May 10, 1984

CENTRAL AMERICAN AID: MORE IS NOT ALWAYS BETTER

INTRODUCTION

The report of the National Bipartisan Commission on Central America (known as the Kissinger Commission), released in January 1984, recommended large amounts of military and economic aid for Central America.[1] The Reagan Administration's economic aid proposals closely reflect the Commission's recommendations in calling for $8 billion of assistance over the next five years (see Appendix I for a breakdown of proposed aid).

Although it is already clear that the economic policy recommendations in the Report will not be fully adopted by Congress, the level of U.S. economic assistance to Central America may be increased substantially. Yet greatly increased economic aid will not necessarily spur economic development and could in fact be counterproductive unless it is carefully channeled to assure maximum private sector involvement and maximum use of free market mechanisms.[2] The $8 billion in assistance originally requested by the Administration may exceed what the various countries in the region can absorb, given questionable economic policies and the constraints on long-term development posed by a climate of uncertainty and violence.

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1 The initial proposal is for an $8 billion, five-year reconstruction and development program, with $6 billion in direct appropriations and $2 billion in insurance and guarantee authority.

2 For a useful discussion of U.S. economic assistance in the context of overall foreign policy, see A Report to the Secretary of State, the Commission on Security and Economic Assistance, Department of State, November 1983.

In the short term, U.S. assistance should be used to relieve the pressures on dislocated persons and refugees. It should also provide funds for economic stabilization for governments that seek to establish free and open societies and pursue sound economic policies while providing security and meeting the minimum needs of the populace.

To lay the foundation for long-term development, U.S. assistance to Central America should be directed toward growth of the private sector. The U.S. Agency for International Development, the Inter-American Foundation, private voluntary groups, and scholarships for Central Americans to study in the U.S. can all promote development directed toward free enterprise rather than centralized planning. In addition, U.S. markets should be opened to Central American exports. On the other hand, there should be no rush to create a new regional economic organization, since adequate institutions now exist.

Development prospects in Central America are strongly related to willingness to adopt economic policies that free economies from damaging government intervention. To highlight such measures, the U.S. should support an economic summit on economic reform. Internal economic reforms and a restoration of a measure of stability to the region should foster private investment and substantially reduce the need for foreign economic assistance.

CENTRAL AMERICAN ECONOMIES

Central America has had a dual economy since its colonial days, consisting of a domestic, partially subsistence, sector alongside an export-oriented commercial sector. After World War II, the countries of Central America experienced an intense period of prosperity, due to an unprecedented improvement in international market prices for their main exports: cotton, coffee, and bananas. Trade among the countries grew rapidly, largely because of earlier steps toward integration and completion of the Central American portion of the Inter-American Highway.

In the 1960s, growth continued because of (1) stable and favorable international prices for the region's export commodities; (2) rapid growth of economic assistance (largely through the Alliance for Progress) and private investment; and (3) the Central American Common Market, established in 1960. Annual real growth in Central America averaged 7.7 percent from 1961 to 1968.

Adverse international economic conditions in the late 1970s derailed this growth. Climbing interest rates drove up the cost of servicing external debt.[3] Severe increases in the price for

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3 For example, the six-month dollar London interbank offer rate (LIBOR) rose from 9.1 percent on average in 1978 to 16.5 percent in 1981. "Currency Diversification and LDC Debt," Federal Reserve Bank of New York Quarterly Review, Autumn 1983, p. 19.

imported oil and petroleum products, combined with a precipitous fall in the prices of commodity exports, played havoc with current account balances and placed a damper on future investment plans in most countries in the region. The collapse of the Common Market and concomitant contraction in intraregional trade, capital flight, and the interruption of credit and investment as a result of political violence and instability exacerbated the effect of external factors.[4]

DEVELOPMENT ASSISTANCE IN PERSPECTIVE

Underlying current proposals for economic assistance to Central America, and embodied in the overall U.S. approach to development assistance since the Foreign Assistance Act of 1961, are certain general premises about economic and political development that should raise questions about the usefulness of massive economic aid to Central America.[5] These premises hold that economic aid produces growth, growth produces stability, and, conversely, underdevelopment produces revolution. The reality, however, is more complex.

Economic Assistance and Growth

First, there is no direct or necessary correlation between large-scale economic assistance and growth. Tanzania, for example, has received approximately $2 billion in foreign assistance over the last decade, according to the Organization for Economic Cooperation and Development, yet shows few signs of economic growth and remains heavily dependent on external aid. Again, OECD estimates show that between 1972 and 1979 Jamaica received more than $525 million in economic assistance, yet its economy consistently declined. In light of these and other cases[6] it would seem that growth and development are correlated more

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4 This is particularly true of El Salvador, where gross domestic product fell 1.6 percent in 1979 and a further 9 percent in 1980. The insurgency of the Marxist-led guerrillas is largely responsible for the country's marked economic decline; it has led to an estimated capital flight of approximately $1 billion, and direct guerrilla sabotage accounts for as much as $1 billion worth of damage to infrastructure.

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6 Hong Kong, Singapore, Malaysia, Ivory Coast, Taiwan, and South Korea, for example, have made sound economic progress on the basis of policies that encourage external investment, foster export development rather than import substitution, and avoid large public sector debt.

closely to economically sound political decisions by recipient countries than to the magnitude of development assistance by an outside donor.

