September 23, 1991

GUIDELINES FOR AID TO THE SOVIET UNION

INTRODUCTION

Hours after the failure of the August 19 coup in Moscow, Western politicians began calling for massive aid to the country still known technically as the "Soviet Union." In Germany, Chancellor Helmut Kohl immediately renewed his pleas for bailing out the Soviet economy and received strong support for his efforts from French President François Mitterrand. In the United States, House Majority Leader Richard Gephardt from Missouri proposed on August 30 a $3 billion Soviet aid package. Two days earlier, House Armed Services Committee Chairman Les Aspin, the Democrat from Wisconsin, urged Congress to cut America's defense spending by $1 billion and to use the money to assist Moscow.

Aspin and others may have good intentions, but their schemes will hurt, more than help, the prospects for genuine economic reform in what remains of the Soviet Union and its successor states. Needed to jump-start the economies of the Soviet republics are sweeping free market reforms—currency convertibility, freeing prices, trade liberalization, quick and massive privatization, deregulation—and the increased trade and foreign investment that will accompany these reforms. To be sure, it is in the interest of the U.S. and other Western countries to assist the independent republics now emerging from the Soviet Union in carrying out these reforms and making the difficult transition from command to market economies. The right way to do this, however, is to encourage the republics to help themselves by building new free market institutions, becoming competitive on world markets, and improving their credit-worthiness.

Creating Economic Hardship. Of course, there also is a wrong way to "help." Massive aid to what remains of the Soviet "center" will retard the efforts of the republics to achieve their independence and help to prop up crumbling and inefficient government and economic institutions. Government-to-government loans, whether to the "center" or to the new republics, will turn the successor states to the Soviet Union into Western dependents, saddling U.S. taxpayers with long-term obligations and creating resentment and economic hardship in the newly-created states.

Those who wish to help the people of the Soviet Union should remember that U.S. foreign aid has had a dismal track record the past four decades in promoting economic development. The U.S. experience in Africa and Latin America—where government-to-government aid often served only to perpetuate dictatorial regimes while economies stagnated—should serve as a reminder of how not to help the people of the Soviet Union and its successor states.

So far George Bush wisely has resisted calls for a massive aid package to the Soviet Union. The issue of aid, however, is at the top of Congress's agenda. Aspin, Gephardt, and others will try to seize the initiative with their expensive and counterproductive aid plans. Many members of Congress are hoping to use the issue of Soviet aid as a pretext to bust last year's budget agreement with the White House and call for even greater increases in domestic spending. To avert this, Bush and Congress should adopt a set of guidelines for aiding the people of the crumbling Soviet Union by fostering its transition from a centrally-planned state economy to a voluntary association of free market successor states.

WHAT WASHINGTON SHOULD NOT DO

Guideline #1: Do not channel aid through the Soviet central government in Moscow. Instead, any aid granted should be given to the republics, preferably to the private sector.

Guideline #2: Do not grant government-to-government loans either to the central government in Moscow or to the republics. Such loans only will saddle these governments with debt they cannot afford.

Guideline #3: Do not provide U.S. taxpayer-backed export or loan guarantees. These will not reduce the risk of loans to unstable governments. They simply transfer the risks to the American taxpayers.

Guideline #4: Do not assist financially in "currency convertibility" until Moscow, or the republics, adopt an independent monetary system truly outside of direct political control. Only an independent monetary authority can tighten the monetary supply to reduce inflation and take the other necessary but sometimes politically difficult monetary decisions.

Guideline #5: Do not support Soviet membership in the International Monetary Fund (IMF) or the World Bank. The Soviet Union is dying. Membership should be considered for the republics or some successor association of republics once they have achieved independence and instituted necessary free market reforms.

WHAT WASHINGTON SHOULD DO

Guideline #1: Organize emergency food aid, if needed, and insist on control over its distribution.

Guideline #2: Use the Index of Economic Freedom as a guide to insist on progress in economic reform as a condition for U.S. assistance to the individual republics. The index outlines the necessary elements of a market economy such as protection of private property rights, limited government regulation, and private banking and financial institutions. Only those republics making progress in enacting these and other reforms which greatly expand economic freedom should be eligible for U.S. assistance.

Guideline #3: Restructure U.S. technical assistance programs. These should cut through bureaucratic red tape and give the republics access to experts from the U.S. private sector, not just government bureaucrats.

Guideline #4: Promote increased trade and investment as an alternative to aid. Most Favored Nation trade status should be offered to emerging republics.

Guideline #5: Require, and monitor, cuts in military output as a condition for aid.

