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THE WOODS REPORT: FOREIGN AID AND ECONOMIC GROWTH

INTRODUCTION

The Administrator of the Agency for International Development, Alan Woods, released a study earlier this year that has profound implications for United States economic assistance policies.[1] It examines less developed countries in terms of U.S. humanitarian, security, and economic interests.

The Woods Report is well timed. Persistent federal budget deficits have led many U.S. policy makers to question whether foreign aid funds are being well spent. Further, the debt crisis in the less developed countries prompts some American lawmakers to question the wisdom of lending huge sums to these countries.

The Woods Report puts the problem of foreign assistance and debt in the proper context of U.S. interests. While the Report does not prescribe policy, it offers essential background for a reevaluation of U.S. assistance policy. Implicitly, the Report suggests that the Foreign Assistance Act of 1961, which governs U.S. foreign aid, be revised and updated substantially.

U.S. Goal. The Woods Report notes the difficulty in defining exactly what is meant by development. Official indicators, such as gross national product, per capita income, and life expectancy are important, yet do not provide a comprehensive measure of progress. In addition to these measures, the Woods Report suggests a concept of development that should be a key goal of U.S. policy: expanded choices and opportunities for the citizens of less developed nations. This concept assumes that individuals seek a number of

1 *Development and the National Interest: U.S. Economic Assistance into the 21st Century*, issued on February 17, 1989. Hereinafter referred to as the Woods Report.

goals: adequate food and shelter, a longer life expectancy, good health, education, and leisure time, among others. The less time and expense spent on, say, obtaining food for the barest level of survival, the more time and resources can be spent on other goals. In this sense, development, understood as expanded choices and opportunities, encompasses most other goals.

Closed vs. Open Systems. Examining the economic performance of less developed countries, the Woods Report finds that, while certain external influences are beyond their control, those countries with fewer restrictions on trade and foreign investment and a greater reliance on market mechanisms tend to enjoy stronger economic growth than the countries with closed, regulated economic systems.

The Woods Report also notes that the amount of private, nongovernment assistance from the U.S. to less developed countries is twice as large as all forms of U.S. official assistance. And further, the opportunity for these countries to sell their goods in developed countries is worth far more than the value of the foreign aid they receive. In fact, foreign aid does not even compensate poorer countries for the costs imposed on them by trade restrictions erected by the developed world.

Guide to Economic Effectiveness. Finally, the Woods Report introduces the idea of an "Economic Opportunity Index." This is a means of classifying countries by their degree of economic freedom, as measured by such indicators as the degree of property rights protection, market-determined prices, and absence of investment restrictions. Since countries with more flexible market systems tend to have comparatively high rates of economic growth, such an Index could serve as a guide to the potential effectiveness of the economic policies of Third World governments.

Policy makers should use the Woods Report as the basis for rewriting the 1961 Foreign Assistance Act. Promotion of Third World economic growth should be the primary goal of the new act, and the Economic Opportunity Index should be expanded and used by Washington as a guide for determining which countries are taking sound steps to boost economic growth. This index thus could be a tool for assessing whether U.S. economic assistance to a Third World country is likely to be used wisely, or would be a waste of American taxpayers' money.

AMERICA'S INTEREST IN WORLDWIDE ECONOMIC DEVELOPMENT

The title of the Woods Report, *Development and the National Interest*, suggests that the U.S. should ensure that its overseas development policy is compatible with other U.S. policy priorities. Some might argue, of course, that reducing world poverty and suffering is in itself a worthy goal for the U.S. and therefore should not be justified on the grounds of narrow national interests. But the Woods Report notes that there are ways to achieve this goal that conflict less with the U.S. budget and other interests.

The Woods Report identifies three general U.S. motives for U.S. foreign assistance.

1) Humanitarian Motives.

Since the earliest days of the Republic, Americans have helped those in need overseas. In 1793, for example, Americans aided refugees from Santo Domingo; in the 1820s, aid was sent to the Greeks to help them over the economic difficulties resulting from their war of independence; and money was sent to famine-stricken Ireland in the 1840s.

Typically, of course, these forms of foreign aid were private and voluntary. Only recently has the federal government become directly involved in assistance. The first major government effort of this kind followed World War I, when Herbert Hoover directed relief for war-torn Europe. After World War II, humanitarian and economic relief once again was extended to Europe. Since the 1950s, the U.S. has provided food on a continuing basis to less developed countries. And today, the Agency for International Development (AID) provides health and medical assistance, as well as financial help, to the world's poor.

2) Political Security Motives.

The Woods Report points out that security concerns also drive U.S. foreign aid policies. The Marshall Plan to reconstruct Western Europe after World War II was intended, in great part, to make Europe less susceptible to communist subversion. Fidel Castro's victory in Cuba triggered the creation of AID and of President John Kennedy's Alliance for Progress, which sought to head off communist expansion in the Western Hemisphere by promoting economic growth.