Accordingly, countries that have progressed economically are those that have refrained from manipulating prices in ways that penalize production, have avoided large public sector debt, and have stimulated an environment attractive to external investment. Where foreign aid has been channeled into centralized bureaucracies and prestigious but ultimately nonproductive projects, such as mammoth steel mills, dams, airports, and sports arenas, and where it has financed consumption rather than increased productive investment, such aid has failed to sustain economic growth. It thus is doubtful whether U.S. economic assistance can provide needed growth and prosperity and meet U.S. foreign policy objectives if funneled into countries that make poor political decisions in using such assistance.

Growth and Stability

The call for massive economic assistance for Central America appears to be based on the assumption that development contributes to political stability. History teaches, however, that development often can be temporarily destabilizing. Even under the relatively favorable circumstances in which industrialization and modernization took place in North America and Europe, political and social systems suffered confrontation and dislocation.

At least in the short run, rising expectations of economic and social progress can be disruptive. Modernization programs artifically imposed by the state in such countries as India, China, and Nigeria have produced what even the most sympathetic observer can only regard as mixed results. Thus there is no certain relation between development and stability, or development and democratic government. But because the long-term benefits of development outweigh the cost of difficult adjustments, the volatility of the process should not prevent development assistance efforts. Policy makers, however, must be alert to problems inherent in the process.

Poverty and Revolution

Social and economic inequity long have characterized El Salvador, as they have other developing countries. If these conditions breed revolution, then Central America--and most of the developing world, as well as the Communist-ruled countries--would have been in flames long ago. Yet the violent insurgency in El Salvador is a recent phenomenon; it has been fostered and sustained by assistance from communist nations in the region, particularly Nicaragua and Cuba.[7]

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[7] Moreover, El Salvador is not the poorest country in the hemisphere, nor does it have the worst income distribution. Ecuador does, followed by Venezuela and Mexico, with 5 percent of national income going to 42 percent, 40 percent, and 36 percent of the population, respectively.

Furthermore, the economic progress in El Salvador prior to the outbreak of civil strife in 1979, although more moderate in the late 1970s than earlier, indicates that economic improvement does not necessarily bring social tranquility. Although the benefits of economic growth were unevenly distributed, growth itself is a catalyst for redistribution.[8] It is the Soviet and Cuban-fed insurgency beginning in 1979 that is largely responsible for the dramatic reversal of the growth process.[9]

GUIDELINES FOR U.S. ECONOMIC ASSISTANCE TO CENTRAL AMERICA

Recognition of the limited role of economic assistance in bringing about development does not mean that there is no role for U.S. aid to Central America. It does mean that aid should be carefully targeted and that unrealistic expectations about the prompt emergence of stable democratic institutions and the growth of a free economy under trying circumstances should be avoided. Among the measures that would halt economic decline and signal U.S. commitment to helping Central America solve its economic and political problems are:[10]

Private sector support

U.S. economic assistance should be used to expand and strengthen the private sector in Central American economies. Sustained economic growth depends upon a dynamic private sector that allocates resources on the basis of free market principles.[11] Centralized economies, on the other hand, are incapable of using resources as efficiently as market economies. The record of countries that have pursued such a statist approach to development is notoriously poor.

The transfer of substantial resources from the U.S. to public sector bureaucracies in Central America would serve mostly to support and expand those bureaucracies. Yet expansion of the public sector and reliance on central planning would be a particularly damaging strategy for developing countries, which can ill

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8 Income distribution in pre-industrial America and Europe was not unlike that of Latin America today, and it improved as a result of growth.

9 Both elections and economic reform measures undertaken by the government have been sabotaged by leftist guerrillas, who have proclaimed economic attrition to be an element in their strategy to gain power.

10 Humanitarian assistance and economic stabilization are important to bolster governments under attack by communist supported insurgencies; long-term development clearly depends upon overcoming the Marxist-Leninist forces now intent on gaining power.

11 There are sectors in Central America that support this approach. See, for example, an interview with Manuel Ayau, rector of Guatemala's Universidad Francisco Marroquin, in the National Catholic Register, March 11, 1984, where he says, "This [development] cannot happen in any system but a market economy."

afford the inefficiency of planning that establishes political expediency above economic expertise, and that would impose a cost on the economy in the misallocation of scarce managerial capacity and other resources.[12]

The rationale for directing U.S. aid to the private sector also rests on the recognition that development is contingent upon human motivation and attitudes toward work, risk, and reward. Assistance that provides previously unavailable credit to small businesses and teaches basic skills to innovative and energetic entrepreneurs would contribute to growth by fostering the individual initiative and self-help that are the very foundation of development.

Efforts to encourage private sector growth should focus on three general areas:

1) access to credit for groups or individuals with viable business ideas or enterprises;

2) start-up financial support for private enterprises capable of providing services on a fee basis (in health and technical training, for example) that have previously been funded by public sector institutions;[13]

3) training in the basic skills required to start and operate small businesses.

In its assistance to small businesses, this approach would place considerably less emphasis on financing at concessional rates. Such artificially low rates in the past have ended in economic investment decisions that required ongoing subsidies, thereby preventing the emergence of self-sustaining businesses. It would also stress working with intermediate financial institutions to improve underdeveloped capital markets, thus extending credit access to new entrepreneurs.[14]

Inter-American Foundation. The Inter-American Foundation, created by Congress in 1969 to provide assistance to disadvantaged people in Latin America who had not benefited from conventional

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12 A useful discussion of statist versus free enterprise approaches to development is found in P. T. Bauer, Dissent on Development (Cambridge, Massachusetts: Harvard University Press, 1976).

13 This kind of project has recently been implemented by AID through its Bureau for Private Enterprise for technical training in Peru and Thailand, and for health services in Africa.

14 AID's Bureau for Private Enterprise is designed for this purpose. It offers financing terms at near-market rates to small entrepreneurs when feasibility studies are positive. The Bureau works with private intermediate institutions to strengthen local capital markets, and is active in upgrading management skills at the small business level.

