POLICY REPORT

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DOES FOREIGN AID HELP? P. 6

Synfuels: The $88 Billion Mistake

by Elena Folkerts-Landau

In a classical maneuver to assure its survival for decades to come, the U.S. Synthetic Fuels Corporation (SFC) initiated an $88 billion crash spending program this summer: It signed its first contract to commit federal funds to the operation of a synthetic fuels plant, the Coolwater coal gasification plant in California, and it signed its first letter of intent to obligate over $2 billion to a single synfuels project, an oil shale plant in Colorado. These events, a "milestone" in the words of SFC's chairman, Edward E. Noble, launched the SFC's drive to commit $15 billion by year's end in an effort to beat slow-paced congressional efforts to bring the scope and scale of the SFC's activities in line with current economic and political conditions.

By spring 1983, the SFC had committed no funds to synfuels projects because well-qualified industrial candidates failed to file applications for financial assistance. By then, the decline in nominal and real oil prices, the dramatic decrease in U.S. oil consumption, the vulnerability of the oil exporters' cartel, public concern over budget deficits, and indications of mismanagement inside the SFC had created disillusion with the federal synfuels program in both Congress and the Reagan administration. Yet the SFC's current initiative, if it is not soon aborted, commits the government to let the corporation monitor and provide follow-up financing for synfuels plants over the course of their 25-year operational life.

The SFC was established in 1980 by Congress, with President Carter's support, as the centerpiece of the Energy Security Act, itself a response to the cutoff of Iranian oil and the subsequent doubling of world oil prices. The independent agency was endowed with an $88 billion, off-budget authorization, $15 billion of which was immediately made available. The SFC's mandate was to stimulate commercial production of synthetic fuels so as to place an upper limit on future energy prices, and thereby insure American consumers against unlimited price increases instigated by OPEC.

> **"The SFC provides a textbook case of market-oriented policies and centrally planned government programs in solving a national problem."**

One of the biggest selling points of the 1980 Energy Security Act was that the program promised to cost the government little or nothing. House Majority Leader Jim Wright (D-Tex.) and Sen. Pete Domenici (R-N.M.), among others, predicted confidently that synthetic fuels would quickly become commercially competitive, and the SFC could therefore confine itself to loan and price guarantees that would require no actual outlays.

Now, three years later, senior SFC officials are predicting that 90% of obligated funds, or nearly $14 billion of the initial $15 billion authorization, will have to be financed by the U.S. Treasury. This is partly because industrial applicants insist on receiving price guarantees, which generate direct money subsidies when a synfuels project becomes operational. Loan guarantees, in contrast, may cast in doubt a company's financial integrity, and so are of limited value to reputable companies.

The Energy Security Act's production goals are now also considered impossible to meet. The mandate to share with private industry the technological risks of producing the equivalent of at least 2 million barrels of oil a day by 1992 would require, at present, more than $400 billion in public outlays. Even the least expensive of synthetic fuels, oil shale, is estimated to cost an average $60 to $90 per barrel over the 20-year lifespan of a synfuels plant, according to both the SFC and industry experts. With the market price of oil currently hovering around $28, a minimum subsidy of $32 per barrel is necessary for producers to break even. Thus, the $67-per-barrel price guarantees currently offered to investors lay the groundwork for $515 billion in public commitments. Synfuels costing an average $90 per barrel over 20 years, such as coal liquefaction, will cause federal outlays to reach at least $818 billion before the energy security goal defined in the Energy Security Act is achieved.

The SFC and its supporters, including the chairmen of the Senate and House energy committees, Sen. James McClure (R-Ida.) and Rep. John Dingell (D-Mich.), argue that such expenditures are acceptable because they do not affect the 1984 budget, but rather reserve their full budgetary effects for the years ahead. An SFC spokesman

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EDITORIAL

Will Dollars Save the Schools?

Three blue-ribbon commissions have reported recently on the sad state of American education, with the National Commission on Excellence in Education winning the rhetoric contest: "If an unfriendly foreign power had attempted to impose upon America the mediocre education performance that exists today, we might well have viewed it as an act of war. We have, in effect, been committing an act of unthinking, unilateral educational disarmament."

Politicians immediately seized on the educational issue. President Reagan quickly announced that he had always been concerned about education and scheduled speeches before the PTA, the American Federation of Teachers, a Tennessee classroom, and a Minnesota regional forum. Walter Mondale proclaimed that he too had always been concerned about education and quickly made two speeches attacking Reagan's "voodoo education" proposals. Mondale's $11 billion spending program, however, was soon topped by presidential rival Senator Ernest "Fritz" Hollings, who bid $14 billion in a speech delivered before the National Education Association.

Suddenly, the media's hottest topic had become governors and their education programs. In response to reports that informed them of the sad state of the public schools—or perhaps in response to the perceived media opportunities—governors around the country began offering new proposals to "fix" education. Most of them seemed to involve money—$233 million in new taxes in Florida, for instance. More cautious chief executives, like Mark White in Texas and Bill Clinton in Arkansas, concerned that perhaps three blue-ribbon commissions and two separate studies weren't enough, appointed state-level commissions to investigate the problem.

There is no doubt that the educational system in America is in deep trouble. In fact, long before the politicians' recent discovery of the issue, *Policy Report* wrote in April 1981: "Education in America is in crisis. SAT scores have been falling for the past 17 years at a rate of about 1% a year. At the Berkeley campus of the University of California, where entering freshmen come from the top one-eighth of high-school graduates, a significant percentage of them need remedial English courses. Many businesses are finding it increasingly difficult to hire employees with basic reading, writing, and mathematical skills. We went on to point out, with some prescience, "The most scandalous aspect of the education crisis is the almost total silence on the issue by politicians."