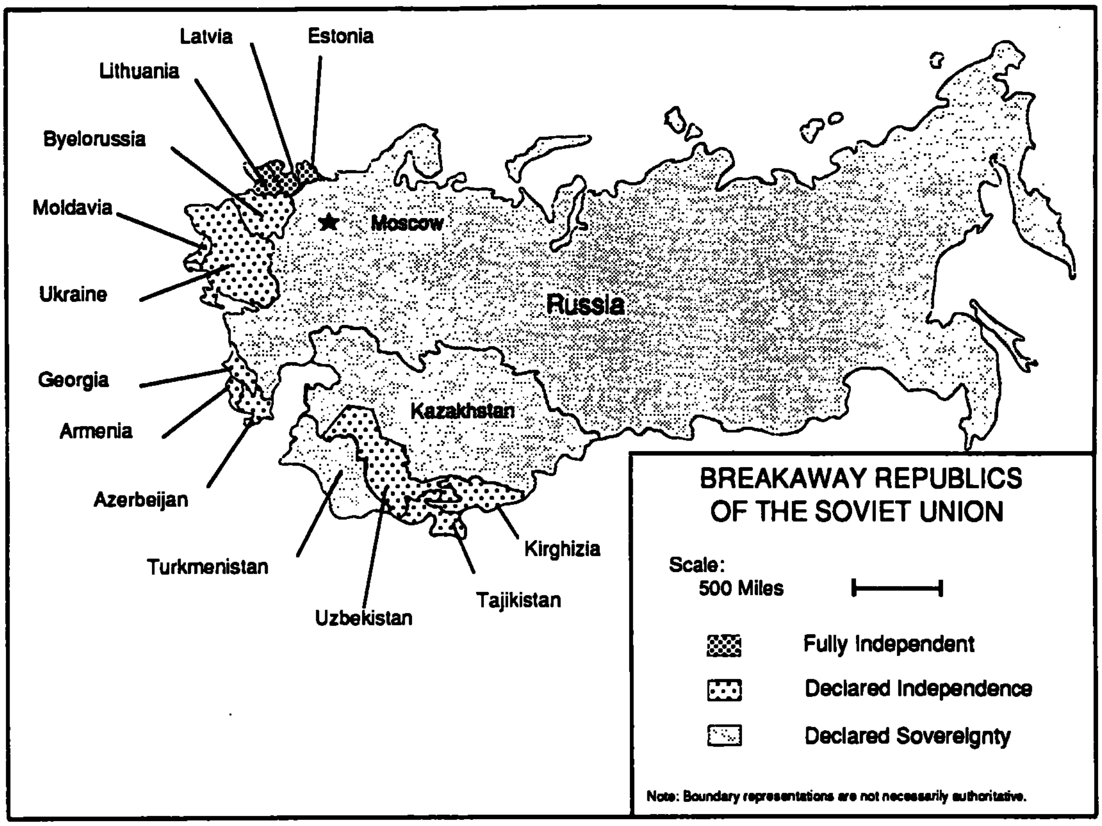
Guideline #6: Announce a date in advance when the aid program will end. The republics cannot be permitted to become addicted to Western government handouts.

THE DISINTEGRATION OF THE SOVIET UNION

The Soviet economy is in a freefall with no parachute in sight. Communist central planning and decades of annual defense expenditures amounting to roughly 25 percent of gross national product (GNP) have yielded a Third World economy. Six years of Mikhail Gorbachev's stumbling toward reform, while failing to fundamentally dismantle and transform the communist economy, have further exacerbated an economic slide that began in the early 1980s. The GNP declined 10 percent in the first half of 1991 and likely will fall another 8 percent to 10 percent by year's end. Foreign trade is down 37 percent. Inflation is over 100 percent annually and could reach 1,000 percent by next year. Those wishing to conduct major economic transactions must barter rather than use the worthless ruble.

Not only is the Soviet economy falling apart, but the Soviet state is disintegrating. Twelve of the fifteen republics have proclaimed their independence. All the republics, including the huge Russian Federation, have declared sovereignty over resources within their boundaries. Gorbachev has been reduced to little more than a figurehead and arbiter of disputes between the republics. Control over economic policy rapidly is flowing to the republics—many of which plan to introduce their own currencies. Although the Congress of People's Deputies, the Soviet parliament set up in 1989, voted overwhelmingly on September 5 to dissolve the old union, and to create a new voluntary association of independent states, any plan for political union is unlikely to withstand the tremendous centrifugal forces of nationalism.

Major U.S. Stake. America's interest is in the continued decolonization and decentralization of the Soviet Union into free and independent states. The independence of the republics is the West's best assurance that the Soviet Union never again will rise to pose a military threat. Independence also fulfills the longstanding dreams of self-determination for millions. America has a major stake in a successful transition to a market economy in Russia and the other republics. Prosperity will increase the probability that



nascent democratic institutions will survive, and will mean greater investment opportunities for American businesses and huge, new markets for American exports. This will invigorate U.S. companies and make the American economy stronger.

Bush and Congress should seek to ensure that U.S. aid helps the development of market institutions and the rapid growth of private business, rather than propping up an irredeemable and discredited "Soviet" economic system. To do so, Bush should set forth a clear set of guidelines for assisting the peoples of the Soviet Union.

WHAT WASHINGTON SHOULD NOT DO

Guideline #1: Do not channel aid through the Soviet central government in Moscow.