U.S. aid efforts, could play a useful role in supporting private sector initiative in Central America.[15] IAF has not yet fulfilled its mission, but its mandate and organizational structure could help small businessmen and peasant or community organizations to develop the skills and resources that could move them into the mainstream private economy. The IAF's grass-roots approach gives it an advantage in targeting assistance--loans, grants, technical assistance, seed money--to the direct self-help efforts of private sector groups.

Farm Cooperatives. There are two reasons for skepticism about this form of support. First, an internal government audit has found that most farm cooperatives in El Salvador are not financially viable; the combined debt for existing cooperatives could reach $2 billion by the year 2000.[16] Second, many of these cooperatives are organized according to a Communitarian, (i.e. socialist), rather than a private ownership model.

If funds are available to support cooperatives, they should go to private ownership cooperatives and those with prospects of becoming self-sustaining. They should emphasize education and training. Technical training in the principles of self-help and financial discipline is an important first step before the cooperative system can absorb large amounts of additional money. Finally, a cooperative exchange program would be especially helpful in emphasizing the business aspects over the social and political aspects, which are sometimes too prominent in Central American cooperatives.

External debt. The combination of the 1979-1980 oil price increases and the commodity price declines between 1980 and 1983 opened up a gap of $1.5 billion in the region's balance of payments. Most governments responded by borrowing rather than adjustment.[17] Concern with maintaining or increasing imports and consumption in the short term appears to have prevailed over the consideration that interest and amortization payments would eventually require the economy to give up real resources and force a reduction in future consumption if foreign exchange earnings and reserves were inadequate.

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15 For a discussion of the history and operations of the IAF, see Cleto DiGiovanni, Jr., The Inter-American Foundation (Washington, D.C.: The Heritage Foundation, 1981).

16 "Agrarian Reform in El Salvador: A Report on its Status," Audit Report No. 1-519-34-2, January 18, 1984.

17 In Costa Rica, for example, total external debt at the end of 1980 was $2,304 million, or 49 percent of GNP. This was an increase of 23.3 percent over 1979, when it rose 16 percent after almost doubling in 1976-1978. Similarly, total external public debt in Guatemala at the end of 1979 was $836.4 million, three times more than in 1975, and increased by 14 percent in 1980 to approximately $950 million. Economic and Social Progress in Latin America (Washington, D.C.: Inter-American Development Bank, 1981).

The high debt service ratios for the countries in the region have forced a sharp reduction in imports, thus reinforcing a decline in output and consumption, and reducing the availability of resources needed for future growth. Except for Costa Rica, none of the region's countries has asked for debt rescheduling. The U.S. should encourage this and facilitate the renegotiations between the countries and creditor banks.

The U.S. also should encourage the gradual adoption of policies that would correct overvalued exchange rates that stimulate imports for consumption (to the detriment of domestic saving and investment); encourage export promotion and diversification, which will lower the debt service ratio and lessen vulnerability to swings in export commodity prices; remove export taxes and other export disincentives; and channel a growing proportion of public sector capital expenditures to providing credit to the private sector.

Trade financing. Trade financing, until recently considered apart from debt service issues in Latin America, is now having an increasing impact on questions relating to external debt. Two factors account for this. First, major debtor countries have been rescheduling payments of trade credits as well as longer-term loans, thus shattering the confidence of U.S. suppliers who have provided about half of the financing for Latin American trade. Second, the inability of countries to obtain credit severely constrains their ability to earn the foreign exchange necessary to meet payments on long-term debt.

Proposals have been made for an Export-Import Bank-administered trade credit guarantee facility for Central America along the lines of that authorized last year for Mexico and Brazil. This kind of government guarantee, however, introduces a number of distortions into the trade and financial system that could become institutionalized. Most serious would be the danger of government guarantees becoming the sole source of trade financing, thus eliminating the role of private banks and the private sector generally, while the state's role increases correspondingly.

An alternative to trade credit guarantees, which also would keep trade flowing, would be for debtors to insulate short-term credits from the overall debt problem by not including them in rescheduling agreements; in return, creditors (banks and suppliers) would restore credit lines.[18] Such an arrangement, relying on the private sector and a balance of the real interests of individuals in a free market, is preferable to the creeping statism potential of a government-backed guarantee program, and deserves full consideration and support.

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[18] For a fuller discussion of such an arrangement, see "Why Latin America's Debt Crisis Won't Go Away," International Business Week, April 16, 1984.

Economic Summit and Central American Common Market. The U.S. should encourage a Central American Economic Summit. A key topic should be the renewal of the Central American Common Market. The Common Market, as a regionally inspired rather than externally created institution, with strong support among Central American nations, would provide an appropriate forum for regional initiatives and cooperation on policy matters, such as a currency union to liberalize trade.

In encouraging the revival of the Common Market, however, the U.S. should discourage the competitive use of fiscal incentives that lead to inefficient production and distort the basis for investment decisions. Excessive protection for government-selected industries (that in fact establishes monopolies) and reliance on centralized economic planning should be avoided. By using part of its economic assistance to provide credit to the Central American Common Market Fund, the U.S. can also encourage a more open trading posture within the Market. Only by gradually reducing their external tariffs can the CACM countries become more competitive in world markets.

New Multilateral Organizations. The Administration should be wary of suggestions for new, multilateral organizations, such as the Central American Development Organization, proposed by the Kissinger Commission. There are already sufficient channels for official resource flows, such as the World Bank, the Inter-American Development Bank, and the U.S. Agency for International Development. The only apparent economic function of CADO, as proposed, would be centralized control of the allocation of assistance funds.

