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FOREIGN AID–A CRITIQUE AND A PROPOSAL

Foreign aid is as Janus-faced an institution as can be found. In a world of sovereign nations, rich and poor, it is an instrument of national policy which can be used by the rich to acquire influence and to increase their power. At the same time, foreign aid redistributes income from the rich to the poor and can thus serve to speed the latter's development.

While foreign aid might never have come into this world without its appeal to both national and trans-national interests, it has also suffered from the resulting ambiguity about its "real" function. Unlike pure power instruments like national military establishments, on the one hand, or overt redistribution mechanisms like the progressive income tax, on the other, foreign aid has never been firmly institutionalized. It has led a precarious existence, bolstered from time to time by cold-war conflicts and then flagging again as immediate dangers passed, or the lack of a "domestic constituency" in the aid-giving countries made itself more strongly felt, or certain unpleasant side-effects of aid-giving became apparent. Lately signals of a new crisis in aid-giving have multiplied in the United States; there is disaffection and disenchantment as well in Western Europe and perhaps in the Soviet Union, and foreign aid is none too popular even in the recipient countries.

The first part of this essay attempts a partial explanation of this state of affairs through a critique of basic concepts underlying present aid programs of the United States as well as some multilateral ones. The second part of the paper discusses an alternative mechanism of transferring aid, which would avoid some of the more conspicuous difficulties that have been encountered. The two parts of the paper are not tightly integrated, however: it is quite possible for a reader to agree with our critique while disagreeing with the proposal, and vice versa.

A CRITIQUE OF PROGRAM AID

Current practice in foreign aid dates from the new principles introduced by the Kennedy Administration in the early sixties. Essentially, this country's doctrine moved at that time to embrace what has since become known as the "program approach" to foreign aid.

From project to program aid

The "project approach" had predominated through the fifties. The

World Bank had been enjoined by its very statutes to extend loans only on the basis of specific projects (in transportation, power, agriculture, and so forth). The first activity of the United States in the field of aid to underdeveloped countries was technical (Point Four) assistance, which had necessarily a project content and which evolved naturally into capital assistance with a similar content. Important departures from this practice occurred in countries on the periphery of the Soviet bloc. To a number of these countries the United States extended massive military as well as economic assistance, with the latter being usually justified in terms of short-term import or budgetary requirements.

By 1960 criticism of the project approach was widespread. It was easy to show how development depended not on a few specific projects, but on an adequate overall investment effort, with respect to both aggregate size and composition, and how ill-designed fiscal, monetary, and foreign-exchange policies could undercut the positive contribution of any individual project to economic growth. Economists further pointed out that the donor country was not really financing the project for which it was ostensibly granting funds, but rather the "marginal" project which the aid recipient would have just given up had he not been handed the additional resources for a project which he probably would have undertaken in any event.[1] For these reasons, so it was argued, a look at the total spending pattern of the recipient country is essential if one wishes to have some assurance that the aid funds are put to productive use. Finally, it was pointed out that project aid necessarily implies a series of biases and perverse incentives: it encourages the aid recipient to prepare large capital projects, to exaggerate the foreign-exchange portion of the total cost of these projects, and to favor public infrastructure projects, which are most easily financed through loans or grants extended from one government to another for project purposes.

While these criticisms of the project approach all contributed to a change in the climate of expert opinion, another important reason for going from project to program aid was the desire to increase the level of aid to some key countries and to provide a solid institutional basis for aid-giving at this higher level. Program aid was conceived as aid given "in bulk" on the basis of a general understanding between donor and recipient about the latter's development program and principal economic policies. (Other terms frequently used in connection with program aid are, in ascending order of euphemization, "leverage," "incentive programming," "making sure of self-help.")

As a result of what was then thought to be the model case of India,

[1] For a critique of this view, see Richard M. Bird, "The Influence of Foreign Aid on Local Expenditures," *Social and Economic Studies*, Vol. XVI (June 1967), pp. 206-210.

the accent was at first primarily on achieving agreement on the recipient's development plan, its size, priorities, and the resulting "resources gap" to be filled by aid in its various forms. But, in most developing countries development plans are primarily statements of intention. Further, even in the rare country with a highly operational development plan, the fulfillment of the plan's objectives would depend crucially, among other things, on "appropriate" fiscal, monetary, and other economic policies. In Latin America, moreover, program aid under the Alliance for Progress was to be forthcoming not only in connection with a broad agreement on economic-development objectives, but was to be premised also on advances in social development that depended on the enactment and implementation of reforms in land tenure, income taxation, educational opportunity, and the like.

The two aid bargains compared

The general idea of moving from the project to the program approach consisted, therefore, in laying the groundwork for a substantial and steady flow of aid through a meeting of minds between donor and recipient on central economic programs and policies of the recipient country.

When the matter is put in this way, the formidable difficulties of the program approach begin to appear. No doubt, by moving the discussion between donor and recipient from where to build what kind of power station to fiscal, monetary, or agrarian reform policies, one is turning from peripheral to central issues of the recipient's decisions. But is that a good thing? We shall now argue that this move raises at least as many problems as it solves.

To facilitate the discussion, it is useful to attempt at this point a conceptual distinction between "pure" project and "pure" program aid. In the real world this distinction will of course be blurred, as these two archetypes of aid hardly ever appear in their pure forms. Hence it should be understood that our subsequent discussion does not cover every conceivable case of project or program aid, but tries to catch the essential difference between two diverse forms of aid-giving. Moreover, we do not aim at extolling project aid, with whose problems and drawbacks we are familiar, but rather at bringing out, with project aid as a backdrop, the heretofore largely neglected political implications and side-effects of program aid.