Now that virtually everyone agrees that we are mired in crisis, perhaps we can face the question of what to do about it. The conventional view—almost unchallenged in the national media—is that we should spend more money on the schools. However, during the past 20 years of falling SAT scores, per-pupil spending on education has been steadily rising. From 1971 to 1981, per-pupil expenditures in inflation-adjusted dollars rose from $1,982 to $2,553—a 29% increase. If more dollars would save the schools, they should have had some effect by now.

The real problem is that public schools in the United States are a near-monopoly. Like all monopolies, they have become inefficient. It is competition or the fear of competition that keeps businesses on their toes. The absence of competition in education has allowed the schools to ignore the demands of their customers, even the demand for basic quality.

If a private business had borrowed more and more money from its banks over the past 20 years, with a steadily declining balance sheet, would it now be able to get a huge increase in its line of credit? Not likely. Yet that is what the schools are asking for—more money to solve the problems that only got worse as spending rose in previous years.

Even if we felt that more spending would improve the schools, should more generations of children have to wait for these improvements? Today's children should have a chance to get a good education now. A program of education tax credits would give them that opportunity.

Why would anyone oppose giving people the right to choose something as basic as education? One answer was given two years ago by a University of Virginia professor, William H. Seawell, with the kind of breathtaking honesty that is rare today: "Each child belongs to the state," said Professor Seawell. Public education is the "training of citizens for the state so that the state may be perpetuated. . . . We must focus again on creating citizens for the good of society." For that reason, Seawell said, tax credits are "philosophically wrong even if they are economically equitable."

In the 19th century, when the imposition of compulsory public education was being debated, many proponents made similar arguments, with particular emphasis on training immigrants to live a proper American Protestant life. Today, however, such viewpoints are rarely expressed openly.

For the past 20 years, we've spent more on education, and the quality of education has declined. It's time to look for new ideas. Tax credits would bring competition, innovation, and choice to our educational system. They're a worthy alternative to any program that would simply spend more money on the system whose performance has been so universally rejected. ■

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boldly wrote in the *New York Times* that SFC's planned $15 billion obligations do not contribute to the federal deficit because their budgetary effect "will take place two to four years after award" of the guarantees.

Not only is such disregard for future fiscal responsibility alarming, but it is also misleading. The public burden today is far greater than first meets the eye because current interest rates are pressured upward by investors' expectations that credit markets will have to absorb $14 billion in Treasury borrowings on behalf of the SFC. (If the SFC's request for access to the remaining $68 billion is granted in 1984, investors will expect an additional 90% of that sum, or $62 billion, in public borrowing, totaling almost $75 billion attributable to the SFC.) Even though funds have yet to be transferred to particular synfuels projects—in transactions that will be recorded off-budget—the effect on current interest rates is the same as an anticipated widening of the actual 1987–1990 federal deficits.

Sincere advocates of the SFC who argue that the country's energy security must be insured at any cost overlook the fact that $15 billion is expected to purchase the capacity to produce less than 60,000 barrels a day of synfuels, or less than two percent of current daily U.S. imports of oil and petroleum products. The Strategic Petroleum Reserve, in contrast, already contains about one year's supply of imports from the Middle East; its transportation and storage costs average $3.75 per barrel, or less than $15 million in annual government outlays in addition to the cost of the oil.

The creation of a centrally planned organization such as the SFC was more a congressional expression for "doing something, even if it's wrong," in the immortal words of Sen. Dale Bumpers (D-Ark.), than it was the outgrowth of thoughtful planning. Rejected by previous Congresses, synthetic fuels commercialization became the legislative bandwagon of the 96th Congress. Beginning with a relatively modest 14-page, $3 billion proposal, synfuels legislation mushroomed when the Carter administration stepped in with its $88 billion scheme to be funded by revenues generated from its proposed windfall profits tax. The Senate then tacked on numerous amendments, packaging synfuels development with solar energy, conservation, gasohol, and other energy programs; in addition, it abandoned the link between the synfuels program and the windfall profits tax.

The conference held in December 1979 to reconcile House and Senate versions of the energy security bill involved seven competing committees. So unwieldy was the proposal that almost no one was able to talk about it as a whole. Eventually, unnecessary or excessive items were added rather than deleted from the bill to gain support for a legislative package. Sen. Bennett Johnston (D-La.), pleased with the conference agreement, remarked that "there's something there for the left and for the right." When asked if the bill was not unlike a cookie jar, with something for everyone, Johnston replied "all of the cookies are good for the country." The bill was passed by an overwhelming bipartisan vote, and signed into law by President Carter on June 30, 1980. Rep. Wright called the measure "the most significant piece of legislation we're likely to enact this year."

What Went Wrong?

Why the SFC went wrong can be explained by a number of factors. First, the legislation was prepared in haste. No printed conference report was available at the time of the vote. And neither Congress nor the public was given sufficient opportunity to react to the end product. There was a lot of rhetoric about energy security, but, as Sen. William Armstrong (R-Col.) commented, "The [SFC] is not . . . supported by those who are knowledgeable of what it takes to stimulate meaningful production of energy from . . . synthetic-fuels substances."

In addition, oil price increases failed to materialize, and energy users and suppliers demonstrated a responsive-

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ness to economic developments that defied the SFC's objectives. Oil consumption in the United States has declined 12% since 1980 from 17 million barrels per day to 15 million, and the share of oil in total U.S. energy consumption has dropped from 45% to 38%. Energy exploration has reached record levels, the number of oil wells drilled having more than doubled to 40,298 between 1980 and 1982 and gas wells having surged 29% to 18,953, before tapering off in recent months.

Most significant has been the voluntary reduction in U.S. crude oil and petroleum product imports from 6.9 million barrels per day in 1980 to an average 4.4 million in 1983. Greater efficiency of energy use and the consequent movement away from energy-intensive industries make it unlikely, furthermore, that imports will be increased to raise inventories significantly. Moreover, global strategic roles have been reversed, with oil-exporting countries more dependent than ever on capital supplied by the industrial nations. In 1980, when U.S. oil-price controls helped boost U.S. imports, the OPEC nations enjoyed a $115 billion current account surplus; today their current account has plunged to a $27 billion deficit, explaining why the OPEC cartel is powerless to fix oil prices far above the market level.