If such an organization were created, however, membership should be drawn primarily from the private sector. Furthermore, a formula should be devised whereby Nicaragua would not benefit from the organization.

Opening U.S. Markets

Efforts should be made to open U.S. markets to the region's leading exports. The matter of nontariff barriers, particularly with respect to textiles, sugar, and beef, is highly controversial due to domestic implications. At the same time, these products are affected by multilateral agreements that afford the Administration some flexibility in giving the products access to U.S. markets. Trade, not aid, is by far the most effective approach to long-term development. Yet while proposals for millions of dollars of aid are discussed, Costa Rica, Honduras, and El Salvador are permitted to supply only 3 percent of total U.S. sugar imports.

Economic policy in recipient countries

The U.S. should use its influence, through economic assistance, to encourage economic reforms in Central America. The question of restructuring tax and incentive policies could be discussed at the economic summit. Inappropriate tax policies that penalize investment and export activity deserve special attention. Other domestic barriers to development to be reviewed are price controls, subsidies, political allocation of credit and foreign exchange, marketing boards, and artificially established exchange rates. The cumulative effect of these mechanisms that suspend operation of market forces is to penalize production and investment and to subsidize inefficient production or nonproduction.[19]

Advocacy of internal reform is a politically sensitive matter in dealing with sovereign states. Yet if domestic policy is not used to create a structure of incentives for production, savings, and investment, development funds cannot succeed in fostering sustained growth. Where the prospects for effective use of economic aid are dim, the rationale for the provision of aid collapses.

Foreign Investment

Foreign private investment in Central America can make a considerable contribution to its growth and development and reduce the need for official resource flows. Foreign capital played a large role in the development of today's industrialized nations. Foreign investment by the developed countries brings capital, managerial skill, and technical knowledge to developing countries; the latter two are exceptionally important.

Yet foreign investment is naturally sensitive to the host country's economic policies. Government monopolies, export taxes, restrictions on areas open to foreign capital, and uncertainty about compensation for expropriation are some of the factors that inhibit investment. Tax rates on business of 60 percent or more, prohibitive regulations on labor compensation and job security, and high tariffs on intermediate goods also discourage investment. In general, countries that have pursued open economic policies and limited government intervention have succeeded in attracting foreign investment that has stimulated their growth.

End Diversion of Aid Funds

The diversion of economic assistance funds for personal use is not only morally repugnant, it is also a serious waste of scarce resources that could otherwise improve the living standards of many.[20] The U.S. should devote the necessary resources to substantially reduce the possibilities for such aid diversion.

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20 For a discussion of policies of developing countries, see Harry G. Johnson, "Obstacles to Development," in Section III, Economic Policies Toward Less Developed Countries (Washington, D.C.: The Brookings Institution, 1967).

21 For some reports of diversion of aid, see "Salvadoran Land Program is Criticized," New York Times, February 15, 1984, and "U.S. Audits in Central America," New York Times, February 19, 1984.

Improvement of the Capacity to Absorb Aid

A rough guide to an economy's ability to use aid to further economic growth, often cited in connection with aid proposals for Central America, is the aid/GNP ratio. When relied upon excessively, however, such a guideline can be seriously misleading, as it has been to observers who point to a moderate aid/GNP ratio as an indication that Central America can effectively absorb further aid.[21]

Other important factors that must be considered are the size, competence, and stability of the civil service that administers foreign aid. The ability of a foreign country to produce the necessary matching funds for some projects is also crucial. Furthermore, to make large new amounts of money available when there is no portfolio of feasible projects ready for implementation is fruitless.

Recent examples of limited capacity to absorb aid in Honduras include:[22] new school buildings that have no books or furniture, new hospitals too expensive for the country to operate or maintain, and $100 million in unspent U.S. money already back-logged in AID's pipeline. In other Central American countries, the logjam of similarly unused aid money totals $379.1 million.[23]

Massive aid flows cannot be used effectively where managerial capacity is severely limited, bottlenecks abound, and government procedures are cumbersome. The dilemmas posed for a poor and underdeveloped country trying to use aid amounts for which it is unprepared illustrate why "throwing money" at development problems is a counterproductive approach to assistance.[24]

CONCLUSION

The United States has vital interests in Central America and should provide that region humanitarian assistance and stabilization support. The purposes of its economic assistance to Central America should be to relieve the suffering caused by political

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21 See, for example, Briefing Book: Central America Democracy, Peace and Development Initiative, U.S. Department of State, February 1984, p. 11.

22 Art Pine, "Can Central America Absorb More Aid," The Wall Street Journal, February 17, 1984.

23 Central Americans themselves have expressed concern regarding their ability to use more aid. Eduardo Ulibarri, editor-in-chief of the Costa Rican daily La Nacion, wrote in the Wall Street Journal of February 17, 1984, that "The necessary measures for absorbing aid...have not been thoroughly thought out."

24 In Fiscal Year 1979, U.S. economic aid to seven Central American countries totaled $141.2 million; by Fiscal Year 1983, ended last September 30, economic aid had grown to $628 million.

violence and economic breakdown and to bolster governments under siege by leftist guerrillas by preventing economic collapse. Economic assistance should be channeled to private sector activities where efficient economic use is more assured. The pitfalls of a statist approach to development should be carefully avoided, as they are costly to both the recipient and donor countries.

The Reagan Administration's economic assistance proposals for Central America implicitly assume that development requires large amounts of external credit. Yet excessive reliance on credit to spur development reverses the natural order of the development process. In an open economic system with opportunities for growth and no disincentives for private initiative, private funds should become available to play the role in growth that has increasingly been shifted to official resource flows.