The Soviet Union is fast becoming a historical footnote. Nearly all authority for economic policy-making is flowing rapidly from central authorities in the Kremlin to the republics. The September 2 Ten-Plus-One agreement between Gorbachev and the leaders of ten republics ended the old union and sounded the death knell for centralized rule. The agreement called for a new, voluntary, multi-tiered confederation and for reducing the responsibility of the central government to ensuring the security of a common "military-strategic" space and coordinating economic and foreign policy issues. Central economic ministries soon will be abolished and all-union state enterprises and control of other property will revert to the republics. Moreover, the republics are dividing up between themselves gold reserves and other resources previously controlled by the central government.

Some argue that the central government is capable of implementing the kind of comprehensive, radical economic reform plan that is needed to save the Soviet economy from collapse. Grigory Yavlinsky, the economist in charge of economic reform for the Soviet Union's new Committee for the Management of the National Economy, for example, is a strong proponent of a unified reform plan. But even he admitted on September 6 that the current political situation makes any all-union economic reform program unworkable and unrealistic. Says Yavlinsky, "There is no place for reform on an all-union level."[1]

Under these conditions, aid to the central government would only slow the process of decentralization now taking place in the former Soviet Union and allow the organs of central power to retain some degree of control. The last vestiges of the command economic system, such as the central bureaucracies and planning agencies, will try to hold onto power as long as they can. Massive foreign aid is their only hope of preventing near-term extinction. The U.S. should not assist their cause. Instead, any assistance given by the U.S. should go directly to the emerging private sector in the republics.

Guideline #2: Do not grant government-to-government loans either to the central government or the republican governments.

Proponents of large-scale aid to Moscow propose giving loans or grants from the U.S. government to the Soviet government. The argument most often advanced is that loan and grant programs would allow the Soviet government to pay for a massive influx of Western consumer and capital goods. Supposedly this would fill the shops, hearten Soviet citizens, and "soak up" some of the enormous quantity of excess rubles now in circulation, and thus lower inflationary pressures.

Large loans and grants would allow Soviet citizens to go on a one-time consumer binge, after which they would be no better off than before. They also would drive local industries producing consumer goods out of business since these enterprises could not compete with the higher-quality Western goods temporarily made available at low, state-administered prices. As these local industries collapsed, unemployment would skyrocket and domestic output would plunge. Further, incentives to privatize the economy would be weakened because goods temporarily would not be as scarce. A major driving force today for privatization is the desire for the private sector of the economy to produce more goods.

There are other reason why loans and grants will do more harm than good. The governments receiving the loans—whether central or republican—would be saddled with huge foreign debt that could hamper economic growth for years. Latin American nations, for example, have become completely dependent on World Bank loans. Each year, the World Bank supplies steadily larger loans to these countries so they can pay back previous World Bank loans. The total Latin American debt now amounts to $428.6 billion.

1 "A Bleak Economy Dims Soviet Hopes for a Free Market," *New York Times*, September 9, 1991, p. 1.

Turning to the Private Sector. The other frequently proposed use of loans and grants to the Soviet Union is to help build airports, communication networks, energy plants, railroads, roads, water systems, and wastewater treatment facilities. These need to be modernized if the people of the Soviet Union are to enjoy a standard of living comparable to that of the West. But while substantial investment is needed to do this, the U.S. and other Western countries should not pour billions of taxpayer dollars into the coffers of the central or republican governments to finance this task. Rather, Washington should encourage the republican governments to use the emerging private sector. In Britain, Chile, Mexico, and elsewhere the private sector is building, operating, and, in many cases, even owning airports, bridges, communication services, wastewater treatment plants, and water supply systems. These projects have been tremendously successful. Private investment can increase competition—thereby keeping costs low and quality high. It also can improve efficiency and service, and decrease the costs to government.[2]

Another problem is that loans and grants to governments would increase, rather than decrease, the politicization of the economy. They would be channelled through government bureaucracies and agencies, thus increasing the power of the *nomenklatura*, or communist bureaucratic class, that brought the Soviet economy to its present sorry state. Moreover, direct loans to the central government inevitably would be used by Gorbachev and the remnants of the bureaucracy to pressure the republics in negotiations, since the central government would decide to whom and where loans were directed.

Although it is best not to give any cash to the central or republican governments, outright grants are far better than loans. Congress and the Bush Administration are more likely to be cautious in spending money if they know that it will never be repaid. Such caution would not exist with loans. Most important, with grants the citizens of the republics at least would not be loaded down with massive debts that they will resent and be tempted to repudiate, and which would destroy their international credit.

Guideline #3: Do not provide U.S. taxpayer-backed export or loan guarantees.

Other frequently proposed sources of U.S. foreign assistance to the Soviet Union are, first, government-backed "risk insurance" and "export guarantee" programs for U.S. exporters and investors doing business in the Soviet Union and, second, government-backed loan guarantees.

Risk insurance programs and some loan guarantees are administered mainly by two U.S. agencies: The Export-Import Bank (Eximbank) and the Overseas Private Investment Corporation (OPIC). Eximbank gives export credit insurance for U.S. firms and medium- and long-term loan guarantees to buyers of American exports. After a seventeen-year hiatus, Eximbank resumed its operations in the Soviet Union this year after

2 William D. Eggers, "Yellow Light for Eastern Europe: Beware Four Economic Development Myths," Heritage Foundation *Backgrounder* No. 796, November 13, 1990, p. 5.