As a starting point for the discussion, we may imagine that aid is given in the form of a check drawn by the donor to the order of the recipient, without conditions or strings of any kind. This unconditional aid can then turn into conditional aid along two principal routes.

First, the donor can insist that the money be spent for certain specific purposes: the result is pure project aid as here defined. Secondly, the donor may require that the recipient country change some of its ways and policies as a condition for receiving the funds: this is our definition of pure program aid.

From the point of view of the recipient, there is a fundamental difference between the two bargains which may conceivably accompany the transfer of aid funds. Pure project aid forces the recipient country to substitute to some extent the donor's investment preferences for its own insofar as the use of the aid funds is concerned. As a result, the recipient country lands in a situation it senses as inferior to the one in which the same amount of aid would be available unconditionally. Nevertheless, the aid permits the country to achieve a position in which it is unequivocally better off than without aid, in the sense that more funds are forthcoming for some purposes while, generally speaking, investments that the country would have made in the absence of aid will not be curtailed. Thus, the conditions attached to pure project aid are not likely to arouse strong hostility in the recipient country and do not require the policy-makers to sacrifice any important objective which they would have been able to pursue in the absence of aid.

The situation changes significantly in the case of the bargain characteristic of pure program aid. The commitment a country undertakes in connection with this type of aid is typically of the following kind: to increase investment and decrease consumption, to increase the share of the private sector and decrease that of the public sector, to devalue the currency and thereby alter *relative* price relationships within the country, to throttle inflation and therefore strike a blow at the particular interest group whose turn it is to benefit from the next inflationary appropriation, credit expansion, or rise in prices or wages; and so on, and so forth. In all these instances, compliance with the conditions attending program aid makes one group within the recipient country worse and another better off than before. The bargain preceding the granting of program aid also implies that the aid-receiving government will alter its previous policy-mix in such as way as to sacrifice in some measure objective A (say, a larger public sector) to objective B (say, growth).

Economists who have discussed the concept of community welfare have long been divided into two groups: those who deny, and those who affirm, that meaningful statements can be made about increases or decreases in collective welfare when, as a result of economic change, one group gains at the expense of another. There is no need for us to enter into this discussion, except to note that its protracted and stubborn nature testifies to the fundamental difference between the two situations that

we have just described. With pure project aid, the recipient government can achieve all of its pre-aid objectives (plus some additional aid-financed ones) and no group in the country need be any worse off. With the type of conditional program aid discussed here, the objectives of public policies will be reshuffled and some domestic group is likely to be hurt. Even though the total resources available to the country are increased through the aid, the hurt group cannot be directly compensated, at least in the short run, for its loss, by the very terms of the aid agreement.

We should mention here one particularly important way in which project aid shades off in the real world into program aid. When the project donor spends its funds on, say, a certain kind of power station, it will often have views, and will attempt to have them prevail, on such matters as accounting practices, power rates, administrative autonomy, and perhaps even public versus private ownership of the utility. Project aid may then also involve policy changes that would hurt some groups or individuals. Even in this case, however, an important difference between project and program aid remains. Program aid is usually given in connection with changes in *central* economic policies of the recipient, whereas the policy changes the donor is liable to insist on in connection with project aid are germane to the construction and operation of the project and are therefore likely to be concerned with matters that are at some remove from the central policy concerns around which the more important group conflicts rage.

The program-aid bargain further considered

It will, of course, be argued that whatever sacrifice is entailed by the policy changes required by the program-aid bargain is more than fully compensated by the other side, namely the aid package itself. The fact that aid is accepted on these terms could be considered as evidence that there is nothing to worry about. After all, the recipient government could have refused aid (as Burma did in general, and Brazil and Colombia at one time or another, in connection with assistance from the International Monetary Fund) if it felt that the conditions were too harsh. But this application of the notion of revealed preference misses several points. In the first place, we were intent on showing the difference between two forms of conditional aid-giving and on pointing out that the cost of obtaining aid is of a different nature in the two cases. Secondly, it is a gross over-simplification to treat a government entering the program-type bargain on foreign aid like a consumer buying himself a bag of apples. Since aid, in this case, has as its counterpart a shift in national objectives and in the short-term fortunes of different social groups, the bargain will be considered a bad one by the circles that value

highly the objective that has been sacrificed and by those groups whose interests have been hurt. Hence, the very bargain that gives rise to program aid can and will be attacked directly by these circles and groups as being damaging to the national interest as they define it. Pure project aid is ordinarily immune to this kind of destabilizing side-effect. Precisely for that reason, those who attack it will often resort to alleging that it is *impure* and carries some unavowed and excessive cost in terms of general economic or political-policy commitments. In other words, to be effective, an attack on project aid will attempt to prove that it is *really* program-type aid.

The difference between a country or a country's government adopting certain changes in its central economic policies as a *quid pro quo* for aid and a consumer disbursing cash for a pound of apples goes deeper still. The program-aid bargain is effective only if the government is genuinely convinced of the positive value of the policies it has adopted in conjunction with the aid—if there has been, that is, a genuine meeting of minds between donor and recipient about the economic-policy measures conducive to development. It is as if the consumer were not only made to hand over the cash, but were asked to positively enjoy this act instead of sensing it as a cost. Moreover, the commitment of the recipient government is ordinarily not just to a single policy action, but to a *policy* that requires implementation through a practically infinite *series* of actions. A more correct comparison of the program-aid bargain would therefore be to the decision of a person who joins the monastic orders: he does not usually consider his vows of poverty and chastity as a payment for the promise of eternal after-life, but as something to be valued and perhaps enjoyed directly and independently of that promise.