As a result, wholesale rejection of commercial synfuels development has eliminated SFC's choice of attractive opportunities. One year ago, Exxon abandoned a shale project in Parachute, Colorado, into which it had already sunk $700 million. Last October Sohio renounced participation in the proposed $3 billion Hampshire coal-to-gasoline project in Gillette, Wyoming. Ashland Oil withdrew from a proposed multi-billion-dollar coal gasification project one month later.

SFC's misguided mandate was also strongly supported by a constituency of public policy specialists who have made it their cause to bemoan the market's imperfections and who were instrumental in justifying a colossal federal energy program. Proliferating in the late 1970s, in tandem with the burgeoning federal energy budget that supported them through university grants, government consulting contracts, and direct employment with the government, these public policy specialists have successfully marketed the concept of a "social cost" of imported oil to be as high as $154 per barrel. More recently, the SFC staff induced its president and vice chairman, Victor A. Schroeder, (who resigned under fire in late August), to announce that the "real" cost of imported oil is $80 per barrel to help justify $80-per-barrel synfuels subsidies.

To arrive at these figures, public policy pundits imputed dollar costs in curious ways to economic dislocations produced by the two world oil price shocks, including inflation, unemployment, the OPEC threat, and the inability of the U.S. to exploit its market power. These social costs were then spread over prevailing oil import levels, thereby raising the per-barrel "cost" of imported oil above its market level of approximately $30 to $154 (Stobaugh), $70 (William Hogan of Harvard's Kennedy School of Government), $59 (William Nordhaus of Yale), and $48 (Stanford Energy Modeling Forum).

"Decontrol resulted in lower oil consumption and greater production. The SFC did none of these."

In reality, the 1974–75 and 1980–82 recessions, which resulted in part from oil price increases and were aggravated by disinflationary monetary policies, were not linked to *future* imports of oil, but rather to *past* imports, when oil could be purchased for less than $3 a barrel. For several decades the industrial nations exploited their market power to import vast amounts of crude oil and petroleum products at prices far below competitive levels. The industrial nations accrued large economic benefits from imported oil during this period, benefits that cannot be ignored today. OPEC's nationalization of foreign interests in oil companies based in the Middle East shifted market power away from the oil-consuming nations and made possible the first oil price shock. Thus the social costs borne by the United States in adjusting to real oil price increases since 1973 have been the price of enjoying $1- to $3-per-barrel oil in prior years. Such costs are irrelevant in designing current energy policy. Moreover, the current distribution of economic power in the world oil market precludes deliberate supply disruptions and, therefore, like other trade commodities calls for no "national policy" at all.

A Study in Central Planning

Three important lessons can be learned from the SFC experience which apply to other areas of public policy as well.

First, the SFC provides a textbook case for testing and comparing the effectiveness of market-oriented policies and centrally planned government programs in solving a national problem. Oil price decontrol was a market solution to oil shortages, whereas the SFC was intended to be a technocratic, centrally administered solution. Decontrol has resulted in lower oil consumption and imports, and greater exploration and production. The SFC did none of these; instead, it is now laying the groundwork for a multibillion-dollar program of government subsidies, and in the process it has created a self-serving bureaucracy.

The trend for private synfuels sponsors to return to Congress for subsidies exceeding the sum specified in the original contractual arrangement is exemplified by the Great Plains project. In 1980 American Natural Resources, leading a consortium of companies including People's Gas, Tenneco, and Transcontinental Gas Pipeline, had their lobbyist provide the exact language in the Energy Security Act to underwrite the construction of their 20,000-barrel-a-day coal gasification project in North Dakota. The Great Plains project has since been awarded over $2 billion in federal commitments. But with the possibility of operating losses reaching $1.7 billion if oil prices fail to rise at a 5% annual rate, project sponsors are presently requesting additional federal assistance.

A second lesson from the SFC experience is that a government agency entrusted with enormous administrative flexibility and vast sums of money must be very carefully staffed, lest it succumb to self-promoting activities. The SFC has awarded its permanent staff annual salaries as high as $108,000, with more than 70 percent of nonclerical personnel earning over $40,000. Several senior executives with no apparent qualifications were hired on the basis of earlier affiliations with the chairman or vice chairman. According to the *Washington Post*, the chairman's executive secretary, who is also the vice chairman's wife, is paid in excess of $31,000 a year. Chairman Noble originally volunteered to work for one dollar per year, but was pressured—on grounds that he should appear professional—into accepting a $69,000 salary, which he promptly declared he would donate to a nonprofit organization of his choice which raises the question why taxpayers should pay for Mr. Noble's charity. SFC officials have refused to exhibit such elementary signs of good will as to place their assets in a blind trust while they select companies for $15 billion in financial assistance. Thus a mockery has been made of congressional intent to attract the nation's best talent by exempting the SFC from government pay scales and conflict-of-interest restrictions.

Exemption from public and congressional oversight has also permitted the SFC to stonewall attempts by Congress and the public to acquire nonproprietary information about the corporation's activities. This advantage, in turn, has encouraged the SFC to resist curtailments in its scope necessitated by changing economic conditions and to behave in a way that runs counter to the spirit of the enabling legislation. For example, the planning department has begun spending $10 million on outside consultants to help justify some or all of the slated $68 billion congressional authorization in 1984. The Inspector General's office hired on a permanent basis two former consultants who failed to deliver a report for which they were paid $35,000. The private sector's rejection of commercial synfuels induced Schroeder to announce that the government would own synfuels projects if no one else did; the board of directors then decided to obligate over $1 billion to peat, heavy oil, and tar sands, thereby affronting the legislation's primary goal of transforming the nation's major resources of coal and shale into usable substitutes for crude oil.

