The Heritage Foundation Issue Bulletin

No. 160 | The Heritage Foundation • 214 Massachusetts Avenue • N.E. • Washington, D.C. • (202) 546-4400

September 27, 1990

THE SENATE SHOULD TAKE A LONG LOOK AT SEED II

INTRODUCTION

Congress will decide this fall what kind of assistance the United States should give the emerging democracies in Eastern Europe. Lawmakers have proposed follow-up legislation to last year's Support for East European Democracy (SEED) Act, which provided loans, enterprise funds, technical assistance, and emergency food aid to Hungary and Poland. The new bill, called SEED II (S. 2944), which passed the Senate Foreign Relations Committee on July 19, extends assistance to the rest of Eastern Europe. The bill is well intentioned; it seeks to ensure the success of democracy and free enterprise in Eastern Europe. Yet a number of its provisions likely will do little to advance the free market in Eastern Europe, and could actually slow economic reforms.

At best, foreign aid to Eastern Europe can help advance market-oriented economic reforms already under way. But in its current form, SEED II contains a number of problems that seriously would hinder its effectiveness. These problems include:

Problem #1: U.S. aid could go to the central government of the Soviet Union. While SEED II excludes the Soviet Union from certain kinds of aid, it gives the President discretion to grant other forms of assistance. Aid to the Soviet central government would be especially inappropriate as long as Moscow continues excessive military spending and assistance to such U.S. foes as Cuba. The bill fails to recognize explicitly the member republics of the Soviet Union as potential recipients of aid. Under the current Soviet economic reform plan, economic decision making will devolve to the republics. Therefore any assistance should go to this level of government, not Moscow.

Problem #2: The bill would force on the Eastern European countries more funds than they can absorb. The $535 million in aid for Eastern Europe and the $50 million in support for U.S. missions and personnel is nearly twice the $300 million requested by the Bush Administration. Because Eastern Europe still lacks the basic building blocks of a market economy, assistance funds likely will be wasted or even go to prop up the current failed system.

Problem #3: SEED II authorizes American involvement in the European Bank for Reconstruction and Development, an organization that is likely to impose on Eastern Europe policies that retard development. This bank will be controlled by West Europeans who in the past have used foreign aid to support non-market policies or their own overseas business interests.

Problem #4: The bill mandates the creation of numerous unnecessary U.S. government programs, commissions, task forces, and a new congressional committee to assist governments in Eastern Europe.

The economic success of Eastern Europe depends on such reforms as establishing and protecting private property rights, dismantling wage and price controls, maintaining low tax rates, and liberalizing trade. However, if SEED II is to provide even marginal benefits, certain provisions should be changed.

Specifically the bill should:

- ♦♦ Extend the definition of Eastern Europe to include eligible Soviet republics;
- ♦♦ Rule out explicitly any form of aid or assistance to the Soviet central government.
- ♦♦ Cut the appropriations level of the bill to the $300 million requested by the Bush Administration.
- ♦♦ Remove language authorizing American participation in the European Bank for Reconstruction and Development (EBRD).
- ♦♦ Eliminate provisions creating unnecessary commissions, programs, and committees.
- ♦♦ Authorize the Bush Administration to negotiate free trade areas with any country that succeeds in transforming itself into a free market system.

THE PURPOSE OF SEED II

The purpose of the SEED II bill – to promote democracy and economic prosperity in Eastern Europe – is a highly desirable objective, and in keeping with America's interest in a stable, non-communist Europe. Yet foreign aid at best can play only a supporting role in promoting these goals and at worst could actually block their achievement. In the past, U.S. foreign aid, for example, has covered the costs of economic failure in less developed countries. This has removed incentives for wide-ranging economic reform.

Further, there is virtually no relationship between the amount of foreign aid received and a country's economic success.[1] Countries that have followed free market policies have had the best record of economic growth. They have provided the best opportunity for the citizens to raise their living standards through their own productive efforts.

In addition, while handing out foreign aid, wealthier countries, including the U.S., follow protectionist trade policies. The damage done to less developed countries by trade barriers more than offsets all the foreign aid given by all the countries of the developed world combined. Offering less developed countries the opportunity to sell their products is a far more effective way to promote economic growth than through cash handouts.

Economic Freedon Index. SEED II in certain ways is an advance over past foreign aid bills. It states explicitly that a principal objective of aid is "to promote the development of a free market economic system...." It goes on to list, in an index of economic freedom, the elements that would characterize a market system. These include establishing private property rights, dismantling wage and price controls, simplifying business regulations, removing trade and investment barriers, establishing the right to private banking and stock exchanges, and a tax policy that provides incentives for economic activity and investment. In all of these cases reforms must come from the countries themselves. At best, foreign aid might help defray certain costs, for example, of translating the commercial code of a developed country into the local language or to hire experts to help privatize state enterprises or to establish employee stock ownership programs.