One matter is already becoming clear: for the commitments entered into in the course of program-aid negotiations to be faithfully adhered to, the recipient government ought to be so convinced of the correctness of the policies to which it commits itself that it would have followed these policies even without aid. Paradoxically, therefore, program aid is fully effective only when it does not achieve anything—when, that is, no *quid pro quo* (in the sense of a policy that would not have been undertaken in the absence of aid) is exacted as the price of aid. (It is ironical that, at least when it is effective, program aid is vulnerable to the very charge that has long been levelled—wrongly, we think—against project aid: namely, that one can never be sure that the project thus financed would not have been undertaken even in the absence of aid.)

In these situations, the donor would set himself the task of *rewarding* virtue (or rather, what he considers as such) where virtue appears of its own accord.

This is indeed a modest and manageable task, but it is also one that does not usually satisfy the donors. Precisely because the institutional basis and public-opinion support of aid are so precarious in the donor country, the proponents and dispensers of aid have quite naturally felt compelled to make extraordinary claims for what aid can accomplish. The most persistent of these claims has been that aid acts as a "catalyst." This term is meant to convey that aid makes the difference between stagnation (or perhaps deterioration) and vigorous economic growth of the recipient country, or between the recipient being hostile and being friendly to the donor country. To these traditional and exaggerated claims for aid, a new variant has been added by the program approach: namely, that aid, properly conditioned, makes the difference between the recipient following the "wrong" and adopting the "right" economic policies.

In this fashion, then, aid is not seen in the role of rewarding virtue, but in the role, infinitely more difficult, of bringing virtue into the world. Now the fact that aid is known to be available *if* certain policies are followed will sometimes serve to strengthen a domestic group genuinely and independently convinced of the correctness of these policies and it is therefore not inconceivable that aid will on occasion help this group to come to power. This is the ideal case in which program aid acts first as a catalyst and then achieves so complete a meeting of minds and so full a sharing of values and objectives between donor and recipient that from then on they will march hand in hand toward a better future.

We have on purpose drawn a caricature, for it is our conviction that this picture of program aid as a catalyst for virtuous policies belongs to the realm of rhapsodic phantasy. At best, situations in which aid helps virtue to triumph in this fashion are the exception rather than the rule. The normal case is far more prosaic: the knowledge that aid is available if certain policies are adopted serves to make these policies more attractive and less costly than they would otherwise be. These policies will therefore often be adopted by aid-hungry governments in spite of continuing doubts of the policy-makers themselves, resistance from some quarters within the government, onslaught against the "deal" from the opposition, and general distaste for the whole procedure.

Naturally, doubts and reservations are not voiced at the moment of the aid compact; hence the delusion on the part of the donor that there has been a full meeting of minds. But soon after virtue has been "bought" through aid under these conditions, the reservations and resistances will find some expression—for example, through half-hearted implementation or sabotage of the agreed-to policies—and relations between donor and recipient will promptly deteriorate as a result.

Problems encountered in buying virtue through aid

It may be argued that once a government has unequivocally committed itself to certain acts as a condition of receiving aid, there is a good chance that it will convince itself that these acts are truly in the national interest, even though previously it may not have thought so. Psychologists have developed the theory of "cognitive dissonance" to analyze individual behavior in similar situations. The theory teaches that if a person engages in "discrepant behavior"—in acts, that is, which cannot be reconciled with what he considers to be his beliefs and values—he will attempt to reduce the resulting dissonance by changing his values in such a way that harmony is restored.

However, the theory also stresses another point that is crucial here: if the discrepant behavior *is induced by either carrot or stick*, there will be far less consequential value change than if the discrepant behavior occurs in some accidental, absent-minded, or experimental fashion. If the behavior is rewarded (as it is, in our case, by the granting of aid), dissonance hardly arises, because, in accounting for his behavior to himself, the actor has a ready explanation and excuse for the fact that he did something contrary to his principles, opinions, or preferences. (For the same reason, declarations of support for a cause against which one has previously fought are unlikely to change a subject's prior beliefs when such declarations are exacted under torture.) Therefore, the very act of rewarding policy changes through aid undermines the determination with which these changes will be carried out and makes backsliding and sabotage more likely.

These considerations explain why certain types of policy commitments on the part of aid-receiving countries are more workable—and therefore have turned out to be more popular with the donors than others. The more workable and more popular commitments are precisely those that are highly visible, verifiable, measurable and, at their best, irreversible. One thinks of a revision of the customs tariff, of the imposition of credit restrictions in order to curb inflation, or, most typically perhaps, of a devaluation. In the latter case, there would seem to be little possibility of backsliding or of second thoughts. Yet, while devaluation cannot be retracted, its intended effects can usually be frustrated by subsequent monetary, fiscal, and wage-price policies. Hence, even in the case of devaluation, a government which harbors a feeling that it has been pushed into an unwise policy can often administer an "I-told-you-so" lesson to the donor just by omitting to carry out certain complementary policies after the devaluation.

In the case of other economic or social policies that sometimes have stood in the center of aid negotiations, the continued psychological

resistance of the aid-recipients to such policies after a formal compact has been sealed can manifest itself more directly and easily. Whether the aid negotiations were concerned with enlarging the private sector of the economy or with establishing the basis for a land reform, the commitments a government has undertaken in these areas can be rendered inoperative through bureaucratic harassment or through lack of administrative energy, respectively. The old Spanish-colonial adage "*se acata pero no se cumple*" (one obeys but one does not comply) will thus be widely practiced once again, and properly so. A country which permits its key economic policies to be determined by this type of international negotiation finds itself in fact in a semi-colonial situation and is likely to adopt all the time-honored methods of stealthy and indirect resistance appropriate to that situation.