If steps are taken to shore up the economies of Central America during a crisis period, and if assistance is targeted in a way that lays the basis for future growth, such as alleviating the debt burden and reviving intraregional trade through the Common Market, the real amount of economic assistance needed by Central America may be much less than that proposed by the Administration.

In the long term, development in Central America requires that the region have a modicum of peace and that the countries adopt economic policies aimed at creating open, free-market systems. If these conditions are met, Central America can again attain the growth levels it enjoyed in the past and become an attractive place to invest. Should these objectives fail to materialize, any amount of development assistance to the region will be in vain.

Virginia Polk
Policy Analyst

APPENDIX I

FINANCIAL SUMMARY

Economic Assistance to Central America
(millions of dollars)

Purpose	Supplemental FY 1984	FY 1985	FY 1986-FY 1989	Total
Stabilization				
ESF	272	541	1,644	2,457
P.L. 480	25	103	--	128
Guarantees	--	470	--	470
Sub-total	297	1,114	1,644	3,055
Growth				
ESF	10	80	789	879
DA	8	87	327	422
P.L. 480	--	--	410	410
Guarantees	--	90	1,240	1,330
Counterpart*	(100)	(220)	(520)	(840)
Sub-total	118	477	3,286	3,881
Equity				
DA	66	196	1,096	1,361
P.L. 480, II	--	17	70	87
Guarantees	--	40	160	200
Counterpart*	(100)	(220)	(880)	(1,200)
Peace Corps	2	18	94	114
State, Refugees	--	15	78	93
Sub-total	168	506	2,381	3,055
Democracy				
ESF	8	20	85	113
U.S.I.A.	7	36	179	222
CADO	--	1	4	5
Sub-total	15	57	268	340
Operating Expenses	2	6	26	34
TOTAL*	400	1,720	6,205	8,325

* Counterpart figures are local currency generations from ESF or P.L. 480 balance-of-payments financing for A.I.D.-supported activities in the region. Since they are programmed for development purposes, they are included in sector sub-totals but not in the overall total.

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To lay the foundation for long-term development, U.S. assistance to Central America should be directed toward growth of the private sector. The U.S. Agency for International Development, the Inter-American Foundation, private voluntary groups, and scholarships for Central Americans to study in the U.S. can all promote development directed toward free enterprise rather than centralized planning. In addition, U.S. markets should be opened to Central American exports. On the other hand, there should be no rush to create a new regional economic organization, since adequate institutions now exist.

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Growth and Stability

The call for massive economic assistance for Central America appears to be based on the assumption that development contributes to political stability. History teaches, however, that development often can be temporarily destabilizing. Even under the relatively favorable circumstances in which industrialization and modernization took place in North America and Europe, political and social systems suffered confrontation and dislocation.

At least in the short run, rising expectations of economic and social progress can be disruptive. Modernization programs artifically imposed by the state in such countries as India, China, and Nigeria have produced what even the most sympathetic observer can only regard as mixed results. Thus there is no certain relation between development and stability, or development and democratic government. But because the long-term benefits of development outweigh the cost of difficult adjustments, the volatility of the process should not prevent development assistance efforts. Policy makers, however, must be alert to problems inherent in the process.

Poverty and Revolution

Social and economic inequity long have characterized El Salvador, as they have other developing countries. If these conditions breed revolution, then Central America--and most of the developing world, as well as the Communist-ruled countries--would have been in flames long ago. Yet the violent insurgency in El Salvador is a recent phenomenon; it has been fostered and sustained by assistance from communist nations in the region, particularly Nicaragua and Cuba.[7]

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[7] Moreover, El Salvador is not the poorest country in the hemisphere, nor does it have the worst income distribution. Ecuador does, followed by Venezuela and Mexico, with 5 percent of national income going to 42 percent, 40 percent, and 36 percent of the population, respectively.

Furthermore, the economic progress in El Salvador prior to the outbreak of civil strife in 1979, although more moderate in the late 1970s than earlier, indicates that economic improvement does not necessarily bring social tranquility. Although the benefits of economic growth were unevenly distributed, growth itself is a catalyst for redistribution.[8] It is the Soviet and Cuban-fed insurgency beginning in 1979 that is largely responsible for the dramatic reversal of the growth process.[9]

GUIDELINES FOR U.S. ECONOMIC ASSISTANCE TO CENTRAL AMERICA

Recognition of the limited role of economic assistance in bringing about development does not mean that there is no role for U.S. aid to Central America. It does mean that aid should be carefully targeted and that unrealistic expectations about the prompt emergence of stable democratic institutions and the growth of a free economy under trying circumstances should be avoided. Among the measures that would halt economic decline and signal U.S. commitment to helping Central America solve its economic and political problems are:[10]

Private sector support

U.S. economic assistance should be used to expand and strengthen the private sector in Central American economies. Sustained economic growth depends upon a dynamic private sector that allocates resources on the basis of free market principles.[11] Centralized economies, on the other hand, are incapable of using resources as efficiently as market economies. The record of countries that have pursued such a statist approach to development is notoriously poor.

The transfer of substantial resources from the U.S. to public sector bureaucracies in Central America would serve mostly to support and expand those bureaucracies. Yet expansion of the public sector and reliance on central planning would be a particularly damaging strategy for developing countries, which can ill

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8 Income distribution in pre-industrial America and Europe was not unlike that of Latin America today, and it improved as a result of growth.

9 Both elections and economic reform measures undertaken by the government have been sabotaged by leftist guerrillas, who have proclaimed economic attrition to be an element in their strategy to gain power.