"The wholesale rejection of commercial synfuels projects by major oil companies indicates their unprofitability."

Further, financial assistance has been offered to Kuwait, Japan, and Germany, an odd approach to enhancing U.S. energy security. And according to SFC's executive vice president, Jim Bowden, plans are underway to expand the nominal $15 billion obligational authority, which is currently available, to $27 billion by allowing approximately 80% of loan guarantees to be converted into price guarantees when plant construction ends; such roll-over financing shifts almost the entire risk of a project onto the taxpayer.

The third lesson taught by the SFC experience is that the implementation of a U.S. president's policies depends critically upon the government's middle-level managers. The administration has largely failed in its efforts to appoint to middle-level positions professionals sympathetic to its outlook on the role of government. As a result, budget cuts have been prevented or undermined by the existing cadre of managers whose career advancement hinges on prolonged federal involvements.

And so it is with the SFC staff. It has successfully imposed its view on a board of directors inexperienced in the operation of government, and it has purged internal dissenters. One department intends to spend up to $10 million in grants to SFC sympathizers from industry and academia to prepare a "Comprehensive Strategy" justifying a further $68 billion in congressional appropriations. This department has been staffed by an assortment of public policy specialists who are on record as forceful sympathizers of a large-scale SFC effort. The arrogance of a bureaucrat about electoral accountability is captured in the words of the acting director of policy development: "I find [the position] unsupportable" he writes, "that 'optimal' economic instruments are 'determined by the political process.'" It is unrealistic to expect the SFC to be sympathetic to congressionally proposed curtailments of its activities when it is managed by a staff committed to the federal bureaucracy's continued role in energy.

Abolishing the SFC

The case against the U.S. Synthetic Fuels Corporation is overwhelming on both economic and political grounds. There is ample evidence that over the past decade Western industrial nations, largely free of oil price controls, have become sufficiently responsive in their energy consumption, imports, and production to preclude manipulative increases in the price of oil without also creating excess supply. The wholesale rejection of commercial synfuels projects by major oil companies further indicates the unprofitability of such ventures, and hence the tremendous increase in the federal budget that will follow if the SFC proceeds according to its plan. In addition, the SFC's administrative abuses and internal mis-

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Does Foreign Aid Help the Third World?

Every month the Cato Institute sponsors a Policy Forum at its Washington headquarters, where distinguished analysts present their findings to an audience drawn from government, the public policy community, and the media. A recent Forum featured Sudha Shenoy, an Indian-born economist now living in Australia. She was a Visiting Scholar at the Cato Institute and at the Center for the Study of Market Processes at George Mason University during the spring of 1983. Commenting on Shenoy's talk was Rufus Waters, chief economist of the U.S. Agency for International Development.

Sudha Shenoy: Foreign aid, as it is called, is neither necessary nor sufficient for economic development. If the conditions for growth are present, aid is unnecessary. If the conditions for growth are not present, aid is inimical.

The term itself is question begging. Aid consists of funds that are given by one government to another government. In other words, it consists of a set of capital transfers. The effect, therefore, depends on the policies of the recipient governments. These policies, of course, will change from time to time. We cannot therefore presume before the fact that giving funds to the government does in fact help the peoples of the less developed countries. It, of course, helps the recipient governments. But governments are not the same as the peoples they govern. So it remains to be shown that in fact any aid given to a government produces effects that the population would regard as beneficial.

If the receiving government follows policies that do in fact promote growth, then aid may be helpful. This doesn't necessarily follow because the government may be funding useless projects, while the growth comes from other sources. If the government follows policies that are inimical to growth, then the transfers are self-defeating—if, that is, our purpose is to further economic growth to help the peoples of the less developed areas, not simply to add to the resources of the governments. In any case, aid cannot be politically or economically neutral. These capital transfers add to the weight of the government in relation to other institutions in the economy. This may or may not be a good thing. The net effect, however, is that the role of the government in the domestic economy must be increased. Thus, aid always affects the domestic situation.

The increase in the relative size and role of government is equivalent to an increase in the resources available via the political process for political distribution, not an increase in resources available via economic mechanisms.

How do we measure the size of the aid or the transfers of funds that go

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from one government to another? Usually the argument runs that aid is insufficient or inadequate because it is so much per capita, a very small sum. But as mentioned, the money goes to governments and not to people. It is distributed not as charity directly to a distressed population, but given to governments in the less developed areas. So the measure is the increase in the size of funds at the government's disposal.

In considering domestic policies of the recipient governments—one is talking about a very large group of countries and of governments with widely differing situations. I suggest, however, that most of these governments follow policies that have certain characteristics in common. I shall illustrate further by reference to the Indian government, which is a standard example of a country that is always said to be in need of aid. The government—certainly the Indian government—tends to concentrate investment in urban areas, particularly in showcase projects in urban areas. Very often these are heavily subsidized industrial projects that are protected by extremely high tariffs and other sorts of subsidies. Agricultural projects often consist of urban support projects—dairies that supply milk and dairy products for urban areas, for instance. In other parts of the world one finds collective farms and other policies that do not necessarily increase agricultural output.

Specifically, if one looks at the Indian situation, the bulk of the population lives in rural areas, and this has not changed over the last hundred-odd years. Eighty percent of the population lives in rural areas. Half the national income derives from agriculture, despite all the government's attempts to change the situation. Three-quarters of the employment is in agriculture or in the rural areas. If, however, one looks at the five-year plans used to justify giving aid to the Indian government, one finds that three-quarters of the investment is in industrial or urban projects. In other words, the policies tend to favor the urban minority, which also happens to be more politically influential. The agricultural investments, as I have mentioned, consist either of support schemes for urban areas or of things like large dams and large canal systems with very little investment in feeder canals to actually take the water from the major canals down to the fields themselves. So the water which otherwise would go down the river to the sea, now goes down the canal systems to the sea, and the Indian government pays interest for the privilege of having such a project.

