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## INTERNATIONAL CO-OPERATION IN AID

Impressions and Papers of the Fifth  
Cambridge Conference on Development  
Problems, 4-17 September 1966 at Jesus  
College, Cambridge.



*Edited by*

**RONALD ROBINSON**

Fellow of St. John's College, Cambridge

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## MULTILATERAL AID<sup>1</sup>

by DR. J. ADLER

*Director, Economic Development Institute, International Bank for Reconstruction and Development*

### Definition of Aid

Throughout this paper the term "aid" is used to denote grants and loans of financial resources in kind from public sources for the purpose—usually made explicit—of assisting the development efforts of developing countries. Loans from governments, government agencies, and international agencies are included because with very few exceptions they are made on terms which must be considered concessionary from the point of view of the recipient countries. The very essence of public loans from national and international sources to developing countries is that these resources cannot be obtained in the same amounts or on the same terms from private sources. Or, to put the same proposition the other way around, "development" loans are included in the definition of aid because the primary objective of national and international lending agencies is not to provide an outlet for the savings of the lending country or to fulfil the normal functions of a finance intermediary.

The figures shown for the various components of "aid" as just defined also include a certain amount of technical assistance, partly because it is impossible to distinguish between technical and financial assistance on statistical grounds, and partly because with respect to a large proportion of technical assistance (e.g., the operations of the U.N. Special Fund) the distinction is difficult on conceptual grounds.

### The Record

According to preliminary figures compiled by the Organisation for Economic Co-operation and Development (O.E.C.D.), net disbursement (gross disbursements minus amortisation receipts) of long-term loans, investments

<sup>1</sup> The views expressed in this paper are those of the author and not necessarily those of the International Bank for Reconstruction and Development.

and grants to developing countries from multilateral sources amounted to \$1,075 million in 1965. The following disbursements are included in this total (in millions):

	\$
World Bank (I.B.R.D.) ... ..	297
International Development Association (I.D.A.) ... ..	277
International Finance Corporation (I.F.C.) ... ..	13
Inter-American Development Bank (I.D.B.) ... ..	112
European Development Fund ... ..	104
European Investment Bank ... ..	12
United Nations Agencies ... ..	260
Total ...	1,075

*Source* : Table 2

The comparable figure for bilateral aid from O.E.C.D. countries which account for virtually all aid from countries outside the Sino-Soviet Bloc, including aid in kind, but excluding guaranteed export credits and contributions to multilateral institutions, was \$6.9 billion. (Table 1.) Net disbursements on aid from the Sino-Soviet Bloc countries may be estimated at \$500 million. Thus the share of multilateral contributions to the total flow of long-term financial resources to developing countries from official sources amounted to 15 per cent. If the net flow of private capital is added, the share of multilateral institutions in the total declines further, to 10 per cent.

In early years the share of aid to developing countries which came from multilateral sources was even smaller; between 1960 and 1964 it averaged 10 per cent of total public aid. Thus, the first impression is that multilateral aid and multilateral aid agencies play a fairly insignificant role in worldwide development efforts. This impression stands in sharp contrast to the political and intellectual interest which multilateral aid appears to hold in the discussions of development and development assistance at international gatherings and in the vast literature on the subject of economic growth.

Two factors may help to explain this disproportionate amount of attention which multilateral as distinct from bilateral aid has received and continues to receive. One—presumably of less importance—is the fact that in the last five years multilateral aid has grown much more rapidly than the flow of aid from bilateral sources. As Table 2 indicates, net disbursements of loans and grants by international organisations, excluding the operations of United Nations agencies, increased more than threefold between 1960 and 1965, from \$268 million to \$865 million. If the United Nations agencies are included, but the changing character of their operations from relief (e.g., U.N. Korean Relief Agency and U.N. World Relief Agency) to activities directly related to the development process (e.g. U.N. Expanded Programme for Technical Assistance and the U.N. Special Fund recently merged into the U.N. Development Programme) are taken into account, the threefold expansion remains the same.

One reason for this increase is the setting up of new agencies. Prior to 1960 the World Bank (I.B.R.D.) was the only major multilateral source of development finance; since then the International Development Association (I.D.A.), the Inter-American Development Bank (I.D.B.), the European

Development Fund and the U.N. Special Fund have entered the scene and have proceeded to expand their operations at a rapid pace. Two new regional agencies, the African Development Bank and the Asian Development Bank will start lending operations in the near future.