Bush waived the restrictions of the 1974 Jackson-Vanick amendment which denies Most Favored Nation (MFN) status to countries that restrict or deny immigration. OPIC supports private investors in developing countries by insuring businesses against political risk and also by financing investments through loans and loan guarantees.

Subsidizing Elite Corporations. According to a 1986 Office of Management and Budget (OMB) report, a mere eighteen U.S. companies, including such giants as General Electric Corporation and Westinghouse Electric, receive over 65 percent of Eximbank assistance. In practice, Eximbank winds up subsidizing trade between foreign countries and an elite group of American corporations. Moreover, the Eximbank has been in financial trouble for years. The bank has a terrible delinquency rate on its loans —48 percent of outstanding loans are delinquent—and between 1982 and 1988 the Bank's net operating losses equaled $2.3 billion.[3]

OPIC also benefits mostly giant multi-billion dollar U.S. corporations. Example: In fiscal year 1989, fully 77 percent of all OPIC investment guarantees were given to only eight major American companies, including American Express Bank, Ltd., Coca Cola Export Corporation, Citibank, and Chase Manhattan Bank.[4] These corporations surely can afford to buy private risk insurance from such firms as Lloyds of London. They prefer, of course, the cheaper government-subsidized risk insurance, which does not reflect the real risks of investing in unstable foreign nations.

Capital Distortions. There also will be calls for the U.S. government to "guarantee" private bank loans to the Soviet Union or the republics. This means the U.S. government agrees to pay off the loans if the debtor is unable or unwilling to do so. Loan guarantees expose the U.S. to financial risk. They also distort the efficient working of the capital market and usually result in unwise and inefficient uses of scarce capital.

The U.S. government already faces a staggering $6 trillion in financial liabilities through the government's programs of direct lending, loan guarantees, and insurance programs.[5] As the Savings and Loan crisis attests, U.S. taxpayers could well wind up having to make good on these expanding liabilities.

The Soviet Union is not a good credit risk for the U.S. government. The Soviet government already owes over $500 million to Japanese firms and over $150 million to U.S. businesses with no payments likely anytime soon. Until real economic reforms are in place, and the political situation stabilizes, the climate for foreign investment in the former Soviet republics will not be favorable, and the risks of investing will be great. Loan guarantees do not reduce this risk. Instead, they simply transfer the risks and liabilities to the backs of American taxpayers.

3 Karen LaFollette, "Government Loans for the Soviet Union: A Disservice to U.S. Taxpayers and Soviets Alike," The Cato Institute *Foreign Policy Briefing*, No. 8, April 26, 1991.

4 Melanie Tammen, "Aiding Eastern Europe: The Leveraged Harm of Leveraged Aid," The Cato Institute *Policy Analysis*, No. 139, September 10, 1990, p. 23.

5 Ronald Utt, "The Six Trillion Dollar Debt Iceberg: A Review of the Government's Risk Exposure," Heritage Foundation *Backgrounder*, No. 774, June 28, 1990, p. 6.

Guideline #4: Do not assist "currency convertibility" until Moscow, or the republics, adopt an independent monetary system outside of direct political control.

For Western businesses to invest in the Soviet Union, they first must believe that they can make a profit. This means, eventually, that they will have to be confident that the rubles they earn can be "converted," or traded-in for "hard" Western currencies, like the dollar or yen, that are useable on world markets. Right now the ruble is not "convertible." If it simply were declared so, there would be a mad rush for everyone holding worthless rubles to trade them in for dollars. This would shake markets worldwide and thus is infeasible.

Several plans have been put forward to gradually or partially make the ruble convertible into hard currency. American and Soviet experts led by Soviet economist Grigory Yavlinsky in July called upon the West to help make the ruble convertible. Under this plan, which was endorsed and promoted by Gorbachev at the July meeting of the so-called "G-7" industrial democracies, the U.S. and other Western countries would deposit between $3 billion and $10 billion in hard currency reserves into a so-called currency stabilization fund that the Soviet government could draw on to exchange for rubles. In theory, none of the money would be used. The purpose would be to create enough confidence in the ruble so, when allowed, people would not feel the need to exchange rubles for dollars, thus preventing the "mad rush" for dollars feared by economists.

This approach has been successful in Poland, which sharply devalued its currency, the *zloty,* and then tied its value directly to the dollar. The *zloty* is now largely convertible. Importers can freely purchase foreign currency with *zlotys* at the official selling rate, and individuals are allowed to retain their foreign currency accounts and buy and sell foreign money. Previously all of these transactions had to be approved by the state.

Long Way Off. While successful in Poland, there are three reasons why this approach will not work in the Soviet Union. First, the ruble cannot be made convertible until a program of deep budget cuts and economic reform is put in place because the budget deficits are financed by simply printing more rubles. Examples of these reforms are tight monetary policy, the institution of realistic interest rates reflecting market forces, and the elimination of easy credit for state enterprises. These reforms are still a long way off. The Soviet and republican governments have failed to resist popular pressures for new social programs and wage increases, and are unlikely to soon drastically cut public spending.