The agricultural sector is subject to many obstacles when it comes to increasing agricultural output, particularly for sale on the market. There are credit restrictions on the wholesale trade in food grains. Until quite recently—in other words, for the key period—there were restrictions on the movements of food grains. You were not allowed to transport food grains from the "surplus" to the "deficit" areas. The result was a fragmented market, whereas there had previously been a national market.

There were also compulsory purchases of food grains at below-market prices, again until quite recently. All of these add up to obstacles to producing for the market as opposed to household consumption, and therefore limit the extent to which farmers would move into production for commercial purposes.

The industrial projects are highly protected by tariffs that are among the highest in the world, by quotas, and by absolute bans on some imports. Domestically produced goods are two to three times as costly as industrial goods available abroad and of much poorer quality. Indian fertilizer prices, for instance, have been several times as high as world prices, and this in a poor agricultural country.

Exports are very heavily subsidized. A measure of the subsidy may be obtained by looking at the prices that are paid on black markets for the so-called export promotion import licenses. If a company exports a certain amount of industrial (not agricultural) outputs, it is allowed access to foreign exchange at the subsidized price. The exchange is, of course, resold in the domestic market at a much higher price. For many exports the value of the black market exchange license is more than the value of the exports themselves. So the industrial products, even when they are exportable, are exported at considerable cost to a very poor economy.

Another case study of aid in-kind concerns the period during which the U.S. government supplied wheat to India under P.L. 480. This stopped during the 1970s. Wheat is a luxury food grain that was sold by the Indian government at below-market prices in urban areas, and therefore went essentially to purchase urban support for the Indian government. The economic effect was of course to pull down wheat prices relative to other prices, and once again to penalize the relatively poor Indian farmer in order to support the very much better off American farmer.

The overall impact of these policies on the Indian national income is discernible. Indian national income rises and falls with the size of the harvest. The agricultural surveys conducted by the Reserve Bank of India—for what they are worth—suggest that there has been a positive fall in capital formation in the agricultural areas, by as much as 50%. This was in the last survey they took at the end of the 1960s. They suddenly stopped it for obvious reasons. I think they only recently restarted these surveys.

The increase in food grains production—the bulk of the Indian diet consists of food grains even in the highest

Sudha Shenoy

income areas—has only just kept pace with population. And given the fall in capital formation in the rural areas, the output is maintained by increasingly labor-intensive methods.

Output of cotton cloth, the next item after food grains in most rural spending patterns, has consistently lagged behind the increase in population. Since the Indian government wishes to increase infrastructure and capital goods production, it limits the output of cotton cloth produced by mills. So the population is more dependent on coarser handloom cloth. Output of both handloom and cotton cloth lags behind population growth.

What has increased quite spectacularly is of course not only capital output—steel mills, machine tools, heavy chemicals—but also urban luxury items—fans, refrigerators, electric lamps, manmade fibers, and so on. The increase in resources going through government also means an increase in resources being siphoned off. And hence we have the increase in urban luxury goods production compared with the lag in output which is consumed by the masses.

Finally, there is one example of successful growth without foreign aid: Hong Kong. (In fact, in one year in the 1950s Hong Kong did receive some money from the UN for refugees, so it's not entirely without foreign aid but that is the only aid it has received.) The growth of Hong Kong has been through its own output of industrial products. But in this case, industrial products are not selected by any government because, being a colony, it has no government capable of doing the things that other governments can do. Hong Kong's products rely on profits and losses, capital gains and capital losses, first of all for selection and then for survival. Hong Kong, in other words, has not done any of the things that we are told should be done if one wants successful growth. It has nonetheless flourished. There are no industrial subsidies because there is no way the industrial sector can be subsidized. There are no export promotion schemes. There are no import restrictions. There is no attempt to establish capital goods industries. Nonetheless, we have in Hong Kong, from what statistics are available, a doubling of per capita income in real terms, and this at the lowest levels of income, over a period of about 20 years.

Hong Kong, incidentally, has also had one of the world's fastest rates of population growth—in excess of 4%.

The growth of Hong Kong started out with things that it was told it should not do. Consumer goods industries produced Chinese foodstuffs, bamboo furniture, and fire crackers, to begin with, then diversified into cotton items, underwear, pajamas, sheets,

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Foreign Aid (Cont. from p. 7)

and so forth. More recently, it produces more sophisticated industrial items—aircraft components, watches, calculators, and textile machinery. I should add that the growth has occurred despite considerable obstacles to its exports by the very governments that say they want to help the underdeveloped areas. Every time Hong Kong has managed to produce an item that somehow displaces an item produced in the developed areas, it is faced with an increase in the tariff or an import quota. Even Switzerland restricts imports from Hong Kong. In other words, if one is successful, one runs into difficulties. If one is not successful, the lack of success is regarded as a reason for aid, which is supposed to produce success. There's something wrong here.

A good example of the interlocking domestic and foreign counterproductive policies can be provided here. The U.S. Department of Agriculture supports the prices of U.S. agricultural commodities. (This is one reason why you had to dump wheat in India when India was a potential market.) Cotton is one of the commodities that are so supported. Since there is therefore a "surplus," you have an export subsidy to offset the price support. Hong Kong, of course, buys cotton at world prices, not U.S. prices. U.S. manufacturers complained, so we had an import tariff to offset the export subsidy to offset the price support. Despite this, the Hong Kong manufacturers were so successful that the U.S. had to add a quota. So you have a quota in addition to a tariff in addition to an export subsidy in addition to a price support.

