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By J. William Middendorf, II

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A FREE MARKET PRESCRIPTION FOR THIRD WORLD DEBT

by

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There is a simple litmus test for evaluating the economic reform efforts now underway in the heavily indebted less developed countries of the world (LDCs). It is the question, "Do the proposed policy changes create the incentives and opportunities to acquire private property for all parts of the population of the country evaluated?" The degree to which this question can be answered positively will determine whether or not the heavily indebted LDCs are on their way to encouraging sustainable growth and recovery and thus establishing a viable trend for a permanent and favorable resolution of the "International Debt Crisis." It is this question that is at the heart of necessary structural economic reform in most developing countries, but especially in those carrying large amounts of foreign debt.

The initiative put forward by U.S. Treasury Secretary James Baker, with its three-pronged attack on the problems of 15 of the most debt-laden developing countries, provides a framework for a resolution of the "Debt Crisis" that could usher in a new era of worldwide economic growth at rates that have not been seen since the late 1960s. The initiative is clearly aimed at providing new financing, but with strings of growth-oriented conditionality attached. It is structured to accelerate LDC economic growth (and with it LDC hard currency earnings) so that LDC debt-service ratios can be gradually brought down to sustainable levels, thus restoring credit-worthiness. As Secretary Baker stated at the October 1985 joint annual meeting of the International Monetary Fund and World Bank in Seoul, Korea, "Financing can only be prudently made available when and as effective policies to promote economic efficiency, competitiveness and productivity--the true foundation of growth--are put in place."

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Ambassador Middendorf spoke at a luncheon meeting in The Heritage Foundation's Shelby Cullom Davis Policy Center on January 7, 1986.

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What is needed now is a clearer idea of what the debtor countries must do and a means for measuring progress in the area of structural economic reform. The grand test for structural economic reform is the one I already mentioned; that is, do the reforms "create the incentives and opportunities to acquire private property for all parts of the population?" This grand test, however, can be further refined in that those policies of developing country governments that have economic consequences should be tested for their degree of harmony with the criteria used by the rational investor. The category "investor" also includes "saver." What are these criteria? The rational investor is interested in: 1) a positive rate of return, 2) on an after tax basis, 3) adjusted for inflation, and 4) consistent with his marginal propensity for security; that is, degree of risk aversion. The policy areas that need to be tested for their degree of harmony with the rational investors' criteria are: monetary policy, tax policy, and regulatory policy. Moreover, the relationships among the three broad policy areas must be tested for what is known in logic as the "Fallacy of Composition," that is, with the purpose of ensuring that the soundness of each policy considered in isolation is additive or mutually reinforcing in a positive direction.

Application of these criteria is extremely important because, too often in the past, structural economic reform has concentrated on macroeconomic variables and ignored the microeconomic impact of the measures undertaken. For example, reducing the government deficit as a percentage of GDP is a worthwhile goal but when done via increasing taxes, especially marginal tax rates, is very likely to be counterproductive and lead to increased capital flight and reduced investment both domestic and foreign, because such measures violate the criteria of the rational investor.

The objectives which the U.S. Executive Directors of the World Bank and International Monetary Fund should pursue were outlined in a memorandum of April 1985 by Treasury Assistant Secretary David Mulford. It is useful to recall these objectives here:

> 1) Use tax policies to encourage savings and investment in support of growth and economic stability. Such policies could encompass overall reductions and stability in income taxes, reductions in marginal tax rates, adjustment of tax systems in light of inflation, the impact of taxation on the misallocation of resources, changes in the structure of commodity or excise taxes, and changes in tax expenditures (deductions or credits.)
>
> 2) Liberalize foreign trade to facilitate exports and to remove import restrictions. These measures could include reduction or elimination of export taxes, development of non-traditional exports, creation of free trade zones, and de-regulation of foreign exchange controls to encourage

productive activity in which the country has a clear comparative advantage.

3) Promote pricing policies reflecting market forces to foster efficient allocation of resources. Such steps could include decontrol of agriculture prices, termination of price controls on industrial products, and lifting ceilings on interest rates.

4) Facilitate appropriate foreign investment. This could include simplification and liberalization of laws regarding foreign investment, active promotion of joint venture activities, and extending the same treatment to foreign investors.