Second, the plan for a currency stabilization fund relies on a new central bank to control the money supply. The Soviet central bank, or Gosbank, consistently has inflated the money supply and thus is mainly responsible for destroying the ruble. The Soviet mint is now printing rubles at four times the rate of 1987. Gosbank head Viktor V. Gerashchenko predicts that 240 billion rubles will be in circulation by the end of the year, up from 136 billion rubles in January. Although the authors of the currency stabilization fund plan insist that the new bank would be independent from government control, there is reason to believe that it would be subject to the same political forces that induced Gosbank to inflate the money supply. Like Gosbank, the new independent state bank likely will print more money or devalue the exchange rate, thus causing South American-style hyperinflation.

Third, many of the newly declared independent republics do not plan to use the Soviet ruble as a currency. They plan on issuing their own currencies. Thus, there may be no central government or central bank which can draw on the currency stabilization fund.

Backing With Gold. An alternative approach that does not rely on the discretion of a Soviet central bank is needed. One option is to back a Russian ruble with the Soviet Union's vast gold reserves, rather than Western hard currency. The Central Intelligence Agency estimates that the Soviet Union has around $25 billion in gold, while Roger Robinson, former Senior Director for International Economic Affairs for the National Security Council during the Reagan Administration, believes the gold reserves may have fallen to between $12 billion and $17 billion, which now is being divided up among the republics. Judy Shelton, an expert on the Soviet economy from the Hoover Institution, proposes that the Russian Republic help create a new monetary system among the republics by making the ruble convertible into gold.[6] The other republics then could peg the value of their national currencies, such as Lithuania's *litas*, to the gold-backed Russian ruble. The advantage of this approach is that the republics would not need Western financial assistance because Soviet gold, rather than Western hard currency, would be used to back up the currencies. The danger, however, is that the non-Russian republics would be dependent upon the continued good faith of the Russian Republic's monetary authority.

Another option for achieving convertible currencies in the republics has been proposed by Johns Hopkins University Professor of Economics Steve Hanke and George Mason University economist Kurt Schuler.[7] The republics would set up currency boards, outside of political control, similar to those already operating in Hong Kong and Singapore. Under such a system, the republics would not have central banks. Instead the currency boards would issue notes and coins that would be backed directly by a foreign currency such as the dollar. Citizens and businesses could exchange these notes and coins for dollars at a fixed rate. Market forces, rather than politicians and uncontrolled government spending, would determine the money supply. This would ensure that the republics have a stable and reliable currency that can be converted to hard currencies. To further enhance the currency board's independence and accountability, three of the five members of the board should be foreigners—for instance, an American, a German, and a Japanese—while two would be local nationals.

Low Reserves. Economist Joe Cobb of the Washington-based Alexis de Tocqueville Institute estimates that reserves totalling $4 billion would be sufficient to back currency boards in all fifteen former Soviet republics. The Soviet Union now has hard currency reserves of between $1.5 billion and $10 billion to back the boards. However, hard currency reserves will become very low by the end of the winter if large pur-

6 Judy Shelton, "A Bretton Woods System for Ex-Soviets," *The Wall Street Journal*, September 4, 1991, p. A12.
7 Steve H. Hanke and Kurt Schuler, "Currency Boards for Eastern Europe," unpublished manuscript, April 24, 1991.

chases of Western consumer items are made. It may, therefore, be necessary to provide some Western assistance to operate the currency boards. Schuler estimates that the West would probably need to provide no more than 20 percent of the total reserves necessary for setting up the boards. The U.S., Western Europe, and Japan should consider advancing the dollars needed to set up these currency boards. Because they would be outside of political control and because three foreigners approved by the West as board members would have considerable influence, currency boards would be a far wiser investment than putting taxpayer money into a Soviet central bank.

Guideline #4: Do not support Soviet membership in the International Monetary Fund (IMF) or the World Bank.

Some Western leaders such as Germany's Helmut Kohl urge that the Soviet Union be granted immediate membership in the International Monetary Fund and the World Bank. The near complete collapse of central government power after the August 19 coup attempt make such calls anachronistic. When asked if he would consider becoming the new Foreign Minister of the Soviet Union, former Soviet Foreign Minister Eduard Shevardnadze said, "When there is no U.S.S.R. what do you need a Minister for?" Similarly, the dying Soviet state does not need membership in the IMF and the World Bank.

Once the political situation in the Soviet Union stabilizes, IMF and World Bank membership for fully independent republics should be considered. However, until that time comes, the U.S. should continue to insist that the IMF and World Bank give only technical assistance, not loans, to the republics or some successor association of the republics.

WHAT WASHINGTON SHOULD DO

Guideline #1: Organize emergency food aid, if needed, and insist on control of its distribution.