Another change is that several of the multilateral agencies have obtained funds from their member governments which enable them to make grants instead of loans. This makes it unnecessary for them to be concerned with the credit-worthiness of the recipient countries and thus eliminates one important limitation on their operations. It also does not give rise to a backflow of amortisation payments which in the case of the "mature" World Bank reached in 1965 a total of \$180 million and thus reduced the amount of net disbursements. (Another factor, that grants do not require payment of interest and that in the case of grant-like funds interest payments are small, is not reflected in the net disbursements figures as shown in Table 2; from the point of view of aid-receiving countries interest payments constitute, of course, just as much a drain on investible resources as amortisation payments.)

The expansion of the operations of multilateral agencies is also reflected in the increase of annual commitments which indicates that the upward trend of disbursements will continue, at least for another two years. According to data on annual commitments (Table 3), and allowing a two-year lag between commitments and disbursements, it seems reasonable to expect a further increase of gross disbursements, which in 1965 amounted to \$1,318 million, by some \$200 to \$250 million in 1966, and by \$500 to \$600 million by 1967. Since approximately one-half of the increase in commitments consists of grants or quasi-grants (including "investment credits" of I.D.A.) only a small proportion of the increase in gross disbursements will be offset by amortisation receipts.

The second reason why aid from multilateral sources receives attention out of proportion to its size is the avowed preference for multilateral aid by developing countries and the assertions, virtually without exception, by the advanced countries that on numerous grounds they too favour the channelling of aid through multilateral sources. For instance, the U.N. Conference on Trade and Development (UNCTAD) adopted without dissent the recommendation that "[international financial co-operation] should encourage the channelling of external resources, wherever possible and appropriate, through multilateral institutions—including regional development institutions."<sup>1</sup>

<sup>1</sup> United Nations. *Proceedings of the United Nations Conference on Trade and Development*. Volume I. Final Act and Report, p. 42. Two other examples of the endorsement of the principles of multilateral aid by aid giving countries are: "The multilateral administration of aid carries many advantages. Both industrialised and developing countries have special competence in the experience and objectivity of the multilateral agencies. It will be the Government's aim as our resources permit to increase the proportion of our aid devoted to the multilateral institutions including those concerned with technical assistance." U.K. Ministry of Overseas Development. *Overseas Development: The Work of the New Ministry* 2736, (London 1965). "We are ready to increase the amount of our own contributions to international institutions as other donor nations demonstrate a willingness to increase theirs . . ." and "We agree that we should strengthen the multilateral institutions to put them into a position to do as effective a job as possible." Testimony of Secretary of State Dean Rusk before the Committee on Foreign Relations of the U.N. Senate, 6 April 1966. (Hearings before the Committee on Foreign Relations, U.S. Senate, Foreign Assistance 1966, pp. 102 and 104.)

## The Case for Multilateral Aid

The case for multilateral aid is strong. It rests on political, economic and institutional grounds.

The political arguments in favour of multilateral aid are the most obvious and have been advanced most frequently. Under ideal conditions multilateral aid is preferable to bilateral aid because it comes "without political strings".<sup>1</sup> It does not impose on the recipient country the obligation to repay the favour of aid with political favours. It makes it difficult for the internal opposition or the foreign enemies of a government to accuse it of being beholden to the source of aid. Conversely, the contributors to a multilateral aid agency derive from the channelling of aid through a multilateral agency the advantage that it is impossible or, at any rate, more difficult to accuse them of sinister machinations of neo-colonialism.

Another important advantage of multilateral aid is that its allocation among claimant nations is presumably not determined by political considerations, but on some "objective" basis. Multilateral aid agencies, not concerned with immediate favourable or unfavourable political reactions to giving or withholding aid, are in a better position than national sources of grants or loans to observe and evaluate the efficacy of a country's development efforts and to take performance into account in the allocation of their resources among countries. They are more able to resist pressure—from donor or creditor countries on the one side, and from recipient or borrower countries on the other—to provide, or withhold aid because they can insist on applying "Objective" criteria in the evaluation of "needs" and "claims" of developing countries.

Moreover, they can more easily insist that the recipient countries make, and live up to, commitments regarding the effective use of foreign resources. They can more readily reach an understanding with these countries with respect to general economic policies and periodically evaluate the effectiveness of these policies. This concern with performance is bound to benefit the recipient countries as well as the donor or creditor countries. The government of a country receiving aid may be willing, or even find it politically expedient, to tell its citizens that it is taking some unpopular measure on the advice of an international or regional agency. It would find it much more difficult or impossible to admit publicly that it is adopting certain measures in order to obtain aid from a bilateral source. The guidance of a multilateral agency and the likelihood that aid-recipient countries will find this guidance acceptable are of great importance also to the sources of development assistance since they make a given amount of total aid more effective.