Finally, I should add something about the sources of the arguments for more aid. I shall confine myself to Britain since I am here in the U.S. If one examines the credentials of the major British proponents of aid, one finds that they are in the main teachers at, or heads of, institutes that are the principal recipients of British aid funds. British aid is technical aid. Technical aid consists in training programs for civil servants from abroad. The heads of the institutions that supply these training programs are the most vocal and vociferous supporters of foreign aid. In the British Parliament one is required to state one's interest before one speaks in support of any legislation or opposes it. I think that the British supporters of aid, at any rate, should be required to do the same.

Cato Journal editor James Dorn talks with Rufus Waters.

Rufus Waters: I agree that aid is not a sufficient nor even a necessary condition for economic development. That's not what we're talking about. Few believe that it is. Rather, we intend that aid will accelerate a process of economic development which is already underway. I think it does that. We have successes. Consider a country whose substantial aid was later phased out—South Korea. Has Korea's post-aid performance compensated for the failures, which are so much more attractive to document? Of course there are those countries which have absorbed aid, but have not in fact performed well. The drama of failure is always more attractive than the quiet reasoning of success.

Let's also recollect the diversity of the aid recipient countries. The inference is that we are dealing with the Third World. Peter Bauer would say that the Third World is unified only by the fact that the members are aid recipients. That may or may not be true, but as you surely would recognize, there is a difference between, say, Spain and Somalia.

Among the aid recipients there are those countries that are classified as the NICs, the newly industrialized countries: Spain, Argentina, Brazil, Taiwan. These countries are distinctly different from what we call the "MICs." The MICs are the middle-income countries, defined by their per capita income, a tenuous kind of definition when you're not quite sure how many capitas you've got. And the LICs, of course, are the less industrialized or the poorer of the group.

There is obviously tremendous diversity here: in population, between India and the Seychelles; in per capita income, between Spain and Sudan; in geographical size, between Vanuatu and Zaire.

There are a couple of characteristics of the aid-giving process that we might be aware of. Congress determines that we will transfer funds. We recognize that we are not necessarily dealing with democratic societies in which choices are open from our standpoint. We cannot decide always on exactly how we will transfer aid. We, as a rule, have to transfer aid to governments if we are going to deal with many of these countries.

As an economist I tend to think in terms of relatives, not absolutes. What is the position of the aid recipient countries, having received aid, by comparison with what would have been their situation had they not received aid?

That is the crucial issue for me. An Austrian economist would leap to the floor and say, "Now, wait! As with opportunity costs here you have a concept which is not measurable. It is nonscientific." I agree it is difficult to measure.

Some people suggest that aid is merely a subsidy to our own export sector. They argue that aid is necessary to generate a supporting constituency.

Similarly, I've heard it suggested that, for example, P.L. 480—food aid—is a conspiracy, that such aid is actually for security reason only, and its real purpose is to permit recipient countries to choose a domestic policy of dependency and thus become our client state.

There is, of course, the charge of paternalism—the suggestion that we alone know what to do for these wretched people.

There is also the suggestion, which I would instantly refute, that aid is a mere form of flagellation; that is, the urge to satisfy the guilt feelings which many have toward those less well off. These arguments are irrelevant for our purposes. We are interested in what aid achieves rather than why it is given. Funds indeed are fungible. We have to see if aid will accelerate a desirable trend in a particular nation. We have the problem of insuring that the marginal dollar of our money does achieve the greatest possible impact. And of course this is difficult. You should be aware that we, with our European friends in the OECD and the Development Assistance Council, are trying what's called policy dialogue. We attempt to use at the margin our relatively small aid funds to induce governments to pursue what are universally agreed to be more rational policies. If in fact sustained increases in prosperity or economic development is their goal, we try to induce them to recognize that it is the structure of ownership of assets that differentiates successful from unsuccessful economies. We do try—certainly in this administration—to induce an emphasis on the private sector. This is quite a shock, and it takes time to persuade people that the private sector will work. We are trying to do that. And we are interested in training and giving people skills—because this is the least appropriable form of wealth. Skills are the form of technology that it is most difficult to steal or to expropriate.

I would close by suggesting in all seriousness that there are several lines of approach. We must try to reduce government involvement in roles that are inappropriate. On the other hand, I see this as an activity to be undertaken during the process by which an elected government decides how to allocate funds.

We in this administration have three distinct roles with respect to aid. First, security aid. Second, humanitarian or emergency relief aid. The United States is the great supplier of humanitarian aid in the world. And third, development aid. It is really only this third part that we are talking about. Is development aid used appropriately, and how can you separate it out from the other? It is extremely difficult. We do our best in a tough situation. I will close by saying that on many issues I agree with Miss Shenoy, but ours is an operational responsibility. I seek your support in helping us to improve the efficiency with which we allocate what *your* government has decided we will allocate.

Sudha Shenoy: It is now generally agreed that aid is non-neutral. It is intended as a political weapon to try and get governments to do what we think they should do. If one claims this is also making them more efficient or whatever, it is nonetheless not disinterested charity. It is a political tool.

Second, I was questioning the whole reason for actually giving the aid, whether from Congress or any other political instrumentality. In other words, I was talking about what happens *before* Congress decides we must give aid.

On the successful aid recipients, such as South Korea, I would really reserve judgment. Do we know whether the success of the South Korean economy is the outcome of either aid received previously or the policies of the present government? The success of particular exports does not give us a clue about the domestic policies that actually produced those exports. ■

Regulation magazine's managing editor Anne Brunsdale talks with Ed Crane.

Capitalism from Cantillon to China

Will China Go 'Capitalist'?: An Economic Analysis of Property Rights and Institutional Change, *by Steven N. S. Cheung. Institute for Economic Affairs, London, 1982. 64 pp. $5.95.*

Progress of Economic Reform in the People's Republic of China, *by D. Gale Johnson. American Enterprise Institute, Washington, 1982. 43 pp. $2.95.*

Since the death of Chairman Mao in 1976 and the overthrow of the Gang of Four, Western observers have viewed the progress of economic reform in the People's Republic of China with great interest. Under the slogan of "readjustment, reform, consolidating, and improvement," the new leadership has attempted to eliminate some of the excesses of the Great Leap Forward and the Cultural Revolution and to bring China into the ranks of affluent consumer economies.