The Russian government on September 9 asked the U.S. and other Western countries to grant emergency food aid this winter to the Soviet Union. To stave off possible starvation and widespread food riots this winter, U.S. humanitarian assistance, coordinated with private American charities, is appropriate.

Grain harvests in the Soviet Union are down significantly from last year. This year's harvest is expected to be only 135 billion tons, compared to 190 billion tons last year. The drop is due in part to poor weather, but mostly to the man-made problems of the Soviet Union's centrally planned economy: shortages of fuel and spare parts for harvesting equipment, breakdowns in the transportation system needed to move grains from the countryside to the cities, and the inefficiency of collectivized agriculture. To make matters worse, farmers are refusing to exchange their produce for the valueless ruble, thus causing hoarding of foodstuffs in the countryside.

The first step is to determine whether in fact there will be a serious food shortage this winter. Similar alarms were raised last year, yet a food crisis never materialized. Undersecretary of Agriculture Richard Crowder and a team of experts already are in the Soviet Union to determine, among other things, the extent of the food problem and the areas likely to be hardest hit.

If food aid in fact is needed, it should not become a crutch for the inefficient Soviet agricultural system. Emergency food relief should be accompanied by an announcement it will be cut off by winter's end. If food aid is continued into the next harvest, it will distort the developing private food market and bankrupt local farmers because they will not be able to compete against the free or subsidized foodstuffs from the West. Already, tiny private family plots, comprising less than 3 percent of agricultural land, produce over a quarter of Soviet agricultural output. Privatizing 30 percent of agriculture by next year's harvest would guarantee plentiful foodstuffs for next winter, and aid no longer will be needed.

Hoover Model. The emergency food aid program also must be designed to ensure that food reaches needy citizens. Last year, about 70 percent of food aid sent to the Soviet Union ended up rotting in warehouses, being sold on the black market, or sold for profit by corrupt officials. To prevent this from happening again, the U.S. should look to the model of Herbert Hoover's humanitarian relief effort to Russia in the early 1920s. After garnering $20 million in food aid from the U.S. Grain Corporation, a federal agency, Hoover enlisted the assistance of private philanthropies and corporations to send over $80 million of food and supplies to Russia in the hard years following World War I and the Civil War.[8] The U.S. retained complete authority for supervising the relief effort. All food was distributed directly by the American Relief Administration, a government agency, which employed thousands of Russian citizens in kitchens set up throughout the country.

Bush should nominate a well-known business leader to coordinate a joint private and public sector food relief program along the lines of the Hoover program. To ensure that the food reaches hungry citizens, the U.S. should insist on complete control over the distribution of food aid in the Soviet Union. America then could decide whether to set up kitchens throughout the republics, or use local groups such as churches, schools, and community organizations to distribute the food.

One new element not used by Hoover should be injected into the plan. Some of the food relief should be sold for rubles—which then would be taken out of circulation. The reason: most people have plenty of rubles, but nothing to buy with them. By pulling some rubles out of circulation, the U.S. could reduce inflation.

Guideline #2: Use the Index of Economic Freedom as a guide to insist on progress in economic reform as a condition for U.S. assistance to the individual republics.

If America ends up sending aid directly to the republican governments, it should be done in a way that guards against waste and prevents aid from being used to prop up

8 Arthur E. Farnsley, II, "Humanitarian Aid in the Twentieth Century: Private and Public," in Doug Bandow, ed., *U.S. Aid to the Developing World: A Free Market Agenda* (Washington D.C., The Heritage Foundation: 1985), p. 15.

holdover communist bureaucracies. Each republic will have to be judged on its merits. To ensure this, aid should be tied to progress in enacting basic economic reforms. A good measurement for such progress is an Index of Economic Freedom that passed the Senate in July. Sponsored by Senator Connie Mack, the Florida Republican, the index defines the key elements of a market economy. These include protection of private property rights, free pricing systems, limited government regulation of the economy, private banking and financial institutions, free trade policies, and low taxes.

The republics should receive American assistance only if they make progress in carrying out reforms listed in the index. Tying all aid to the adoption of free market reforms would create competition among the republics for Western aid and provide a powerful incentive for each republic to move quickly and broadly in reforming its economic system.

Guideline #3: Restructure U.S. technical assistance programs.

The Bush Administration proposes helping the Soviet Union improve its food distribution system, convert its military industrial complex for civilian purposes, and better develop its oil, gas, and other energy resources. If done effectively, technical assistance can be a critical catalyst in the initial stages of building a market economy. For instance, American experts could advise republican governments and businesses on how to create financial institutions and capital markets, protect private property rights, train managers, and privatize state-owned enterprises.