Today the bulk of AID funds goes to those less developed countries that are America's political allies. In some cases the assistance is specifically linked to U.S. use of military bases.

3) Economic Motives.

In recent decades, America's own economic and commercial interests have become more dependent on the economic conditions in less developed countries. One reason for this is that trade is of growing importance to the U.S. economy; stagnation in the Third World means fewer purchases of U.S. goods and services. Another reason is that U.S. businesses have substantial investments overseas, which are sensitive to local economic conditions. And third, American banks have made huge loans to less developed countries, another reason why local economic growth is important to the U.S.

HOW TO MEASURE DEVELOPMENT

In addition to detailing the motives behind U.S. development policy, the Woods Report raises a crucial question. How is success measured? It may be clear that certain countries (and jurisdictions), such as Hong Kong, South

Korea, Singapore, and Taiwan, are doing well, while others are not. For scores of countries, however, the economic snapshot is very fuzzy. A sophisticated measure thus is needed for U.S. policy makers to gauge the local economic situation and the impact of U.S. foreign assistance.

The Woods Report examines four categories of indicators of progress – or the lack of it.

1) Material Progress.

The most familiar indicators of material progress for countries are gross national product per capita and the rate of economic growth. The Woods Report notes that strong economic activity not only means rising living standards but is the basis of most other forms of progress, such as better education and improving environmental quality.

2) Employment and Productivity.

The ability of economies to continue to employ new workers in productive activities is especially important in less developed countries, where populations are rising rapidly. The Woods Report estimates that between 1985 and 2010 more than one billion new jobs will be needed in these countries. Especially important for job creation are a dynamic farm sector and opportunities for small businesses.

3) Health and Population.

Longer lifespans, lower infant mortality rates, elimination of disease, and general improvements in health are also a part of development and thus a measure of assistance policy effectiveness. The Woods Report notes that recent improvements in health and life expectancy have led to what some development economists consider a population "problem." Yet most policy makers would consider longer lives and fewer infant deaths as signs of success. The real problem is to make certain that the economic system offers sufficient opportunities for a growing population to engage in productive economic activity.

4) Political Freedom and Social Pluralism.

Another important characteristic of development is the ability of citizens to control the political system and enjoy the freedom to hold differing viewpoints and pursue differing life styles. The Woods Report stresses the importance of freedom and pluralism as an indicator of development. "At base, development means choice; the greater the range of choice, the greater the degree of development." The Report explains that "Each minute of the day that does not have to be devoted to survival is a minute that can be 'invested' in learning, playing, earning disposable income, or improving one's home or community."[2] Unless citizens have the freedom to achieve their goals, social as well as economic, development is being held back.

2 Woods Report, p. 7.

PROBLEMS IN MEASURING PROGRESS

The Woods Report rightly calls attention to the difficulty in measuring developing countries' performance. In the poorer countries, governments often cannot provide reliable figures concerning their own finances. It is thus nearly impossible to determine accurately their rate of economic progress. Even when such figures as per capita income can be estimated with confidence, the data do not provide information concerning what the average citizen can purchase with his or her income. To say that Americans earn an average $17,600 per year, while the average for many Africans is less than $500 conveys very little information, for it does not tell policy makers the full story – for example, what $500 means in the context of the local economy.

Enormous Underground Economy. Perhaps the most serious problem with official economic statistics is that they fail (because they are "official") to take account of the enormous black markets, or informal sectors, that exist in most less developed countries. Excessive government regulation drives many entrepreneurs "underground." Research by Peruvian economist Hernando De Soto indicates that Peru's informal sector is valued at nearly 40 percent of that country's GNP.[3] Researchers in other countries have found similar results.[4] Economic activity, in fact, is likely to be much more vigorous than the official statistics indicate.

Educational levels and health information are also difficult to determine in less developed countries. Here too, the governments often are simply not capable of collecting accurate data. And as the Woods Report notes, "the errors and omissions in many commonly used data sets are often larger than the changes they are being used to measure."[5]

Such deficiencies highlight the inherent problems of the Global Poverty Reduction Act, currently under consideration by the U.S. Congress. This act would require AID to seek to reduce rates of Third World infant mortality, poverty, and female illiteracy in the next decade. The goals are worthy, but the Act does not offer a realistic means to achieve its goals, nor does it suggest ways of securing correct measurements on which to base policy.

ECONOMIC RELATIONS AND DEVELOPMENT

The Woods Report makes clear that private, commercial economic relations between developed and less developed countries are far more important than foreign aid. As the world becomes more economically interdependent, trading links become crucial to development.

3 Hernando De Soto, *The Other Path* (New York: Harper and Row, 1989), p. 12.

4 See various works by Marcos Victorica of the Instituto De Estudios Contemporaneos in Buenos Aires, Argentina, or Oscar Vera Ferrer of the DESC Sociedad De Fomento Industrial in Mexico City, Mexico.