The fact that certain commitments have less latitude in implementation and are therefore less prone to sabotage than others has naturally led to a preference of aid negotiators for these types of commitments. In this way we can explain the increasing tendency to make program aid depend on the taking of specific monetary and exchange-rate measures and on the "appropriate" behavior of certain fiscal and monetary indicators, while less and less attention is paid to economic growth and social justice, supposedly the principal objectives of aid.

The hidden costs of program aid

The resistance of the recipient country to some of the policy commitments it has underwritten in the course of the aid negotiations is not the whole story. The general unhappiness about having had its arm twisted can find other outlets than backsliding on these same commitments.

In a simple model of international relations we may assume that, for the sake of independence, self-respect, and defense against accusations of being a satellite, the government of B, a poor country, is determined to maintain a certain *average distance* from country A, a great power and a potential donor. Country B measures this distance along two dimensions, the extent to which it adopts economic policies suggested by A and the extent to which it takes A's position in the leading issues of international politics. Under these conditions, a success on the part of the great power in having B "do the right thing" in economic policy will result in a strong urge on the part of B to compensate for this move in the direction of A by a move in the opposite direction in international politics. Only in this fashion can the desired average distance be maintained. That this model of international behavior is not completely unrealistic, in spite of its simplicity, can be shown by recalling a few episodes of the recent past: the attempt of the Quadros government in Brazil to move in the direc-

tion of a strongly neutralist posture in international relations after having adopted economic policies long advocated by the United States and the International Monetary Fund; to some extent, Pakistan's rapprochement with China; and, lately, a number of "surprising" foreign-policy positions taken by the present Indian government just after it had finally been so "reasonable" in its decisions on domestic economic policy.

In this manner, a "successful" program-aid negotiation in the course of which the recipient agrees to a variety of economic policies suggested by the donor may well have hidden, though considerable, costs: first a direct cost to the donor in terms of the loss of certain diplomatic and foreign-policy supports he thought doubly secure because of the aid extended; secondly, a serious loss of public support for the aid program in the donor country, as a result of what will be felt as ingratitude, hostility, and "irresponsible antics" on the part of the recipient. In this indirect fashion, the attempt at maximizing the productivity of aid by exercising "leverage" involves the risk of drying up the flow of aid at its very source.

Other frictions created by the program approach

Our case can be further bolstered by important differences between project and program aid related to the diplomacy of the aid process. Consider first the donor's claim to have his advice taken seriously on the ground that he contributes substantial resources. This claim is strong in the case of projects, where the donor's contribution often amounts to one-half or more of the total cost of the project. It is much weaker in the case of program aid, for here the donor's contribution is measured against the recipient country's national product or, at best, its total investment or imports. In such comparisons, the aid effort is almost always likely to look disproportionately small in relation to the important changes in national economic policies that are being sought.

Next, we may examine the donor country's implied claim that its own judgment is superior to that of the recipient. In the case of projects financed by the donor, the justification and credibility of the claim is usually quite strong. The donor country is likely to know more about the construction of highways and power stations than the recipient, simply because it is economically more advanced and has specialized knowledge in the areas in which it stands ready to finance projects. When it comes to appropriate economic policies to foster growth along with price stability and an acceptable distribution of income, the claim of the donor country to superiority is far more questionable. Frequently the donor country itself is far from having fully solved these very problems. Even if it has done better at them than the aid-recipient, the applicability of

its experience to the wholly different economic, social, historical, and political circumstances of another country must be much in doubt. The claim to superior knowledge is therefore fairly credible and innocuous in the case of project aid. It is not credible in the case of program aid—indeed, it is profoundly irritating.

The diplomacy of aid is even more directly involved in our final point. It is in the nature of the aid relationship that comparatively low-level officials of the donor country are paired off in aid negotiations with high-level officials of the recipient countries. This irksome difference in levels is far less pronounced in the case of project aid than program aid. In discussing the layout and specifications of a highway, an engineer of an aid mission or of the World Bank may perhaps exchange arguments at one point with the director of the highway agency of the aid-receiving country. But the matters discussed in conjunction with program aid relate, as we have seen, to central economic policies and issues. Given the centralization of decision-making and the thinness of the elite in the typical aid-receiving country, these matters can ordinarily be decided only at the very top of the political structure, by the President and his Minister of Finance. And who are their counterparts around the negotiating table? At best, the director of the local aid mission and, usually, various mission staff members. In this way, program aid recreates a typical colonial situation in which the rulers of the recipient country have to deal as equals with, and often feel that they have to take orders from, persons who, within their own country, are miles away from the seat of power. There is no need to expand on the resentment created by this situation.

Recapitulation and some recommendations

These, then, are some of the disadvantages of the program approach to foreign aid. To recapitulate: the program approach will accentuate old and create new discord within the recipient country and it will erode the government's support; it will lead to attempts at backsliding and reneging on the commitments that have been entered into; it will have a hidden cost for the donor and will diminish public support for aid programs in the donor countries as it impels the recipient to assert his independence by moving away from the donor in areas not covered by the aid agreement; and the negotiations leading to program aid will prove highly irritating to the recipient, both because he will not recognize the claim of the donor to superior knowledge of the questions that are typically the subject of program-aid negotiations and because the gap in the respective levels or ranks of those who do the actual negotiating between donor and recipient is painfully wide.