Most foreign technical assistance programs, regrettably, are unsuccessful in promoting the development of free market institutions. The technical assistance offered by the U.S. through its Agency for International Development (AID), for instance, is widely regarded throughout the developing world as particularly unhelpful. AID has been criticized by East Europeans and by American businesses and private organizations as ineffectual and overly bureaucratic. Typically, AID sends teams of bureaucrats with little or no private sector experience and little knowledge of local circumstances on short-term junkets to Eastern Europe to offer advice. Congressional hearings on AID last year found countless instances of waste, fraud, abuse, and bureaucratic inefficiency in the agency. Each year the AID Inspector General has found new failures, such as poorly designed projects, ineffective management and use of resources, poor decision-making, and simple waste.[9]

British Success. AID's experience in Eastern Europe and throughout the developing world demonstrates that it is not capable of adapting quickly to new circumstances. There is, however, one technical assistance program that is well regarded throughout Eastern Europe—the British "Know How Fund." This was first launched in June 1989 in Poland and other funds were developed for Bulgaria, Czechoslovakia, Hungary, and the Soviet Union. These funds are designed to help erect the framework for a market

9 Bryan T. Johnson, "At AID, New Inspector General Reports Confirm Need for Reforms," Heritage Foundation *Backgrounder Update* No. 166, August 9, 1991.

economy by relating British "know how" in banking, capital market development, financial services, privatization, and other critical areas.

The British government funds private sector experts to assist Eastern Europe. For instance, British experts have filled key positions in Poland's Ministry of Finance and Ministry of Ownership Changes, and in the Czechoslovakian Federal Ministry of the Economy. According to East Europeans, a major advantage of the "Know How" Fund over other technical assistance programs is its flexibility. Unlike AID programs, "Know How" Funds permit East Europeans to have a greater say in who will be hired, and for what purposes.

An American version of "Know How" Funds would be slightly different from Britain's. The U.S. government would provide vouchers to the republic governments and some emerging private businesses, which they could use to purchase the services of American consultants and firms. This would eliminate a layer of bureaucracy and give the republic governments greater control over what kind of technical assistance they receive. The vouchers then would be redeemed for cash in a small U.S. office set up to administer the program. The office could be either a part of AID, or preferably, it could be associated with the Department of the Treasury. The main responsibilities of the office would be attending to paperwork and guarding against corruption.

Guideline #4: Promote increased trade and investment as an alternative to aid.

The U.S. and other Western countries can best promote economic development in the republics by reducing trade barriers and encouraging increased foreign investment.

Trade protectionism in industrial countries costs the Third World more in lost exports than the total of all foreign assistance they receive.[10] America can promote increased trade with the former Soviet republics first by granting Most Favored Nation trading status to those newly independent republics committed to moving toward a market economy. This will grant these republics the lowest possible U.S. tariffs on their products, a privilege now enjoyed by over 100 countries. Another way to encourage greater trade with the republics is by proposing free trade area agreements with those republics that adopt free market reforms. While none of the republics now meet the necessary requirements — mainly because their industries are all state-owned and prices are still set by the state—most of the republics eventually could be candidates.

Increasing American investment in the republics also will be necessary to stimulate economic growth. Investment by American and Western firms will supply these countries with hard currency, entrepreneurial skills, managerial and marketing expertise, jobs with higher wages, technology, and capital for investment. In most of the less developed world, multinational corporations—not Western development experts—have been responsible for training local populations in business management and marketing.

10 *Development and the National Interest: U.S. Economic Assistance into the 21st Century*, United States Agency for International Development, Washington D.C., February 1989.

This already is happening in Eastern Europe. American computer giant International Business Machines Corporation is establishing a Computer Technology and Development Center in Budapest and General Electric Corporation is introducing modern management techniques and worker training programs there. Eastman Kodak Company is setting up a management training center in the Polish city of Konstancin.

As Latin Americans have discovered, it is far better for foreign businesses to invest directly in the economy than it is for Western banks to grant loans to the government. The reason: the money is invested by businessmen from the West rather than by government bureaucrats. More important, unlike Western bank loans, if the multinational corporation fails, its stockholders alone—and not the taxpayers of the debtor and creditor nations—suffer the consequences of the loss.

In addition to offering MFN status for the republics, the U.S. can encourage greater investment by reducing taxes on American businessmen who work there. Currently Americans working overseas are allowed to exempt $70,000 of the amount they earn working in a foreign country from U.S. income taxes. This amount should be increased to $140,000. By doubling the amount of foreign income deducted from U.S. taxes for businessmen working in the republics, the U.S. would create greater incentives for higher-paid, senior executives to work there.

Guideline #5: Require and monitor cuts in military output as a condition for aid.

Reforming the Soviet economy must include drastic cutbacks in military spending. The Soviet Union remains the most militarized state on earth. With an economy perhaps half the size of America's, Soviet arms output still surpasses that of the U.S. and all its allies combined. In Russia and Ukraine, up to 50 percent of industrial output is military-related. NATO Secretary General Manfred Woerner said in Brussels on September 7 that the Soviet military-industrial machine continues to outproduce the West, and still "commands the best brains and resources." Unless the republics divert substantial resources from the military sector, they cannot hope for economic recovery.

This massive shift of resources and manpower will not be completed in a few weeks or months. The best hope for a rapid shift from a military to civilian-based economy will be the quick development of a private sector capable of absorbing the scientists, technicians, and other workers who no longer will be building weapons. In the meantime, there are important steps that the Russian and other republican governments can take to demonstrate to the West that they are serious about this conversion of the defense sector.