5 Woods Report, Box 2.1, p. 28.

Thus, as the Woods Report points out, the most important thing the U.S. can do to help less developed countries is to keep it own economy growing and its markets open to Third World goods. The Report cites a Wharton Econometrics estimate that, in the past, for every 1 percent increase in real U.S. GNP, the economies of less developed countries have grown by 1.5 percent.[6] A 1 percent fall in U.S. GNP is linked to a 2 percent decline in the Third World.

Trade Link. Trade is the most important aspect of this link between the U.S. and less developed economies. A strong, growing U.S. economy can purchase more goods from the Third World. In 1987, for example, the U.S. bought $149 billion in goods from these countries, 35 percent of their total exports.

The Woods Report also notes that trade protectionism in the U.S. and other developed countries costs less developed economies more than the total of all assistance currently sent to these countries. Estimates of these costs range from 2.5 to 9 percent of the total GNP of the developing world. Thus if the U.S. and other developed countries would end all foreign aid, while opening their economies to all imports, the poorer countries would gain. Moreover, states the Report, countries that sell more goods in the U.S. also tend to purchase more goods from the U.S.

THE FACTORS ASSOCIATED WITH DEVELOPMENT

The Report notes how U.S. policy makers routinely predict inaccurately which countries will grow. In the 1950s and 1960s, for instance, it was assumed that the Latin American countries, often rich in resources and at that time enjoying high growth rates, were the best bets for future prosperity. By contrast, Hong Kong, Singapore, and Taiwan were lackluster economically and stagnation was widely predicted; South Korea, indeed, was considered an economic basket case. Today, these four Asian countries have exceptionally strong economies and high living standards. And the Latin American economies in general are stagnant and mired in debt.

The Woods Report reviews factors that have been associated with these differing economic fortunes.

1) The Global Economic Environment.

There are numerous factors beyond the control of the less developed countries that, nevertheless, affect their economic fortunes significantly. The growth rate of the developed world is one factor; another is world prices. For instance, high prices for export commodities, low real interest rates, and exchange rate stability contributed to high growth rates in Latin America and Africa during the 1950s and 1960s. And the oil crisis and collapse of fixed exchanged rates in the early 1970s harmed these same nations.

6 Woods Report, p. 75.

2) Growth and the Ability to Adjust.

Despite factors beyond their control, however, developing countries generally have considerable control over their fates. The Woods Report notes that it is important to a country that its economic and political system be flexible enough to adjust to changes in market conditions. Further, the government must be credible and have the confidence of the people. If it is not, citizens and overseas investors will be reluctant to make long-term investments.

3) Economic Policies and Growth.

The Woods Report identifies a number of specific economic policies in developing countries that are associated with high rates of economic growth. A country with a relatively free trade policy, for instance, tends to have a high rate of growth. The Report found that over the past two decades imports and exports both tend to rise over time in countries with consistent economic growth. Less developed countries with chronic problems, on the other hand, tend to restrict trade and then see stagnating imports and exports. The Woods Report cites a World Bank study that underscores this point.[7] Classifying countries as outward- or inward-oriented in their economic policies, the study finds that, between 1963 and 1973, the outward-oriented countries had an average annual GNP growth rate of around 9.5 percent, compared with a rate of only about 4 percent for inward-oriented countries. Between 1973 and 1985, outward-oriented countries grew at nearly an 8 percent annual rate, while the more inward-oriented slipped to under 3 percent.

Incentive to Take Risks. The Woods Report found that the investment climate has a similar important effect on economic growth. When foreign or domestic investors face bureaucratic red tape and corruption, exchange and investment controls, punitive tax rates, political insecurity, and generally arbitrary government behavior, they have little incentive to take risks or make long-term commitments. The Woods Report cites a study that rates countries according to their investment climate. The countries with the most desirable investment climates had per capita income growth averaging 5.86 percent in 1987, compared with a 2.18 percent rate for countries with a moderately desirable climate. Per capita incomes in countries with the least desirable climates actually shrunk that year by a rate of 1.06 percent.[8]

The Woods Report calls attention to how policy reforms can lead to dramatic changes in economic growth. The most dramatic case is China. In 1979, China introduced reforms allowing farmers to sell their crops at market-determined prices and keep most of the profits. As a result, per capita food production by 1986 had risen by 55 percent over the 1976-1978 average.

7 The World Bank Report, 1987, Chapter 5, cited in the Woods Report, p. 54.

8 Frost and Sullivan, Inc., "Measurement of the Investment Climate for International Business," report prepared for AID, September 6, 1988, cited in Woods Report, p. 55.