After this indictment of program aid, is there anything good to be

said about it? Certainly there is. The main virtue of program aid has been to permit, in the early sixties, a considerable increase in the volume of aid extended to a number of countries. Two questions therefore arise which we shall take up in turn:

First, is it possible to change the practice of program aid in such a way as to avoid some of its more unpleasant side-effects?

Secondly, and more ambitiously, is it possible to go beyond both the limitations of project aid and the liabilities of program aid, and devise a wholly new approach? This question will be taken up in the next section.

The answer to the first question is not particularly difficult. The very analysis of the program approach that we have given yields a partial remedy; for, if the policy-makers were fully aware of the political side-effects of aid-giving under the program approach, they would become more circumspect in its use.

Some specific recommendations also emerge from the preceding pages. Since, in our opinion, the program approach overreaches itself when it attempts grandiosely to bring virtue into the world, the explicit or implicit conditioning of aid on changes in policies of the recipient countries should be avoided. This does not mean that the donor cannot make his opinions and preferences known; but it does imply that elaborate arrangements should be made to divorce the exchange of opinions about suitable economic policies from the actual aid-giving process. The educational virtues of such discussions will be strengthened rather than weakened as a result. Finally, the donor should resist the temptation to measure "performance" of the recipient at frequent intervals by narrow quantitative indicators, when by its very nature such performance can be assessed properly only over a relatively long period of time by a combination of quantitative information and qualitative judgment.

AN ALTERNATIVE MECHANISM FOR FOREIGN AID

In spite of these possible avenues of improvement of current practices, the present aid-giving processes are sufficiently defective to warrant a search for new techniques—however Utopian they may appear at first sight. To our minds, the basic requirements of a satisfactory aid technique are three in number: (1) it should permit the transfer of a substantial volume of funds to the poor countries, (2) it should not be tied systematically to the achievement of a meeting of minds on central economic-policy decisions of the recipient countries, and (3) it should still exert pressure toward the efficient use of the resources that are provided.

We shall now discuss a scheme that gives promise of satisfying these conditions and would have two important additional merits. First, it

would place international development more on a people-to-people basis and thereby rekindle public interest in it. Secondly, it would institutionalize more openly and firmly than heretofore the redistribution of world income from the rich to the poor countries.

Like any new scheme, the one to be described here is replete with uncertainties and difficulties. Fortunately it lends itself to being introduced gradually and it could therefore initially supplement rather than replace existing resource flows. Once perfected in one country as a result of experience, the proposed alternative mechanism for transferring aid might largely supersede current bilateral programs and might also spread to other donor countries.

The essence of the plan is to involve the individual taxpayer of the donor countries in the foreign-aid program. Instead of paying taxes for a package of government expenditures that includes foreign aid together with all domestic programs, taxpayers could elect to use a limited portion of their income-tax obligation for contributions to one or several World Development Funds. These Funds would not be administered by any government and would channel financial assistance to various investors, public and private, in developing countries.

For their "contribution to foreign aid" the taxpayers would receive a full tax credit from the Internal Revenue Service. Such a tax credit would require legislation, but not on an annual basis. In the last resort, the government would of course still be the donor to developing countries, in that its tax revenue would be reduced by the amounts that individual taxpayers were earmarking for foreign aid, but the resulting funds would not belong to the government and their allocation and uses—and, to some extent, their amount—would no longer be determined by it.

Before turning to the details of the scheme, a brief justification for handling national expenditures for foreign aid so differently from expenditures for all other purposes is in order. A national decision to extend financial assistance to developing countries must necessarily be made by the established constitutional processes of each donor country and its implementation requires action by existing national fiscal authorities. At the same time, the foreign-aid decision must be interpreted as the assumption, on the part of the donor country and its citizens, of an obligation to contribute to world development. But this intent of the foreign-aid decision stands in great danger of being jeopardized and perverted if the resulting funds are administered by donor-country governments. Our discussion of program aid is suggestive in this respect. Foreign aid that is supposed to transfer income from the rich to the poor countries becomes all too easily, when it is administered by national

governments, an instrument through which the rich impose their will on the poor! The possibility and even likelihood of this unfortunate mutation is a risk peculiar to foreign-aid expenditures, and strong institutional safeguards against it are required. Here lies the basic justification for the break with traditional canons of fiscal policy that is implicit in our tax-credit proposal. (The establishment of multilateral agencies such as the World Bank has been one response to the need for moving away from the extension of development aid by national governments, but the response has not fully met the need, both because of the limited funds these institutions command and because they depend entirely and *directly* on governmental contributions.)

The following discussion first outlines the basic mechanism of tax credits and then treats the difficult problem of efficiently allocating the funds thus obtained.[2] Finally, some possible objections to the scheme are considered, and it is contrasted to earlier tax-incentive proposals. At this stage, the proposal is necessarily quite tentative. We have tried, nevertheless, to be concrete and specific, primarily to explore the feasibility of the idea and to invite further discussion.

The tax credit

In more detail, the tax-credit mechanism might work somewhat as follows. Individual taxpayers could claim a full tax credit for their foreign-aid contributions, up to 5 per cent of their federal income tax or $10,000, whichever is smaller. A hypothetical average taxpayer with an adjusted gross income of $16,000 and a tax liability of $2,030 could, for example, obtain a tax credit of $102 under this scheme. The claim for credit would have to be substantiated by a receipt from the depository bank or other satisfactory documentation. The limits of 5 per cent and $10,000, while arbitrary, are designed to eliminate the possibility of undue influence by wealthy individuals on the operations of the Development Funds proposed below and to hold the potential cost of the scheme to the Treasury to reasonable dimensions. Corporations would not be eligible for this credit for similar reasons, the danger or suspicion of "private imperialism" being particularly acute in their case.