One step would be for Moscow to halt immediately the production of Intercontinental Ballistic Missiles (ICBMs) and Sea-Launched Ballistic Missiles (SLBMs), the most dangerous and provocative weapons in the Soviet arsenal. These missiles, armed with nuclear warheads, can reach American territory in minutes. From 1985 to 1990, Moscow produced 715 new ICBMs compared to America's 68. Accelerated withdrawal of the last Soviet troops from Germany, Poland, and the Baltic states would be another sign of good faith. Moscow also should adopt and begin acting on a plan for military reform similar to that proposed last year by Boris Yeltsin aide Major Vladimir Lopatin, which calls for a smaller, professional, all-volunteer army. The U.S. and its allies should establish a committee of military experts to monitor these developments and insist on continuing reform as a condition for aid.

Guideline #6: Announce a date in advance when the aid program will end.

Third World nations around the globe have been living off foreign aid for decades. Haiti, Tanzania, and Zaire, and many others have become addicted to foreign aid. Because they have not been told otherwise, these countries have come to expect foreign taxpayers to prop up their economies indefinitely. In the last twenty years, no major aid recipients have left the U.S. foreign aid dole.[11]

The U.S. government has not always extended aid indefinitely to foreign countries. In the early 1960s, for instance, the U.S. inadvertently did South Korea and Taiwan a big favor by cutting off economic aid. This forced both countries to remove many government controls from the economy.[12] Trade was liberalized, exports were encouraged, and the state's tight grip on the economy was relaxed.[13] The result: an economic boom that still is going strong.

The U.S. should ensure that the emerging democracies in the Soviet Union have the same chance to enjoy steady economic growth experienced by South Korea and Taiwan. This means not becoming dependent on the loans of Western countries or multilateral lending institutions like the IMF and World Bank. Moreover, American taxpayers should not be expected to finance Soviet or republican government expenditures for decades to come. Therefore, the U.S. should announce that foreign assistance from America to the Soviet Union will be cut off at the end of five years. Japan and Western Europe should be pressed to do the same.

CONCLUSION

The political revolution that swept through Eastern Europe a year and a half ago has reached the Soviet Union with stunning speed and finality. The last great empire on Earth is disintegrating rapidly and long-suppressed peoples are tasting the fruits of freedom. There is an understandable urge among many politicians to reward the courageous democrats of Lithuania, Russia, Ukraine and the other republics with showers of cash. However, massive infusions of aid can do little to alleviate pain in an economy that may well decline by 20 percent this year alone. Large-scale aid, moreover, will do nothing to remove the communist economic structures that are at the root of the economic crisis.

11 Patrick Buchanan, "Hazards of the Foreign Aid Fix," *Washington Times*, September 4, 1991, p. G-1.

12 The Chilean experience is also illustrative. During the regime of General Augusto Pinochet, Western aid to Chile largely was cut off. In the absence of foreign aid, Pinochet implemented radical free market reforms, including large-scale privatization such as the privatizing the pension funds. Chile is now one of the wealthiest countries in Latin America.

13 Alvin Rabushka, "Tax Policy and Economic Growth in Advanced Developing Nations," report prepared for the U.S. Agency for International Development, 1987, p. 344.

George Bush should hold his ground in opposing massive aid to the Soviet Union. Americans overwhelmingly are opposed to a large-scale aid bailout for the Soviet Union. According to a *Wall Street Journal*-NBC poll, conducted soon after the failed August 19 coup, Americans oppose U.S. aid to the Soviet Union by a 56-39 percent margin. However, this has not stopped such legislators as Representatives Richard Gephardt and Les Aspin from calling for expensive bailout programs.

Bush should state categorically that the Soviet central government will not receive aid from the U.S. or support for membership in the International Monetary Fund (IMF) or the World Bank. Any assistance offered should go to the republics, and should be tied to an index of economic freedom to ensure that basic reforms are carried out. This index would gauge each republic's progress toward enacting reforms and enhancing economic freedom, thereby promoting sustainable economic growth and development. The U.S. also should not grant government-to-government loans, loan guarantees, or cash for government construction projects to the Soviet Union.

Increasing Trade and Investment. If needed as a humanitarian measure, temporary emergency food aid should be supplied to the people of the Soviet Union. But U.S policy makers must ensure that the food actually reaches hungry citizens and is not used for political leverage by communist bureaucrats. To avoid this, the U.S. should insist on controlling the distribution of food aid. U.S. assistance for creating a convertible currency should be made contingent upon the adoption of an independent monetary system outside of political control. To be effective, technical assistance should be restructured along the lines of the British "Know How" Funds, which use British public money to pay for private economic counseling of East European governments. In the long-run, increasing trade and encouraging U.S. private investment is a better way to assist the people of the Soviet Union than foreign aid handouts.

Foreign aid should not be granted unless the republics—especially Russia—commit themselves to reducing drastically the production of military arms. It makes no sense for foreigners to sink billions of dollars into the failing Soviet economy while billions of rubles are squandered on the inefficient and wasteful military-industrial complex.

William D. Eggers
Policy Analyst