AN ECONOMIC OPPORTUNITY INDEX

To help gauge what internal policies are most likely to spur growth, the Woods Report proposes an "Economic Opportunity Index." This rates countries according to economic policies that history shows tend to promote economic efficiency or inefficiency. The factors used by the Index include:

◆ ◆ **The Control of Credit and Monetary Policy.** Are private banks allowed, for example, or does the government control most credit allocations? Does the government mandate special credit preference to the public sector at the expense of the private sector? Are rates of return on deposits held below the level of inflation?

◆ ◆ **The Level of Taxation.** How high are tariffs on imports or do such taxes discriminate against the private sector? Are public sector enterprises exempt from import, export, or other taxes? Is interest earned on government bonds exempt from taxes?

◆ ◆ **The Way Prices are Determined.** To what extent are prices subject to government controls? Are energy or other important prices held down below other domestic prices?

◆ ◆ **The Nature of Foreign Exchange Rates.** To what extent does the market exchange rate differ from the official rates? Does the public sector enjoy preferential access to foreign currency? Does the government require exporters to turn over foreign exchange to the central bank?

◆ ◆ **Policy Responses To External Shocks.** Are domestic prices allowed, for example, to adjust to changes in the world prices? Are economic stabilization policies introduced in a timely manner?

◆ ◆ **The Bureaucratic Impact on Economic Activities.** How easy is it to secure a business license, for example? Is bribery an important factor in gaining approval for business activities? Does the judicial system protect private property rights?

The findings of a 42-country survey made with these indicators were clear. During the period of 1980-1983, which included the last world recession, real per capita GNP grew by 0.73 percent on average for less developed countries with positive economic opportunity ratings. Countries with poor ratings, by contrast, saw per capita GNP declines of 0.5 percent, while countries with extremely poor ratings on average declined by 2.1 percent. During the period 1984-1987, characterized by strong worldwide economic growth, per capita GNP grew at an average annual rate of 1.9 percent for countries with greater economic opportunity, while countries with poor ratings did not grow at all and very poor countries continued to decline at an annual rate of 1.3 percent.

Recalling the Woods Report's definition of development as an expansion of individual opportunity and choices, this Index gets to the heart of the development phenomenon. The policies that tend to promote economic flexibility and efficiency also seem to be factors that promote greater individual choice and give individuals incentives to engage in productive activities.

IMPLICATIONS OF THE WOODS REPORT

The Woods Report is a thoughtful and well-documented review of economic development in less developed countries. The Report, however, stops short of identifying the policy implications of its findings. Yet its lessons seem obvious. Among them:

1) U.S. foreign aid has at best a marginal effect on economic development in the Third World.

2) While many factors that effect economic growth are beyond the control of less developed countries, domestic economic policies are well within their control. These domestic policies affect economic performance enormously.

3) Countries with more flexible, open markets tend to grow faster economically than do countries with less economic freedom and extensive state direction over their economies.

4) Trade protectionism by developed nations harms the less developed world enormously.

5) Only free market policies allow less developed countries to achieve strong economic growth.

RECOMMENDATIONS

Congress currently is considering a major revision of the Foreign Assistance Act of 1961. This quarter-century-old Act created AID and still governs U.S. foreign assistance. Thus the Woods Report is well timed to serve as the basis for revising the Act. The Bush Administration and Congress should work together to:

♦ ♦ **Rewrite the Foreign Assistance Act, making promotion of free market-oriented economic growth in the Third World the major policy goal of U.S. foreign assistance.**

Free market economic incentives and individual entrepreneurial activity are the best means for promoting economic productivity. A free market system not only provides such incentives but is the most flexible economic system, allowing for quick market adjustment when world economic conditions change.

♦ ♦ **Develop further an Economic Opportunity Index to be used to evaluate progress in less developed countries and to guide U.S. foreign aid decisions.**

An Index measuring more precisely the degree of economic freedom and opportunity possessed by various countries would allow the U.S. to judge better which countries are making economic progress and promoting productivity and individual initiative. It also would focus the attention of American officials on the need for free market economic reforms as the best means to promote development.

CONCLUSION

In the past, strategies to promote economic development in less developed countries have focused on transfers of wealth and technologies. While well intentioned, these policies have proved to be of little positive benefit, and in many instances, were even counterproductive. Today, many analysts recognize policy reforms by the governments themselves as the best means to promote their country's economic growth. The Woods Report shows that the policy reforms that best promote such growth are those that put economic decision-making power into the hands of individual citizens.

Growing Out of Poverty. U.S. foreign aid, alone or even mainly, cannot eliminate poverty in less developed countries. Promoting free market policies, however, could prompt reforms that will allow poorer countries to grow out of poverty. The Woods Report provides a convincing case for the U.S. to redirect its development policies to help poorer countries and at the same time to advance U.S. national interests.

Edward L. Hudgins, Ph.D.
Director, Center for International
Economic Growth