From *Statistics of Income* data it may be crudely estimated that the *maximum* amount that could have been made available for development in this way in 1965 was about $2.3 billion, compared with actual public

[2] The tax-credit mechanism and a number of the other points made here were suggested by the remarkable effectiveness of a somewhat similar Brazilian scheme for regional development. See Albert O. Hirschman, "Industrial development in the Brazilian Northeast and the tax credit scheme of Article 34/18" to be published in the *Journal of Development Studies* (October 1968). A Portuguese version is available in *Revista Brasileira de Economia*, Vol. XXI (December 1967), pp. 3-32.

economic assistance from the United States in the fiscal year 1966 of about $2.5 billion. Since incomes are now higher and aid lower, the potential of the tax-credit scheme would at present be in excess of current aid levels. The important question of the probable actual yield of this incentive will be taken up later.

Return to the investor

Apart from the psychic satisfaction of helping the poor of the world become less poor, the benefits which an individual might get from taking part in this scheme should be narrowly limited. For every $100 (or other round figure) deposited, the taxpayer would receive a "Share in Development." To avoid complications, this document should not be a marketable asset. The possibility may be held out, however, for such shares to earn a small return, on the order of 2½ per cent a year for 40 years, until the face value of the "loan" is fully repaid. Whether or not this return is actually received would depend on the nature of the use made of the funds on average, as discussed below. Any such return would presumably be taxable as normal income to the taxpayer.

Another possibility might be to introduce a lottery feature with some such prize as a tourist trip to the less developed country or countries of the winner's choice.

Uncertain and small as these incentives would be, they should serve to make the tax-credit option a preferred alternative to simply paying taxes. Their primary purpose is to maintain the interest and involvement of taxpayers in the progress of the less developed world without imposing serious service and transfer problems on the recipient countries.

How to channel the funds

One can envisage various ways in which the funds provided by the tax-credit mechanism might flow to less developed countries from the United States or from any other developed countries that might adopt this idea. At one extreme, all the tax-credit funds might be remitted by the depository banks to a single World Development Fund, which would then allocate them to different activities in different countries. This alternative does not attract us at all, since such a single Fund would surely be tempted once again to influence the central economic policies of recipient countries and to engage in the leverage practices which have been criticized above.

At another extreme, every individual investor might search out some qualifying activity in some less developed country into which he would like to put his money. While the option of doing this might well be kept open (given the limits on the tax credit, the possibilities of abuse

are negligible), it would clearly be impossible for most of those potentially affected by the tax credit to behave in this way. Nor would it necessarily be desirable, even if they could do so, for those activities in which individuals would prefer to put their money as investors are often very different from those which they would wish to finance to promote world development. Some compromise is needed to avoid monolithic bureaucracy, on the one hand, and self-centered individualism, on the other.

One possibility is for the funds to be channeled in some proportions (which could be reconsidered at periodic intervals) to special sections of the existing multilateral organizations, such as the World Bank and its affiliates, the Inter-American Development Bank, and the other regional banks now in the process of formation. This solution would have the advantage of avoiding the setting up of a new bureaucracy, but there is some question about channeling all available funds to these far from infallible international agencies.

Partly for this reason and partly to explore the possibilities of still more decentralized aid-giving, we shall discuss here an alternative: to set up a number (say 10) of independent private organizations called Development Funds as agents for disbursing the funds collected through the tax credit. Each Fund would be managed by a small professional and administrative staff. Recruitment would be on an international basis from the considerable body of those in both private and public sectors, in both poor and rich countries, who now have relevant experience in the problems of investment and development.

The principal aim of these Funds would simply be to transfer available funds as quickly and as efficiently as possible to less developed countries. (In the event that the Funds could not invest the amounts provided by the tax credit within, say, three years, the money could revert to the Treasury. This three-year rule applies in the Brazilian scheme for the development of the Northeast.) The rules outlined below would offer some guidance in this task, but the main test of success would, in the nature of the operation, have to be something as vague and general as the approval of the Board of Directors of the Fund. Each Fund might have a separate board of 6 to 8 members, or there might be one general Advisory Board of 16 to 20 members for all the Funds. In either case, at least half the membership of the board (or boards) should consist of citizens of less developed countries. No one country should have a majority on any board. The board members would serve in their private capacity and not as representatives of any country or organization. These stipulations are designed to emphasize the international and nongovern-

mental character of the Funds and to permit drawing as widely as possible on world competence in guiding their operations. How these boards and the Fund managements might be initially constituted and perpetuated is a matter for further study.

Some operating rules

The main restriction imposed on the investment policy of the Funds is that any project in which they invest should be partially financed by someone else. The required complementary investor (or investors) might be a local private entrepreneur, a local development bank, the government or a public enterprise, and perhaps also some other international lending agency, or any combination of these.

The requirement that someone else be willing to put up some of his own money for the project in question (probably a specified percentage of the total cost) is crucial to ensure efficient use of funds and to avoid that the recipient country considers the cost of capital to be zero. The percentage of the matching requirement might vary with the country: it might well be set at a lower level for the poorer countries. (In setting such general, though flexible, rules some of the economic criteria derived from the experience of present aid-giving agencies might prove very useful.)

It deserves emphasis that the Funds would be institutionally neutral. The degree of their involvement in a country's economic life should not be affected by the way in which that country chooses to draw the borderline between the public and private sectors. The only generally unacceptable partners would be private foreign enterprises and bilateral lending agencies, although there could be exceptions even to this rule, particularly when it is clear that principal ownership and control rest in local hands.