Much of SEED II funding goes to technical assistance and cultural, scientific, and educational exchanges which are designed to promote the values and institutions of free market democracy. In some cases these forms of aid might be helpful. For example, East European countries desperately need manpower training in business, accounting, and economics. A provision of the bill provides grants for schools or universities in Eastern Europe. Such schools might contract out to American educational institutions to provide instruction in these areas. The bill also seeks to cement democracy in Eastern Europe through democratic institution building programs, such as civic education exchanges, strengthening institutions of free broadcasting, and institutionalizing civilian control of security forces.

WHY THE SEED II BILL FALLS SHORT

To be sure, the bill's emphasis on market-oriented reforms and private sector development is a welcome change from past foreign aid bills that consisted largely of government-to-government grants and loans. Yet, in its

1 Edward L. Hudgins, "The Woods Report: Foreign Aid and Economic Growth," Heritage Foundation *Backgrounder* No. 708, May 18, 1990.

present form, SEED II will not effectively promote the kind of economic development its authors would like. However well-intentioned the SEED II bill may be, it still contains numerous flaws. These include:

Problem #1: The bill contains vague language which fails to explicitly extend the definition of Eastern Europe to include the member republics of the Soviet Union and fails to exclude fully the Soviet central government from receiving aid. Section 3 of the SEED II bill states that "a European country shall be regarded as an eligible East European country if the President determines that the use of such authority would assist the emergence or transition of that country from communist rule through the development or strengthening of democratic institutions and the practices of a free-market economy." While Title XII in the bill prohibits loans and grants to the U.S.S.R., Moscow still would be eligible for all other forms of aid, such as technical, health, housing and humanitarian assistance, if the President so decides.

There are a number of problems with direct aid to the central government of the U.S.S.R. First, leading proponents of the free market and democracy within the Soviet Union have asked America not to give any form of aid to Moscow. Latvian Prime Minister Ivars Godmanis told The Heritage Foundation on July 25, 1990, that any aid to Moscow would simply go down "a bottomless pit." Criticizing Western assistance to Soviet Leader Mikail Gorbachev, Leningrad Mayor Alexander Sobchak told the *New York Times* on July 30 that Soviet bureaucrats "are masters at wasting billions on grandiose plans to build communism." Boris Yeltsin, President of the Russian Republic, has said repeatedly that any foreign assistance should be given directly to the member republics, not to Moscow.

Overextended Kremlin. Second, America has no interest in perpetuating either the inequities and inefficiencies of the Soviet economic system, or the imperial nature of the Soviet state. When the U.S.S.R. or its predecessor, the Russian Empire, have been strong, they have attempted to dominate and absorb their neighbors. The reduced Soviet threat to the West is due largely to Moscow's economic inability to sustain its overextended military empire. The Kremlin, for example, still gives billions of dollars to Cuba and other client states. Any assistance to shore up that economy, particularly as Soviet military production continues to grow, runs the risk of reviving that threat.

Many of the republics of the U.S.S.R. are striving to gain complete independence from the Soviet Empire. America should support these forces of freedom and democracy, not the central government. Soviet reforms should be assisted only to the extent that they contribute to the peaceful decolonization of the Soviet empire.

Lastly, any form of aid to the central government in Moscow makes little sense in view of Gorbachev's decision to create a free market in the Soviet Union. The current "500 day plan," originally proposed by Russian Republic President Yeltsin, endorsed by Gorbachev, and overwhelmingly approved by Russia's Parliament on September 11, 1990, gives economic power to the republics. Control of the economy will be in the hands of the individual republics, not in those of the central government. As a result, 23 Soviet central ministries controlling such policies as government regulation of industry, and prices would be abolished. Gorbachev could be reduced to little more than a figurehead. According to Yeltsin, "the role of the U.S.S.R. President will be comparable to that of the Queen of Great Britain."

If any technical assistance to create a free market economy is given to the Soviet Union, it should go to the republics, not to Gorbachev.

Problem #2: Seed II authorizes more spending than East Europeans can absorb. The SEED II bill provides $535 million in aid to Eastern Europe, plus $50 million for increased funding for U.S. embassies, consulates, and trade centers and diplomatic personnel. This is well above the $300 million requested by the Bush Administration. Yet East European countries cannot absorb such massive amounts of aid at this time.