On the other hand, it must be recognised that multilateral agencies are not fully independent and cannot operate as if they exist in a political and institutional vacuum. They obtain the bulk of their financial resources through contributions from their wealthy member governments, or in the form of loans raised in national capital markets with the approval of member

<sup>1</sup> For an enlightening discussion of the limited effectiveness of political "strings" cf. Edward S. Mason, "The Diplomacy of Economic Assistance—Aid With or Without Strings", Middlebury, Vermont, 1966.

governments. They are not, however, and cannot be, executors of the political will of their wealthy contributor governments just as they cannot be "borrowers, clubs" in which all decisions regarding the use of their resources are left to the discretion of the recipient countries. It is the very essence of all multilateral activities that they impose some constraint on the pursuit of national policies, particularly of those which may be harmful to the interests of other members of the same organisation.

The fact that the channelling of aid through multilateral agencies, including regional agencies, imposes effective limitations on the pursuit of national objectives has been the chief reason for the small share of multilateral aid in the total flow of resources to developing countries. It is, of course, no accident that the distribution of bilateral aid is vastly different from the distribution of aid from multilateral agencies. The allocation of aid from the United States has reflected the country's special interests and commitment in the Far East (Taiwan, Korea, Viet-Nam) and in Latin America; by far the largest proportion of bilateral French aid goes to the former French colonial territories in Africa; the British aid is heavily concentrated in the developing countries of the Commonwealth. It is hardly conceivable that these three major aid-giving countries—and others in similar circumstances—would want to channel their aid to "special interest" areas or countries through multilateral aid agencies since the latter cannot be expected to reflect in their pattern of operations the special preferences of national sources of finance. The insistence on using the resources of multilateral agencies in line with special national objectives, even if they were enlarged for that purpose, would be resented by the other members of the multilateral agencies and would be considered an inappropriate infringement of their independence. Moreover, the aid-giving countries presumably would not wish to give up their identity as the source of "special" aid, not necessarily because they expect a "special" *quid pro quo* but because they consider it in their interest to emphasise the relationship between the donor country and the recipient country as "special".

The corollary of the special interest of a donor country in an aid-receiving country is the conviction of some recipient countries that their development aims are being served better by maintaining a special bilateral relationship with one or the other of the aid giving countries than by obtaining aid from a multilateral agency. Some aid-receiving countries are reluctant to give up their "special" status and to rely entirely on aid from multilateral sources because they fear that the amount of such aid may be smaller or its terms more onerous. Some are ready and willing to bestow special political favours on a donor country or countries in return for development aid. These special relationships must be recognised, notwithstanding the fact that the overwhelming majority of spokesmen for developing countries have taken the position that they prefer, on political grounds, aid from multilateral agencies.

While the political arguments for multilateral aid are clear and convincing, even if they are advanced in the realistic setting of existing international relations, the economic arguments are more complex and less straightforward. There are no *a priori* grounds for the assertion that the economic advantages for multilateral aid cannot also be obtained through bilateral aid. The



economic arguments in favour of multilateral aid therefore must rest on contention that certain advantages are more likely to obtain if aid flows through multilateral channels.

The most obvious advantage to recipient countries of channelling through multilateral agencies is the fact that multilateral aid is generally (though not necessarily) untied with respect to the source. There is no need to prove in this context that untied aid is "worth more" and leads to a better allocation of resources than aid tied to purchases from the country giving the aid or credit. It may be worth while to point out, however, that the difference between the purchasing power of tied aid and untied aid is not just a minor matter. A study of the experience of Pakistan<sup>1</sup> indicates that the tying of a large proportion of aid received by Pakistan resulted in an average price increase of 15 per cent on all commodities imported under bilateral arrangements, despite the fact that in recent years Pakistan has been in a fortunate position of having access to aid from a large number of countries which were organised in a consortium led by the World Bank. It is clear that in the case of other countries which obtain aid and loans from one or two sources the "loss" through the tying of aid to purchases in the aid-giving country is substantially higher. The adverse effect of tying aid to purchases in a specific country becomes particularly pronounced in the case of government guaranteed export credits and in the case of resources which are tied both to a specific project and to purchases in a particular country.

The fact that a given amount of tied aid usually buys less than if it were untied is the disadvantage that can be most readily quantified. It may be, however, that other consequences of tying aid are more important in the long run. Aid tied to purchases in the donor or creditor country limits the choice of technology used in investment projects and may thereby commit the aid-receiving country for an indefinite period to a technology unsuitable to its resources endowment, while a more appropriate technology may be available in other countries. In some aid-giving countries existing arrangements also limit the choice of technical assistance because statutory provisions do not permit the use of consultants or technical advisers from other countries for projects financed under bilateral aid arrangements.