Should the Funds be restricted to the financing of a limited list of certain "productive" or "essential" activities? For a number of reasons, we do not think so. It is up to the recipient countries to determine whether they want to be permissive or restrictive in this respect. Every sovereign country will evidently be able to restrict the access of its nationals to the Development Funds in any way it sees fit and the Funds should be left to use their best judgment, within those limits, without further direction.

The financing provided by the Funds should be flexible—equity, medium-term, or long-term loans, or a combination of these. For non-revenue-producing projects in the public sector the terms might be very soft—for example, a 50-year loan, with a 10-year grace period and a 2 per cent interest rate. For normally revenue-producing projects, public

or private, the terms should be correspondingly harder both to encourage them to produce revenue in actual practice and to provide financing for other activities in the future.

Return flow

Depending on the nature of the investment, payment of interest, principal, and dividends could be stipulated either in convertible or in local currencies. As most developing countries are at present either too debt-ridden or too poor to shoulder large additional amounts of international indebtedness, the net return flow stemming from the Funds' investments should be strictly limited. Some small inflow of foreign exchange from successful projects would be desirable to cover the administrative expenses of the Funds, and, as noted above, to enable them to pay out a small return of capital to the original individual "investors." Any such repayment to investors would depend on the average return to the Funds, since one taxpayer's money would not be distinguishable from another's. The backflow of dollars from past investments should not normally exceed that needed for these purposes, but if it did so occasionally it would provide a useful reserve and supplement to the ordinary resources of the Funds.

Since the Funds are conceived primarily as channels and should not end up controlling or owning enterprises in the less developed countries, even the payment of dividends, interest, and amortization in local currency requires careful consideration. One suggestion with merit is that the original individual investor might be allowed to designate his favorite charity or other nonprofit organization in the developing country as the recipient of such funds. This would, however, require too much cumbersome tagging of funds with individual names. An alternative proposal along similar lines is that each recipient country would designate or set up one or several nonprofit organizations which, on approval of the Development Fund concerned, would receive any repayments, stock-sale proceeds, or profits and disburse such monies to worthy activities. This feature would offset to some extent the bias toward investment in revenue-producing activities in the private sector that might perhaps be considered inherent in the scheme, no matter how much the Development Funds might be directed to maximize economic development, rather than financial returns alone.

Fund investments in equity require special consideration. Again to avoid permanent entanglement of the Funds in the recipient countries' affairs, all such investment could be in nonvoting stock (as is the present practice of the International Finance Corporation) and one could require

the Funds to turn over any such equity after a period of, say, ten years to the nonprofit organizations just referred to.

Competition and coordination

The purpose of creating ten or twelve Funds instead of one is to encourage diversity and competition. It would therefore be best not to assign certain countries or groups of countries or certain types of investments to one Fund rather than another. In time, of course, one might expect the different Funds to acquire their particular areas of competence both regionally and functionally, but there seems no reason to specify in advance what these areas should be. Nevertheless, a few general rules in this regard might be useful to avoid undue concentration or neglect. For example, it might be specified that no Fund could have more than 50 per cent of its total investment in any country or type of activity. In general, more than one Fund could invest in the same country or the same activity. Such overlapping would in our view be something to be desired, both to increase the bargaining power of the poor countries, and to stimulate multiple approaches to the solution of the development problem.

Initially the monies collected under the tax-credit scheme could be divided equally among the various Development Funds, but one could gradually relax this automatic distribution as the Funds began operating and building a distinctive record and personality on the basis of which each would appeal to the taxpayers. In view of the limited monetary return, the ensuing competition for the taxpayers' contributions would take place on the basis of the overall development performance of the Funds. Such competition would act as a spur to efficiency and would encourage a continuing search for better development strategies. Because the taxpayers would have to decide which Fund or Funds to favor, the competition would also serve to enhance and keep up the taxpayers' interest in the development process.

It may be hoped that, as a result of competition among the less developed countries, each will secure a "fair" share of the total funds available. This competition among recipients is another element of efficiency built into the scheme. Whatever the ensuing distribution of aid funds, it is quite unlikely to be as irrational, from the point of view of economic development, as it has been in actual practice over the past twenty years, when we have had central coordination over the distribution of bilateral aid granted by the United States and when Korea, Taiwan, Jordan, and Greece have been our overwhelming favorites, on a per capita basis. Nevertheless, some corrective mechanism ought to be available in case a

country or group of countries, say, India and Pakistan, should be unduly neglected. In such case, it might be desirable for a central advisory board to suggest or direct that the taxpayer-investor should favor those Funds that specialize in South Asia or, alternatively, that each Fund should increase its outflow to India and Pakistan. (It is because of this eventuality that the initial choice of taxpayers about the Fund to which their money should go, while a useful device for encouraging participation and recognizing successful operation, cannot be binding.)

Another problem on which some central guidance may be needed relates to the point in time at which a heretofore aid-receiving country will have done so well that it should no longer have access to the special financial resources dispensed by the Funds. The managers of the individual Funds, interested in displaying a good performance, may want to keep such countries indefinitely among their clients. There may thus be some limited functions which should be handled by a central advisory board.

Parallels and problems

Our scheme can be better understood by comparing it with other types of international capital movements and other types of tax-credit arrangements. It is clear that we have created a hybrid between public and private capital movements. To some extent, the proposal could be considered an attempt to revive private portfolio investment—with the important difference that the source of the investment funds is public tax monies rather than private savings. Do we then have here a throwback to the "private profit at public expense" arrangement that characterized the guaranteed Indian railway bonds of the 19th century? Not really, since we have narrowly circumscribed the potential return to the private investors from their tax savings. In this fashion, we avoid in general the principal economic drawbacks of portfolio investment: the insistence of the investors on a high, fixed rate of return and the resulting periodic inability of the borrowing countries to service their debts. In our scheme, the investor will be grateful for even a minimal return since the opportunity cost of his investment is zero.