10 Humanitarian assistance and economic stabilization are important to bolster governments under attack by communist supported insurgencies; long-term development clearly depends upon overcoming the Marxist-Leninist forces now intent on gaining power.

11 There are sectors in Central America that support this approach. See, for example, an interview with Manuel Ayau, rector of Guatemala's Universidad Francisco Marroquin, in the National Catholic Register, March 11, 1984, where he says, "This [development] cannot happen in any system but a market economy."

afford the inefficiency of planning that establishes political expediency above economic expertise, and that would impose a cost on the economy in the misallocation of scarce managerial capacity and other resources.[12]

The rationale for directing U.S. aid to the private sector also rests on the recognition that development is contingent upon human motivation and attitudes toward work, risk, and reward. Assistance that provides previously unavailable credit to small businesses and teaches basic skills to innovative and energetic entrepreneurs would contribute to growth by fostering the individual initiative and self-help that are the very foundation of development.

Efforts to encourage private sector growth should focus on three general areas:

1) access to credit for groups or individuals with viable business ideas or enterprises;

2) start-up financial support for private enterprises capable of providing services on a fee basis (in health and technical training, for example) that have previously been funded by public sector institutions;[13]

3) training in the basic skills required to start and operate small businesses.

In its assistance to small businesses, this approach would place considerably less emphasis on financing at concessional rates. Such artificially low rates in the past have ended in economic investment decisions that required ongoing subsidies, thereby preventing the emergence of self-sustaining businesses. It would also stress working with intermediate financial institutions to improve underdeveloped capital markets, thus extending credit access to new entrepreneurs.[14]

Inter-American Foundation. The Inter-American Foundation, created by Congress in 1969 to provide assistance to disadvantaged people in Latin America who had not benefited from conventional

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12 A useful discussion of statist versus free enterprise approaches to development is found in P. T. Bauer, Dissent on Development (Cambridge, Massachusetts: Harvard University Press, 1976).

13 This kind of project has recently been implemented by AID through its Bureau for Private Enterprise for technical training in Peru and Thailand, and for health services in Africa.

14 AID's Bureau for Private Enterprise is designed for this purpose. It offers financing terms at near-market rates to small entrepreneurs when feasibility studies are positive. The Bureau works with private intermediate institutions to strengthen local capital markets, and is active in upgrading management skills at the small business level.

U.S. aid efforts, could play a useful role in supporting private sector initiative in Central America.[15] IAF has not yet fulfilled its mission, but its mandate and organizational structure could help small businessmen and peasant or community organizations to develop the skills and resources that could move them into the mainstream private economy. The IAF's grass-roots approach gives it an advantage in targeting assistance--loans, grants, technical assistance, seed money--to the direct self-help efforts of private sector groups.

Farm Cooperatives. There are two reasons for skepticism about this form of support. First, an internal government audit has found that most farm cooperatives in El Salvador are not financially viable; the combined debt for existing cooperatives could reach $2 billion by the year 2000.[16] Second, many of these cooperatives are organized according to a Communitarian, (i.e. socialist), rather than a private ownership model.

If funds are available to support cooperatives, they should go to private ownership cooperatives and those with prospects of becoming self-sustaining. They should emphasize education and training. Technical training in the principles of self-help and financial discipline is an important first step before the cooperative system can absorb large amounts of additional money. Finally, a cooperative exchange program would be especially helpful in emphasizing the business aspects over the social and political aspects, which are sometimes too prominent in Central American cooperatives.

External debt. The combination of the 1979-1980 oil price increases and the commodity price declines between 1980 and 1983 opened up a gap of $1.5 billion in the region's balance of payments. Most governments responded by borrowing rather than adjustment.[17] Concern with maintaining or increasing imports and consumption in the short term appears to have prevailed over the consideration that interest and amortization payments would eventually require the economy to give up real resources and force a reduction in future consumption if foreign exchange earnings and reserves were inadequate.

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[15] For a discussion of the history and operations of the IAF, see Cleto DiGiovanni, Jr., The Inter-American Foundation (Washington, D.C.: The Heritage Foundation, 1981).

[16] "Agrarian Reform in El Salvador: A Report on its Status," Audit Report No. 1-519-34-2, January 18, 1984.

[17] In Costa Rica, for example, total external debt at the end of 1980 was $2,304 million, or 49 percent of GNP. This was an increase of 23.3 percent over 1979, when it rose 16 percent after almost doubling in 1976-1978. Similarly, total external public debt in Guatemala at the end of 1979 was $836.4 million, three times more than in 1975, and increased by 14 percent in 1980 to approximately $950 million. Economic and Social Progress in Latin America (Washington, D.C.: Inter-American Development Bank, 1981).

The high debt service ratios for the countries in the region have forced a sharp reduction in imports, thus reinforcing a decline in output and consumption, and reducing the availability of resources needed for future growth. Except for Costa Rica, none of the region's countries has asked for debt rescheduling. The U.S. should encourage this and facilitate the renegotiations between the countries and creditor banks.

The U.S. also should encourage the gradual adoption of policies that would correct overvalued exchange rates that stimulate imports for consumption (to the detriment of domestic saving and investment); encourage export promotion and diversification, which will lower the debt service ratio and lessen vulnerability to swings in export commodity prices; remove export taxes and other export disincentives; and channel a growing proportion of public sector capital expenditures to providing credit to the private sector.

