit when the target group is rationed than when the target market clears. The reasons for this are the following. Interest subsidies mainly serve to reduce borrower payments; lowering payments, however, does not assist borrowers who cannot obtain finance (in the terms used above, whose credit is being "rationed") because of insufficient creditworthiness. In contrast to interest subsidies, loan guarantees can operate equally effectively in either market clearing or rationed regimes, because they operate primarily by raising the bank's returns." Thus, in a situation where the target market is not clearing (where credit for a target groups is being rationed), guarantees are relatively more effective than subsidies in reallocating credit.

- When it subsidizes one target group, the government either partially or wholly crowds out other target groups from the market, or must raise the subsidy provided to those groups. Credit subsidies create demand for more credit subsidies, because as each group obtains credit assistance from the government, marginal groups are increasingly crowded out and increase their subsidy requests in order to maintain their original credit level. Thus, at least to some extent, subsidized federal lending simply rearranges credit among target groups and incurs program costs.

Payer, Cheryl, <u>Lent and Lost: Foreign Credit and Third World Development</u> (London and New Jersey: Zen Books Ltd.), 1991, pp. 45-48.

In the formative years of the U.S. foreign loan program (the mid and late 1950s) the question of grants versus loans was discussed in the State Department and in Congress. The pro-aid faction within the administration faced stiff opposition to its proposals to establish an ongoing, semipermanent aid program, as contrasted with previous *ad hoc* efforts. Since the aid program was originally set up by those who wished to wage a propaganda war against communism and those who wished to export their surpluses on credit, repayment was not a high priority item. It was assumed that the debtors knew that loans did not have to be repaid. "In a truly sanction-free bilateral situation, loans *are* grants if a candid creditor lets the expected net capital flow get below zero." The debtor countries noted the paradox and drew the conclusion they wished to draw: the creditor governments did not expect them to repay debts with their own money, and in fact did not want them to.

U.S. House of Representatives (Subcommittee on Economic Stabilization of the Committee on Banking, Finance and Urban Affairs), "A Guidelines Handbook on Federal Loan Guarantee Programs" (Washington, D.C.: U.S. Government Printing Office), February 1979.

This document outlines and defines basic guidelines for federal loan guarantee programs. Included in these guidelines is a clear delineation of when guaranteed and insured loans are an appropriate type of credit assistance. As stated in this document, guaranteed and insured loans programs are appropriate when:

- Private lenders can, in time, be expected to overcome private market imperfections;
- The need for assistance can be expected, in time, to decline or disappear;
- Public objectives can be achieved at the least public and private cost and with minimum federal intervention by influencing the private sector to finance the activity.

METHODOLOGY OF RESEARCH

1. The literature search was performed primarily at the Georgetown University Library. The first step was a search of the ABI Inform on-line data base. This CD-ROM computer system contains over 200 business periodicals and articles for the last five (5) years, current up through June 1992. A search was conducted on terms such as "development finance", "economic development", "public finance", "development loans", and "loan guarantees".

2. In addition, a search was conducted at the Joint World Bank/International Monetary Fund Libraries. Most of the documents in this database focused on the Bank's Structural Adjustment Programs or the use of credit in specific sectors such as agriculture. None examined the use of credit versus grants.

3. The team contacted Janice Stallard of CDIE, who has collected numerous publications related to capital project development. The team also contacted Jack MacCarthy, who is conducting research on the Development Loan Fund. Neither of these individuals were aware of any publications that focused on the use of credit versus grants.

4. The next phase of the literature search was a review of seven economic development journals and periodicals. The publications and years searched are as follows:

   - Economic Development and Cultural Change (1980-1992)
   - Finance and Development (1978-1979, 1988-1990)
   - Journal of Development Economics (1980-1992)
   - Journal of Economic Development (1984-1992)
   - Journal of International Affairs (1980-1992)
   - Public Finance Quarterly (1980-1992)
   - Public Finance (1980-1992)

   This search did not provide any useful articles.

5. The next part of the research consisted of searching various periodical and abstract guides. The resources searched are as follows:

   - Public Affairs Information Service - 1985-1992
   - International Policy Abstracts - 1985-1992

   This search did not turn up any relevant information.

6. The final step of the research involved searching the University's on-line data base for books on development finance or economic development. This search turned up a limited amount of information. However, two books had chapters within them that related directly to the topic at hand and from their bibliographies more articles were discovered. The books found are as follows:

   - <u>Assisting Developing Countries: Problems of Debts, Burden-Sharing, Jobs, and Trade</u> by Charles R. Frank, Jr., Jagdish N. Bhagwati, Robert d'A. Shaw, and Harald B. Malmgren.

   - <u>Lent and Lost: Foreign Credit and Third World Development</u> by Cheryl Payer.

7. Contacts from the survey of think tanks and universities also provided suggestions regarding pertinent literature, such as the articles by William G. Gale.