Professor Steven N. S. Cheung is well qualified to analyze the current state of the Chinese system and the prospects for institutional change. Not only has Cheung established himself as a leading theorist of social change, but he is also well acquainted with China, having lived there until 1948 and visited in 1957 and 1979. In *Will China Go 'Capitalist'?*, Cheung provides a useful and informative background to present events in China, discusses obstacles to progress toward markets, sets forth a general theory of institutional change, and then applies it to modern China, concluding that the Chinese economy will gradually move toward market institutions (private property) without adopting the terminology of "capitalism." The reality of freer markets will be realized without the Western terminology, Cheung argues, largely because of the popular Chinese identification of "capitalism" with the chaos, corruption, and rights violations of the Kuomintang regime that was overthrown in 1948.

Cheung interprets institutional change in terms of changes in the structure of property rights and argues that transaction costs are the determinants of property rights structures. Transaction costs are categorized into the costs of operating an institutional arrangement and the costs of adopting or changing institutions. Cheung argues that, while the operating costs of the Chinese communist system are enormous, the costs of changing the system (a large component of which is made up of information costs) are being diminished by the opening of Chinese society to the West. Writes Cheung, "If the Chinese leaders hold firm to their policies of the open door, political stability, and increasing productivity—together with a gradual recognition of consumer preferences—*then the rules of the game will be altered in a way that must conflict with the current structure of property rights*. Something will have to give." That something, argues Cheung, will be communist economic practice.

Policy Report Reviews

University of Chicago economist D. Gale Johnson does not share Cheung's optimism. In his review of Chinese economic performance and evaluation of the prospects for the future, Johnson writes, "China is a socialist economy and will remain one. The present leadership does not intend to establish a capitalist market economy, even though it does favor a major expansion of activities under private economic auspices. There is no explicit or implicit intention to abandon socialism. The goal is to make China's socialist economy function much better for the benefit of the people of China." Relying largely on newly available data from China, the writings of Chinese officials and economists, and three recent visits to China, Johnson sets forth the structure of the Chinese economy and carefully compares performances under the various policies of the central government. Johnson is pessimistic about the prospects for government introduction of realistic pricing policies but is optimistic about the growth of private enterprise (in 1978, after the Cultural Revolution, only 150,000 individuals were engaged in private enterprises; in 1980 alone, 810,000 individuals began their own businesses in Chinese cities and towns).

The contrast between Johnson's pessimism concerning the prospects for free markets in China and Cheung's guarded optimism may lie in Cheung's greater emphasis on an "invisible hand" understanding of processes of institutional change. While Johnson focuses on the conscious policies that would have to be initiated by the Chinese political leadership to move the economy toward a market system (and the difficulties they would face under present political constraints), Cheung focuses on the dynamics of change, showing how already-introduced changes will alter those constraints in the future, making further changes less costly. For Cheung, change takes on almost a life of its own; his approach is far more "systemic" than Johnson's. Together, however, these two essays provide a fascinating look into the world's most populous economy and the prospects for its transformation into a competitive market system.

The Entrepreneur: Mainstream Views and Radical Critiques, *by Robert F. Hébert and Albert N. Link. Praeger Publishers, New York, 1982. 128 pp. $21.95.*

It has long been the received view that entrepreneurship is the driving engine of market capitalism, but coming to grips with just what entrepreneurship is has proven a difficult task. Throughout the history of economic thought the entrepreneur has been identified by various theorists with the adventurer/merchant, the agent of arbitrage, the investor/capitalist, the business manager, and the inventor, depending upon the emphasis placed on the functions of risk taking, opportunity perception, innovation, and managerial skill. Some theorists have portrayed the entrepreneur as primarily an agent of disequilibrium (e.g., Joseph Schumpeter), while others have seen him as an equilibrating agent (e.g., Israel Kirzner).

Professors Hébert and Link of Auburn University have produced a very useful overview and critical examination of the works of various theorists of entreprenueurship, proceeding largely chronologically from Richard Cantillon to Kirzner, Harvey Leibenstein, and G. L. S. Shackle. The authors begin with a discussion of the importance of entrepreneurship to economic theory, its relationship to property rights, and the parallel evolution of forms of business organizations and entrepreneurial theory. The ideas of the first modern theorist of entrepreneurship, Richard Cantillon, are discussed in some detail, and it is made evident that Cantillon's *Essai sur la Nature du Commerce en General* (published in 1755, 21 years after the author's death) is an important work still deserving of careful study. Cantillon, himself a brilliant entrepreneur who profited enormously from his foresight of the course of John Law's "Mississippi Bubble" schemes, focused on the function of risk bearing. Unlike other economic agents, entrepreneurs "buy at a certain price and sell at an uncertain price." The entrepreneur is an owner of capital (including the "entrepreneurs of their own labor," an early version of human-capital theory) and an agent of arbitrage; entrepreneurial profits thus become the legitimate reward for economic adjustment and the fuel of the market economy.

Hébert and Link proceed to examine the work of the French physiocrats, including Quesnay, Badeau, and Turgot, and the classical economists, Say, Smith, Ricardo, Bentham, and Mill. Their overview of neoclassical theories, especially those of the "Austrian" (market process) school, is informed and insightful. They also examine currently evolving theories of the Harvard School, which exmphasizes a functional approach that empirically investigates the environment within which entrepreneurs act; Shackle, who emphasizes decision making within radical but "bounded" uncertainty; the "Neo-Austrians," especially Ludwig von Mises and Kirzner, the former emphasizing risk bearing and the latter opportunity perception; Leibenstein, whose theory of "X-efficiency" denies the existence of a unique production function and highlights the "input-completing" function of the entrepreneur in overcoming market imperfections; and human capital theorist T. W. Schultz, in whose theory entrepreneurship is a factor of production to which earned rents accrue.