Trade financing. Trade financing, until recently considered apart from debt service issues in Latin America, is now having an increasing impact on questions relating to external debt. Two factors account for this. First, major debtor countries have been rescheduling payments of trade credits as well as longer-term loans, thus shattering the confidence of U.S. suppliers who have provided about half of the financing for Latin American trade. Second, the inability of countries to obtain credit severely constrains their ability to earn the foreign exchange necessary to meet payments on long-term debt.

Proposals have been made for an Export-Import Bank-administered trade credit guarantee facility for Central America along the lines of that authorized last year for Mexico and Brazil. This kind of government guarantee, however, introduces a number of distortions into the trade and financial system that could become institutionalized. Most serious would be the danger of government guarantees becoming the sole source of trade financing, thus eliminating the role of private banks and the private sector generally, while the state's role increases correspondingly.

An alternative to trade credit guarantees, which also would keep trade flowing, would be for debtors to insulate short-term credits from the overall debt problem by not including them in rescheduling agreements; in return, creditors (banks and suppliers) would restore credit lines.[18] Such an arrangement, relying on the private sector and a balance of the real interests of individuals in a free market, is preferable to the creeping statism potential of a government-backed guarantee program, and deserves full consideration and support.

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[18] For a fuller discussion of such an arrangement, see "Why Latin America's Debt Crisis Won't Go Away," International Business Week, April 16, 1984.

Economic Summit and Central American Common Market. The U.S. should encourage a Central American Economic Summit. A key topic should be the renewal of the Central American Common Market. The Common Market, as a regionally inspired rather than externally created institution, with strong support among Central American nations, would provide an appropriate forum for regional initiatives and cooperation on policy matters, such as a currency union to liberalize trade.

In encouraging the revival of the Common Market, however, the U.S. should discourage the competitive use of fiscal incentives that lead to inefficient production and distort the basis for investment decisions. Excessive protection for government-selected industries (that in fact establishes monopolies) and reliance on centralized economic planning should be avoided. By using part of its economic assistance to provide credit to the Central American Common Market Fund, the U.S. can also encourage a more open trading posture within the Market. Only by gradually reducing their external tariffs can the CACM countries become more competitive in world markets.

New Multilateral Organizations. The Administration should be wary of suggestions for new, multilateral organizations, such as the Central American Development Organization, proposed by the Kissinger Commission. There are already sufficient channels for official resource flows, such as the World Bank, the Inter-American Development Bank, and the U.S. Agency for International Development. The only apparent economic function of CADO, as proposed, would be centralized control of the allocation of assistance funds.

If such an organization were created, however, membership should be drawn primarily from the private sector. Furthermore, a formula should be devised whereby Nicaragua would not benefit from the organization.

Opening U.S. Markets

Efforts should be made to open U.S. markets to the region's leading exports. The matter of nontariff barriers, particularly with respect to textiles, sugar, and beef, is highly controversial due to domestic implications. At the same time, these products are affected by multilateral agreements that afford the Administration some flexibility in giving the products access to U.S. markets. Trade, not aid, is by far the most effective approach to long-term development. Yet while proposals for millions of dollars of aid are discussed, Costa Rica, Honduras, and El Salvador are permitted to supply only 3 percent of total U.S. sugar imports.

Economic policy in recipient countries

The U.S. should use its influence, through economic assistance, to encourage economic reforms in Central America. The question of restructuring tax and incentive policies could be discussed at the economic summit. Inappropriate tax policies that penalize investment and export activity deserve special attention. Other domestic barriers to development to be reviewed are price controls, subsidies, political allocation of credit and foreign exchange, marketing boards, and artificially established exchange rates. The cumulative effect of these mechanisms that suspend operation of market forces is to penalize production and investment and to subsidize inefficient production or nonproduction.[19]

Advocacy of internal reform is a politically sensitive matter in dealing with sovereign states. Yet if domestic policy is not used to create a structure of incentives for production, savings, and investment, development funds cannot succeed in fostering sustained growth. Where the prospects for effective use of economic aid are dim, the rationale for the provision of aid collapses.

Foreign Investment

Foreign private investment in Central America can make a considerable contribution to its growth and development and reduce the need for official resource flows. Foreign capital played a large role in the development of today's industrialized nations. Foreign investment by the developed countries brings capital, managerial skill, and technical knowledge to developing countries; the latter two are exceptionally important.

Yet foreign investment is naturally sensitive to the host country's economic policies. Government monopolies, export taxes, restrictions on areas open to foreign capital, and uncertainty about compensation for expropriation are some of the factors that inhibit investment. Tax rates on business of 60 percent or more, prohibitive regulations on labor compensation and job security, and high tariffs on intermediate goods also discourage investment. In general, countries that have pursued open economic policies and limited government intervention have succeeded in attracting foreign investment that has stimulated their growth.

End Diversion of Aid Funds

The diversion of economic assistance funds for personal use is not only morally repugnant, it is also a serious waste of scarce resources that could otherwise improve the living standards of many.[20] The U.S. should devote the necessary resources to substantially reduce the possibilities for such aid diversion.

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20 For a discussion of policies of developing countries, see Harry G. Johnson, "Obstacles to Development," in Section III, Economic Policies Toward Less Developed Countries (Washington, D.C.: The Brookings Institution, 1967).

21 For some reports of diversion of aid, see "Salvadoran Land Program is Criticized," New York Times, February 15, 1984, and "U.S. Audits in Central America," New York Times, February 19, 1984.

Improvement of the Capacity to Absorb Aid

A rough guide to an economy's ability to use aid to further economic growth, often cited in connection with aid proposals for Central America, is the aid/GNP ratio. When relied upon excessively, however, such a guideline can be seriously misleading, as it has been to observers who point to a moderate aid/GNP ratio as an indication that Central America can effectively absorb further aid.[21]

Other important factors that must be considered are the size, competence, and stability of the civil service that administers foreign aid. The ability of a foreign country to produce the necessary matching funds for some projects is also crucial. Furthermore, to make large new amounts of money available when there is no portfolio of feasible projects ready for implementation is fruitless.