5) Support private sector-oriented growth, encourage privatization, and discourage, where appropriate, direct government activity in the economy.

All of the foregoing are, of course, designed to encourage the kind of structural economic reform that would satisfy the rational investor's criteria for savings and investment.

FLIGHT CAPITAL

One of the problem areas that holds great promise for a resolution of the "Debt Crisis" if properly addressed is the area of Capital Flight. By concentrating on economic reform in the debtor countries, the Baker Initiative is designed to create incentives for flight capital to return and be invested in the domestic economies of the debtor countries.

As the Federal Reserve has pointed out in an incisive paper entitled, "Why is Net International Investment So Small?":

> There seems little doubt that substantial capital exports have taken place from the countries that were borrowing. Unfortunately, one must assume that in large part this represents capital flight. The assets, thus acquired, probably do not produce income and taxes from the capital-exporting country, and probably are not available to strengthen its foreign exchange position and its economy generally. In other words, given economic and political conditions of the capital-exporting countries, these foreign assets are not likely to play the same constructive role for the home countries that capital exports from developed countries have ordinarily played. To be sure, changes in the policies of the respective countries, giving adequate protection to the owners of capital and a positive real

return on domestic assets, may change that situation. They may convert what today is flight capital into an important resource for the country.

According to this Federal Reserve Study:

> For the [world's] eight largest [non-U.S.] borrowers over the years 1974-1982,...calculation[s] show an increase in debt (equity and direct investment included) of $317 billion, while the current account deficit adjusted for change in official reserves, amounts to only $207 billion. Thus, there seems to have been a capital outflow of $110 billion. The degree to which borrowing financed this capital outflow differs among countries. For Brazil, only 12 percent of the inflow was compensated by outflows; for mexico, 45 percent; for Venezuela, almost the entire inflow was absorbed into outflows.

Nearly 100 percent capital flight? Clearly, with a change in domestic policies, there is reason to believe that this money could be attracted back to the debtor countries, which would, of course, be a major contribution to a positive outcome for the Baker Initiative.

As Secretary of State George P. Shultz pointed out in his recent address to the General Assembly of the Organization of American States, "Beyond the Debt Problem: The Path to Prosperity in Latin America":

> In 1984, the average growth rate for all developing countries was 4.4 percent. There was a wide variation between Asian developing countries, where growth averaged 8.1 percent, and sub-Saharan Africa where growth averaged only 1.6 percent. The Western Hemisphere average was 3.1 percent.
>
> Why this wide variation? What are the factors that promote growth in some countries and inhibit it in others?
>
> The successful countries have encouraged private initiative, avoided excessive regulation, and provided adequate incentives for productive investment. They have avoided excessive government consumption and control. The most successful countries have not relied on protectionism and import substitution, but have followed a more outward-looking strategy. Many of them borrowed money--but they used it productively.

REDUCING STATE OWNERSHIP

As one who has worked with citizens of developing countries for 30 years, I do not think I can emphasize strongly enough my feeling that the Third World must work toward a better balance between government and free enterprise, which at present is so heavily skewed toward state ownership.

The trend toward government ownership is clearly seen in Mexico, where, according to trend data, there were only 84 government enterprises in 1972. By 1982, there were 760. During the same period, total government spending as a percentage of gross national product increased from 23 percent to 46 percent. By 1982, following the bank nationalization, the great majority of Mexico's major industries were under government control, and the government's share of total capital formation had reached 45 percent. It is an interesting footnote that in the period 1957-1972 (during most of which Dr. Ortiz Mena, now President of the Inter-American Development Bank, was Finance Minister), Mexico's compound annual rate of GDP (gross domestic product) growth was 6.6 percent, whereas during the period 1973-1983, after the oil boom began, this GDP growth rate averaged 4.7 percent. Even in Brazil--where in 1979 President Figueiredo created a special ministry with the objectives of: selling government-owned enterprises to the private sector, where feasible; restricting the indiscriminate growth of state-owned enterprises; and strengthening the free enterprise system--little progress has been made and the spending of government and its companies approaches 50 percent of the gross domestic product.

A good sign for positive change is that some of the empirical research which has been conducted on the macroeconomic consequences of the statist "solutions" so long favored in much of the developing world is beginning to receive wider publicity and beginning to affect the thinking of high-level policy makers.