The activities of the Development Funds will have something in common with those of the World Bank, the International Finance Corporation, and the Inter-American Development Bank, but might perhaps be modeled more closely along the lines of such private organizations as ADELA (Atlantic Community Development Group for Latin America) and Edge Act financing corporations like the Chase International Investment Corporation. We are suggesting a great expansion in this kind of activity, funded by the tax-credit option and oriented toward

both the private and public sectors of the developing countries. An important difference from all these institutions is not only the source of the funds, but our plan to have the Development Funds function purely as one-time channels. There would be no return flow from interest, dividends, repayments, or stock-sale proceeds beyond the sums needed for administration and for the limited (and uncertain) return to investors. In this fashion, all investments made by the Funds would eventually come to be locally owned and controlled.

The scheme could be criticized on the ground that, unlike direct investment, it does not provide for the transfer of managerial and technical skills along with the investment funds. The fact is, however, that such skills are already widely available through international technical assistance, management contracts, co-production schemes, and similar institutional arrangements. Recourse to such arrangements would be further stimulated and the skills of private enterprise and management would be amply drawn upon, if the scheme were adopted.

The proposed tax credit goes far beyond any tax incentives to investment in less developed countries presently available in the United States. A number of provisions in the present tax law have been advertised as such incentives. Present tax provisions do in fact place direct investment by American firms in less developed countries on a slightly more favorable basis than direct investment by such firms in more developed countries. As a rule, however, investment in the United States is even more favored because of the 7 per cent investment credit. (The major exceptions to this statement are those investors who can take advantage of the low tax rate applicable to Western Hemisphere trade corporations or of the privilege of tax deferral through tax-haven subsidiaries.) Proposals to extend the investment credit to investment in developing countries would simply put such investment on an equal footing with domestic investment in the United States. This is hardly a positive incentive policy, especially when, as is now apparently the preferred approach, the credit is to be extended country-by-country on a tax-treaty basis rather than by statute, as with domestic investment.

The most generous tax incentive that has been seriously, though fruitlessly, discussed, a 30 per cent investment credit, would admittedly constitute real favoritism at last. But favoritism to what? To *direct* investment by *American* firms—or to precisely the kind of foreign investment that carries with it all too often a set of problems and opportunities for friction at least as formidable as those accompanying program aid. Our proposal avoids these difficulties, as well as the need for recipients of the tax benefit themselves to hunt down favorable investment opportunities. For these reasons, the proposed tax credit to individuals is

totally different from anything that is now in the tax law or that has been contemplated.

Like all tax incentives, our proposal constitutes, of course, a special favoritism to certain activities, but we submit that it is an unneutrality as worthy as fostering private charities, probably more so than many tax-exempt foundations, and certainly more so than percentage depletion in the oil industry. The increased rigidity of budgetary policy implicit in any fiscal measure of this kind could be reduced, if desired, by making the percentage credit in any year variable between appropriate upper and lower limits, say, 3 and 8 per cent. A more basic justification for the special fiscal treatment of foreign aid implicit in our scheme has already been given at the beginning of this section.

Another traditional objection to tax incentives, and a harder one to answer, is that they are usually ineffective. We have no secure basis for estimating the probable flow of funds resulting from this proposal, or the cost to the Treasury. For reasons suggested above, it would probably be greater than that under the other tax-incentive proposals mentioned, which simply means it would be more effective in achieving the supposed aim. Most of those who bothered to take this option would probably be relatively well-to-do people, but this is hardly an objection, since it means the funding of the program would be more progressive in its incidence than that of the usual aid program. If we assume that the limits suggested above (5 per cent of the income tax, or $10,000) were adopted and that all of those with adjusted gross incomes of over $10,000 took advantage of the tax credit, the potential funding from this source in 1965 would have been on the order of $1.5 billion, but this is only the crudest of guesses. One might expect the initial amount available to be relatively small and to grow with time and success.

CONCLUSION

Despite all the points requiring further thought, it perhaps deserves reiteration that the proposed scheme avoids the problems of grappling with the "central issues" of economic policy and the consequent detailed interference in domestic economic policies of recipient countries that so mars the present public programs of foreign aid. It also avoids most of the traditional objections to increased reliance on foreign investment, primarily because there is no question of increased foreign "control" either by American corporations or by the U.S. Government, nor even by the proposed Development Funds themselves. The scheme may seem overgenerous to the developing countries. For the reasons given in the first part of this paper, however, we are convinced that such generosity is in the best interests of the aid-giving countries themselves.

One most desirable side-effect might be felt immediately as a result of a trial adoption. Considering the small and uncertain return the taxpayer might expect, we would have, for the first time, a concrete indication of how many people in the United States care enough about foreign aid to be willing explicitly to divert some of their tax dollars to it. Our initial assumption is that more aid is a good thing. This proposal would, if nothing else, enable us to know how many people agree with us.

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- * 4. Fritz Machlup, *World Monetary Debate—Bases for Agreement.* [Reprinted from *The Banker*, Vol. 116 (Sept. 1966)]
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- † (1) Klauss Knorr and Gardner Patterson (editors), *A Critique of the Randall Commission Report.* (1954)
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Fritz Machlup, *Remaking the International Monetary System: The Rio Agreement and Beyond* (1968). [This volume may be ordered from the Johns Hopkins Press, Baltimore, Maryland 21218, at $6.95 in cloth cover and $2.45 in paperback.]