The SEED II bill provides $225 million in loans, grants, and stabilization assistance. Much of this could go to direct investments. Yet funds or other forms of assistance to encourage private investment make little difference in an economy that has not yet shed its socialist institutions. In Hungary, for example, the East European country that has gone the farthest in enacting free market reforms, the economy is unable to absorb over $600 million in private investment funds – offered by such private consortia as the Austro-Hungary Fund, First Hungary Fund, and the Hungarian Investment Co. Businessmen and investors, both domestic and foreign, find the lack of clear property rights, the slow pace of privatization, and the small capital markets and dearth of private banking, among other things, make economic activity difficult. Other countries less economically advanced than Hungary will be even less able to use foreign aid productively. An example of just such a failure of foreign aid is seen in the Philippines. Western countries have authorized $4 billion in assistance and promised another $6 billion. Most of this money is unspent because of the lack of fundamental economic reform.

More important than foreign capital to Eastern Europe is to introduce reforms that make the economic climate favorable to private enterprise. Such reforms would include easy repatriation of profits, creating a convertible currency, lowering taxes, securing private property rights, and reducing inflation. If these things are done, private foreign investment will come and local entrepreneurs will begin generating capital.

Problem #3: The bill authorizes American participation in the anti-free market European Bank for Reconstruction and Development (EBRD). The SEED II bill would authorize $1.67 billion to the newly formed EBRD. The first year contribution to the bank would be $70 million. Conceived by the French soon after the political revolutions in Eastern Europe, the EBRD will be controlled primarily by West European governments. The members of the European Community together have 51 percent of the votes in the Bank; the U.S., 20 percent. It will have at its disposal $25 billion in capital for aid to Eastern Europe.

If the past record of West European foreign aid policies is any indication, the U.S. can expect the EBRD to hinder rather than promote the development of free market policies in Eastern Europe. Western Europe, for example, has been the major donor of aid to Africa over the last two decades, yet this region has stagnated economically.[2] Numerous African countries such as Tanzania, Uganda and Zaire have become dependent on foreign aid, which has allowed them to practice disastrous statist economic policies. The West Europeans, moreover, are likely to use part of the aid to promote their own business and investment interests in Eastern Europe, providing unfair, government-subsidized competition for American enterprises.

The President of the new Bank, Jacques Attali of France, is a socialist who has opposed free market reforms. He has moved to centralize the lending authority of the EBRD. Among his budget proposals is one that projects the average payroll cost for each of the 450 employees of the bank to be over $100,000. The mixed socialist -capitalist countries of Western Europe will not make for good bank partners in promoting free markets. The U.S. would have very little control over how American taxpayer dollars are spent in a bank controlled by the West Europeans. If any American aid is given to Eastern Europe, it should go directly from the donor government to the private sector.

Problem #4: Seed II creates numerous, unnecessary U.S. government programs, commissions, task forces, and a new congressional committee to assist governments in Eastern Europe. The bill creates a host of new U.S. federal government programs. Examples: the SEED Business Education Coordinating Board, the Commission on East European Small Business Development, International Executive Training Corps, Practical Business Training Program, Worker Training Assistance, and the Books-for-Eastern Europe.

Programs such as these, while of merit, should be and already are being undertaken by the private sector. The Institute for Humane Studies (IHS) at George Mason University, for example, a non-profit, free market educational organization, is translating economics textbooks and free market literature into East European languages and distributing them to students in Eastern Europe. IHS is also helping set up free market think tanks throughout Eastern Europe and providing scholarships for East European students to attend American Universities. Americans have assisted in establishing a new International Management Institute in Hungary. The Washington-D.C. based Free Congress Foundation, is training East Europeans in the rudiments of democratic governing. The American Bar Association is training Soviet lawyers in the U.S. The American Bankers Association is exploring ways to help East Europeans establish banking institutions, procedures and training.

---

2 For a more in depth analysis of the problems of the European Bank for Reconstruction and Development see Edward Hudgins, "The Eastern Europe Development Bank: Turning the East Bloc into Latin America," Heritage Foundation *Backgrounder Update,* No. 132, April 4, 1990.

Universities all over the U.S., such as Rutgers University and Duke University, are setting up programs to assist the East Europeans in their transition to democracy and the free market. There is no need to waste taxpayer's money by creating new government programs that duplicate private sector efforts.

Crowding Out Private Sector. Mandated by the bill is the establishment of an East European Business Information Center run by a Director of American Business who would hold the rank of ambassador. The U.S. government would also create and run American business centers in Eastern Europe that would be funded by fees charged to users of the center. While these services for American business are highly desirable, they need not be provided by the United States government. If there is a need for American business centers in Eastern Europe and a clearinghouse for information on business opportunities in Eastern Europe, then surely enterprising American, or even East European businessmen, will provide such services. The U.S. Chamber of Commerce has already opened up offices in Hungary and Poland. Further, without the weight of government red tape and bureaucracy, the private sector undoubtedly will do a far better job than the government of providing these services. By getting involved in operating business centers, the government crowds out the private sector in what could prove to be a lucrative field for entrepreneurs.