The concluding chapter presents a useful taxonomy of entrepreneurial theorists. The authors collapse 17 theorists into four generic categories: "'Pure' Uncertainty," "'Pure' Innovation," "Uncertainty and Ability/Innovation," and "Perception and Adjustment." They conclude that the various strains of entrepreneurial theory remain to be adequately synthesized and that "consensus on the nature and role of the entrepreneur will be long in coming." Hébert and Link provide a valuable contribution to economic thought, and are must reading for those who seek an understanding of the operation of the entrepreneur in various markets. ■

Synfuels (Cont. from p. 5)

management discredit its board, the administration, and Congress.

To abolish the SFC is not a partisan issue. The SFC's creation was an honest mistake, made during troubled times. But now, when much effort is being devoted to restraining the size of social and defense programs, it is inconceivable why the SFC should be spared. Unlike the energy and education departments, the SFC does not even enjoy the shield of an indigenous lobby; nor does it bestow significant political gain on either party.

At the least, therefore, an amendment to treat the SFC's activity as an on-budget entry would subject the organization to public and congressional scrutiny. Transferring SFC's activities to a conventional federal agency, such as the Energy Department, would have the triple advantage of subjecting the SFC to on-budget treatment: The SFC would be subject to the requirements of the civil-service system and to conflict-of-interest and sunshine legislation; and to pressure at the cabinet level for all agencies to make budgetary concessions contributing to paring down the synfuels program. The most effective approach would be simply to rescind Title I of the Energy Security Act, thereby abolishing the SFC.

Several bills have been introduced this year in both chambers of Congress to "eliminate a crash commercialization program" in synthetic fuels, as described by Rep. Tom Corcoran (R-Ill.). But the chairmen of the subcommittees with oversight, Sen. McClure and Rep. Philip Sharp (D-Ind.), oppose the measures and have postponed hearings. Meanwhile, as SFC obligates every additional dollar, it lays the contractual foundation for government involvement spanning decades. With federal budget deficits over the course of 1984–88 estimated at around $800 billion, Congress can seize the opportunity to slash $88 billion, or more than 10%, at once. ■

Next Month in Policy Report:

Is the Dollar Too Strong?

Four New Books on Supply-Side Economics

"To be governed . . ."

Today canned beans in sauce, tomorrow the world

Officials of Stokely-Van Camp . . . say that a merger with Pillsbury will raise antitrust problems. On Thursday, Stokely filed suit in Indianapolis federal court, alleging that the proposed acquisition would prove anticompetitive in the canned-beans-in-sauce market.

—*Washington Post*, July 10, 1983

And the trains will run on time

Business, labor and government could attempt to cooperate in considering the nation's industrial future and allocation of resources.

—Felix Rohatyn in the *New York Times*, July 7, 1983

Getting the government out of energy

A task force of utilities and Wall Street investment firms devised a new plan for raising $1 billion in private funds to help pay for the controversial Clinch River breeder-reactor project.

Securities sold to raise the money would be backed by government repayment guarantees, in case the Clinch River project goes sour.

—*Wall Street Journal*, June 28, 1983

Maybe he missed the point

Timothy Muris, the co-author of a chapter presenting a free-market alternative to the Federal Trade Commission in the [Reason] Foundation's book *Instead of Regulation*, has been named the chief of the Federal Trade Commission's consumer-protection branch.

—*Reason Report*, Summer 1983

Why we knead the council

At its last legislative session before going on summer recess, the [D.C. City] Council approved a measure that would allow smaller-sized loaves of bread to be sold in the District.

Current law requires that bread be sold only in weights of a half-pound, one pound, 1½ pounds, or multiples of a pound. With the approved change, a loaf of bread would simply have to weigh at least 8 ounces after cooling.

—*Washington Post*, July 13, 1983

Nobody here but us lobbyists

Well, the military industrial complex, in the sense in which Ike used it, I think, was a warning that forces would . . . try to exert an unhealthy influence on policy. I have to say I can't see the slightest evidence of that.

—Defense Secretary Caspar Weinberger in the *Los Angeles Times*, July 10, 1983

Liberty and planning

To the assembled provincial politicians, members of his new, Gaullist-leaning National Association of Elected Officials, [Gaullist leader Jacques Chirac] declaims: "It is you who are the advance guard of democracy. It is you who must assure that individual liberty continues to flourish. . . ."

When he was minister of agriculture, for example, Mr. Chirac annually brought together three farm organizations that couldn't agree on anything. He recalls:

"I told them we will discuss until we agree on the priorities for French agriculture, and no one will leave the room until we do. It worked. That is the government's role in planning."

—*Wall Street Journal*, July 1, 1983

Ask the experts

Attorney General William French Smith set off a rhubarb in defending the president's recent dealings with the International Longshoremen's Association and the Teamsters, saying that Reagan would not be able to deal with Congress if he had to avoid all convicted criminals.

—*Washington Post*, July 29, 1983

Rep. Pat Roberts (R-Kan.) noted that in six years the EPA had referred only four cases of fraudulent laboratory practices to the Justice Department for prosecution. One of these—the IBT case—has been accepted.

"My gosh, we probably indict more congressmen in six years than that," Roberts said.

—*Washington Post*, July 28, 1983

And arbitrary arrests are down 15%

Secretary of State George P. Shultz last night recommended to the U.S. Senate that military and economic aid to the Salvadoran government should continue because the regime has made progress on the human rights front. . . .

Speaking before the "letter of certification" went to the Senate Foreign Relations Committee, [State Department spokesman John] Hughes said, "The violence levels have been reduced markedly since January 1981 . . . civilian deaths attributable to political violence are about 25 percent of what they were at the time."

—*Washington Times*, July 21, 1983

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