Recent examples of limited capacity to absorb aid in Honduras include:[22] new school buildings that have no books or furniture, new hospitals too expensive for the country to operate or maintain, and $100 million in unspent U.S. money already back-logged in AID's pipeline. In other Central American countries, the logjam of similarly unused aid money totals $379.1 million.[23]

Massive aid flows cannot be used effectively where managerial capacity is severely limited, bottlenecks abound, and government procedures are cumbersome. The dilemmas posed for a poor and underdeveloped country trying to use aid amounts for which it is unprepared illustrate why "throwing money" at development problems is a counterproductive approach to assistance.[24]

CONCLUSION

The United States has vital interests in Central America and should provide that region humanitarian assistance and stabilization support. The purposes of its economic assistance to Central America should be to relieve the suffering caused by political

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21 See, for example, Briefing Book: Central America Democracy, Peace and Development Initiative, U.S. Department of State, February 1984, p. 11.

22 Art Pine, "Can Central America Absorb More Aid," The Wall Street Journal, February 17, 1984.

23 Central Americans themselves have expressed concern regarding their ability to use more aid. Eduardo Ulibarri, editor-in-chief of the Costa Rican daily La Nacion, wrote in the Wall Street Journal of February 17, 1984, that "The necessary measures for absorbing aid...have not been thoroughly thought out."

24 In Fiscal Year 1979, U.S. economic aid to seven Central American countries totaled $141.2 million; by Fiscal Year 1983, ended last September 30, economic aid had grown to $628 million.

violence and economic breakdown and to bolster governments under siege by leftist guerrillas by preventing economic collapse. Economic assistance should be channeled to private sector activities where efficient economic use is more assured. The pitfalls of a statist approach to development should be carefully avoided, as they are costly to both the recipient and donor countries.

The Reagan Administration's economic assistance proposals for Central America implicitly assume that development requires large amounts of external credit. Yet excessive reliance on credit to spur development reverses the natural order of the development process. In an open economic system with opportunities for growth and no disincentives for private initiative, private funds should become available to play the role in growth that has increasingly been shifted to official resource flows.

If steps are taken to shore up the economies of Central America during a crisis period, and if assistance is targeted in a way that lays the basis for future growth, such as alleviating the debt burden and reviving intraregional trade through the Common Market, the real amount of economic assistance needed by Central America may be much less than that proposed by the Administration.

In the long term, development in Central America requires that the region have a modicum of peace and that the countries adopt economic policies aimed at creating open, free-market systems. If these conditions are met, Central America can again attain the growth levels it enjoyed in the past and become an attractive place to invest. Should these objectives fail to materialize, any amount of development assistance to the region will be in vain.

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APPENDIX I

FINANCIAL SUMMARY

Economic Assistance to Central America
(millions of dollars)

Purpose	Supplemental FY 1984	FY 1985	FY 1986-FY 1989	Total
Stabilization				
ESF	272	541	1,644	2,457
P.L. 480	25	103	--	128
Guarantees	--	470	--	470
Sub-total	297	1,114	1,644	3,055
Growth				
ESF	10	80	789	879
DA	8	87	327	422
P.L. 480	--	--	410	410
Guarantees	--	90	1,240	1,330
Counterpart*	(100)	(220)	(520)	(840)
Sub-total	118	477	3,286	3,881
Equity				
DA	66	196	1,096	1,361
P.L. 480, II	--	17	70	87
Guarantees	--	40	160	200
Counterpart*	(100)	(220)	(880)	(1,200)
Peace Corps	2	18	94	114
State, Refugees	--	15	78	93
Sub-total	168	506	2,381	3,055
Democracy				
ESF	8	20	85	113
U.S.I.A.	7	36	179	222
CADO	--	1	4	5
Sub-total	15	57	268	340
Operating Expenses	2	6	26	34
TOTAL*	400	1,720	6,205	8,325

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* Counterpart figures are local currency generations from ESF or P.L. 480 balance-of-payments financing for A.I.D.-supported activities in the region. Since they are programmed for development purposes, they are included in sector sub-totals but not in the overall total.

May 10, 1984

CENTRAL AMERICAN AID: MORE IS NOT ALWAYS BETTER

INTRODUCTION

The report of the National Bipartisan Commission on Central America (known as the Kissinger Commission), released in January 1984, recommended large amounts of military and economic aid for Central America.[1] The Reagan Administration's economic aid proposals closely reflect the Commission's recommendations in calling for $8 billion of assistance over the next five years (see Appendix I for a breakdown of proposed aid).

Although it is already clear that the economic policy recommendations in the Report will not be fully adopted by Congress, the level of U.S. economic assistance to Central America may be increased substantially. Yet greatly increased economic aid will not necessarily spur economic development and could in fact be counterproductive unless it is carefully channeled to assure maximum private sector involvement and maximum use of free market mechanisms.[2] The $8 billion in assistance originally requested by the Administration may exceed what the various countries in the region can absorb, given questionable economic policies and the constraints on long-term development posed by a climate of uncertainty and violence.

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1 The initial proposal is for an $8 billion, five-year reconstruction and development program, with $6 billion in direct appropriations and $2 billion in insurance and guarantee authority.

2 For a useful discussion of U.S. economic assistance in the context of overall foreign policy, see A Report to the Secretary of State, the Commission on Security and Economic Assistance, Department of State, November 1983.