SEED II also establishes a new congressional committee, termed the Joint Task Force on East European Parliamentary Development. It is charged with providing material and advisory support for newly elected parliaments in Eastern Europe and investigating creating a 35-nation interparliamentary organization. The creation of an entirely new congressional committee with a $12 million budget to provide support for parliaments in Eastern Europe is unnecessary. By giving jurisdiction in promoting parliamentary democracy in Eastern Europe to an existing committee or subcommittee, Congress could avoid some of the red tape and duplication of effort that often follows from the creation of a new committee.

SEED II would add unnecessarily to other parts of the U.S. government as well. Warns Melanie S. Tammen, Director of the Global Economic Liberty Project at the Cato Institute, "a senior Agency for International Development (AID) official estimates that AID alone would have to expand its staff by several hundred to carry out the programs mandated in the Senate Foreign Relations Committee's SEED II bill."[3]

---

3 Melanie S. Tammen, "Aiding Eastern Europe: The Leveraged Harm of Leveraged Aid," *Cato Policy Analysis*, No. 139, September 10, 1990, p. 7.

RECOMMENDATIONS

While the SEED II bill is not without merit, its current flaws offset what little effectiveness it might have in promoting economic freedom and democracy in Eastern Europe. To remedy these flaws, U.S. policy makers need to take a long look at SEED II. Among the amendments they should consider are:

1) Extending the definition of Eastern Europe to include explicitly eligible Soviet republics and rule out explicitly any form of aid or assistance to the Soviet central government. According to the "500 day plan" already adopted by the Supreme Soviet and the Russian Parliament, it will be the governments of the individual republics, not Moscow, that will determine the future economic fate of the Soviet Union. Therefore, it will be the reformers in the republics who will require technical training and assistance. The Kremlin's bureaucrats should start looking for new jobs, not for aid from the U.S.

2) Cutting the appropriations level of the bill to the $300 million requested by the Bush Administration. The U.S. is in the midst of a severe budget crisis. The federal government can not afford to waste any money on foreign aid that will not be used productively by the countries that receive it. If the $535 million requested in SEED II passes the Appropriations committee, this is precisely what will happen. Until major structural changes take place, the East European countries will not be able productively to absorb massive amounts of foreign aid.

3) Removing language which authorizes American participation in the European Bank for Reconstruction and Development (EBRD). Despite the Bush Administration's May 29, 1990, pledge for U.S. participation in the EBRD, authorizing such funds would be a mistake. Modeled after the World Bank, and controlled by the social democracies in Western Europe, the bank likely will impose on Eastern Europe the same faulty policies that the World Bank has inflicted on Latin America or that the Western Europeans have supported in Africa. Further, the U.S. Congress would have little control over how American taxpayers' money is spent in such a bank.

4) Eliminating provisions which mandate the creation of unnecessary U.S. government commissions, programs, and congressional committees. Many of the numerous programs and commissions are unnecessary because they duplicate efforts of the private sector or other federal agencies.

5) Authorizing the Bush Administration to negotiate free trade areas with any East European country that succeeds in transforming itself into a free market system. Trade barriers in developed countries rob poor countries of opportunities to profit by the production and sale of goods. Such barriers also call into question the sincerity of America's call for free market reforms in Eastern Europe. A free trade area requires both parties to remove all tariff and most non-tariff barriers. While in the short run, the East European nations are unlikely to produce many goods that will sell in the American market, the opportunity to do so would stimulate investment and production for the future. America also would benefit from free trade agreements with East European countries: U.S. firms would have unrestricted access to East European markets, and American consumers would pay lower prices for imported goods.

CONCLUSION

While not unsalvageable, the Senate version of the SEED II legislation has numerous flaws which should be removed. U.S. and international foreign aid in the past has done little to help less developed countries and in many cases has done much to hinder reforms. The SEED II bill is an improvement over past foreign aid proposals. It ties assistance explicitly to the promotion of a free market and lists, in an index of economic freedom, the specific goals to be achieved.

Making Effective Aid Policy. The challenge for American policy makers is to avoid the foreign aid failures of the past and to avoid equating the amount of money given to a country with actually assisting the country in its struggle to reform. Lawmakers must take care to see that the intent of SEED II, the promotion of free markets and democracy, is translated into effective policy. Rushing to spend money is not the way. The careful use of aid will better insure that Eastern Europe will join the ranks of the developed world and need no aid in the near future.

William D. Eggers
Research Associate