In Public Enterprises in Mixed Economies, by Robert H. Floyd, Clive S. Gray, and R. P. Short, it is noted that:

> For 25 developing countries for which data were available, Short estimates the average (weighted by GDP) overall public deficit, before reduction by government current transfers, at 5.5 percent of GDP during the mid-1970's. He further estimates that the overall deficit in developing countries increased by 2.5 percentage points of GDP between the late 1960's and mid-1970's.
>
> Defining the "budgetary burden" of public enterprises as the residual of government transfers and loans, less loan service payments by the enterprises, Short estimates this burden to average 3.3 percent of GDP for 34 developing

countries, compared with a 4.4 percent estimate for the central government's overall budget deficit in these countries. In other words, public enterprises accounted for three-fourths of the central government deficit in the countries in question.

As I have witnessed during the last 30 years, most heavily indebted developing countries have suffered ever more stifling bureaucratization of their economies. This has resulted in:

o State ownership of economic activities in, for example, extractive industries, manufacturing finance, and international trade and commerce, even movie theaters, far beyond the traditional limits of infrastructure and occasionally accomplished through expropriation, often without adequate compensation;

o Regulation of private economic activity via money, credit, and exchange controls, licensing systems, and price and wage controls;

o The state's consumption share of gross national product; and

o Government investment expenditure--typically more than half of national capital formation.

In many developing countries, the state-owned sector is so large, relative to the domestically owned pool of private capital, that a simple sale of those state enterprises that are running the largest deficits would be difficult, and attracting foreign capital for this purpose also would be difficult. Indeed, there are still many who would view selling off parastatals to "transnationals" in the same way as they view foreign direct investment--selling off their "national patrimony."

The adjectives most commonly used when state-owned firms are discussed are "deficit-ridden," "unproductive," and "unappealing," but these same adjectives were applied to such once bankrupt U.S. companies as Weirton Steel, which found a solution to its problems by having the employees themselves purchase the company. Weirton Steel is now one of the most profitable steel companies in this country, in spite of the global steel crisis. As in the case of Weirton Steel, I believe that there are other potential and feasible solutions over the long term. For, as President Reagan has said, "Developing countries need to be encouraged to experiment with the growing variety of arrangements for profit-sharing and expanded capital ownership that can bring economic betterment to their people." There are alternatives to state ownership, and they should be explored and adapted to the conditions existing in each of the less developed countries.

MORE PRODUCTIVE EXISTING INVESTMENT

Unfortunately, in many developing countries, even that investment that exists in the form of privately owned free enterprise suffers from inefficiency and lack of existing capacity utilization. Part of the inefficiency and failure to use capacity fully is due to inadequate training in modern management methods and part is due to insufficient access to working capital, especially for small and medium size enterprises. The first part of the problem requires better management education and training which is at best a medium-term process.

However, the second part of the problem, that is, inadequate working capital, could be dealt with fairly rapidly and easily. In many of the heavily indebted developing countries, small and medium sized enterprises must give substantial credit terms to their customers to remain competitive and to maintain sales volume. Terms of credit of 60 to 70 days are common and up to six months are not unusual. Since these enterprises are already suffering from poor access to financing and traditional banking credit, the extension of credit to customers further crimps cash flow and working capital. As Logan Jones has advocated in his unpublished paper, "To Expedite Economic Growth," a simple solution to this problem would be for purchasers to give their suppliers negotiable promissory notes which could then be discounted in the banking system. As Mr. Jones noted in his paper, "...the Japanese long ago recognized the gravity of the financial problems of small industry. To help solve the problems, they instituted in 1956 their Law on Prevention of Delayed Payments to Subcontractors. (In this context, the term 'subcontractor' embraces any firm making or processing components, subassemblies, or accessories of another manufacturer's product.)"

CONCLUSION

While there are those who view the Baker Initiative as merely a framework for a resolution of the "Debt Crisis," this constitutes much too narrow a focus. The real purpose of the Baker Initiative is to create the incentives and opportunities for the developing countries to assume their share of global economic growth to which their potential entitles them. It is a program of enlightened self-interest for both the developing and developed countries, in that dynamic global economic growth will generate new opportunities for trade, investment, and employment for both categories of countries. As Secretary Baker rightly noted in Korea, "In today's highly interdependent world economy, efforts at economic isolationism are doomed to failure."