On general grounds there is, of course, no need that bilateral aid should be tied to purchases in the aid-giving country. Until 1959 most of the development aid provided by the United States was untied. In recent years, however, the overwhelming part of bilateral aid from the United States and elsewhere has been tied to the aid-giving or creditor country, mostly for balance of payments reasons but in the case of some countries also to serve the interest of their export industries. For some countries it is difficult to refute the accusation that the primary objective of bilateral aid is not the development of the aid-receiving economy, but rather the promotion of exports of the aid-giving or creditor country.

Some observers have pointed out that the general practice of multilateral aid agencies of tying their loans and grants to specific projects rather than providing financial support for development programmes also constitutes

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<sup>1</sup> Mahbub ul Haq, "Tied Credits - A Quantitative Analysis", published by Macmillan London, in the volume on *Capital Movement and Economic Development*.

a serious limitation on the effectiveness of aid comparable to the tying of aid to purchases in specific countries, or, it might be added, to specific commodities. It would go beyond the scope of this paper to argue once again the issue of project versus programme aid.<sup>1</sup> It may be useful, however, to point out that in the case of projects financed by multilateral agencies the choice of the project is not determined or influenced by the preference of any aid-giving country or supplier of capital equipment, a factor not uncommon in the case of bilateral project financing. The selection of projects submitted to multilateral aid agencies for financing is normally made by the authorities of the aid-receiving country and the choice of the project is scrutinised by the multilateral aid agency to assure that the project is an essential high priority part of a formal development programme or fits into broadly conceived development strategy.

Moreover, many of the limitations which are admittedly inherent in the project approach have been overcome in practice by broader definitions of the project concept. The World Bank, the International Finance Corporation and the International Development Association, for instance provide financial resources to development banks or development finance companies which in turn finance industrial enterprises and thus serve an entire sector and not just a project or projects. The International Development Association has met the high priority needs of one country by providing finance for the import of a broad range of intermediate goods essential for the utilisation of existing productive facilities. The World Bank has also recognised that under certain conditions financial resources not tied in any way to particular projects are essential. In its report on Supplementary Financial Measures it recommends that the agency administering the proposed scheme would make up a shortfall in export earnings of a primary producing country without reference to specific projects, provided that the country's development effort is conducted within the framework of a well-conceived development plan.<sup>2</sup>

Multilateral aid has also the advantage that it can more easily ensure continuity than the sources of bilateral aid. The freedom of action of bilateral aid agencies is frequently restricted by budgetary appropriations limited to one year. Multilateral agencies on the other hand, although they depend also on budgetary appropriations in the case of grants and approval of national authorities in the case of borrowing operations, usually have sufficient funds at their disposal to commit themselves for longer periods, or at least to give recipient governments fairly firm indications as to the level of support they can expect, given satisfactory performance.

Finally, the channelling of aid through multilateral agencies offers a particular advantage to the smaller advanced countries since it enables them to make their contributions to the development efforts of poor countries without setting up their own national machinery for the administration of aid. The decision of the Government of Sweden to make supplementary contributions of \$5 million a year to the International Development Association over the last several years was at least in part based on this

<sup>1</sup> Cf. for an incisive discussion of the issue—and its complexity—H. W. Singer, "External Aid: For Plans or Projects?", *Economic Journal*, September 1965, pp. 539-45.

<sup>2</sup> Report on *Supplementary Financial Measures* prepared by the World Bank at the request of the United Nations Conference on Trade and Development. Washington, D.C., 1965.

consideration. More generally, the continued support of multilateral agencies by a number of smaller countries reflects the recognition that they thereby save administrative expenses.

### **The New Role of Multilateral Aid Agencies**

The strongest case for multilateral aid can be made, however, on what for the lack of a better term might be called institutional grounds. It has been recognised for a long time and asserted most forcefully in the discussions in the United Nations Conference on Trade and Development (UNCTAD) that financial assistance to the developing countries touches only one facet of the development problems which the poor countries are facing. A broad analysis of these development problems must take into account not only the requirements of development finance, but also such major issues as the debt burden of the developing countries and the fluctuations in the export earnings of primary producing countries. By their nature, however, these other problems cannot be solved through bilateral arrangements but must be tackled through some concerted international action. If, for instance, a developing country experiences difficulties in meeting its debt service obligations and if debts are owed to a number of creditor countries, an effective debt settlement is virtually impossible unless at least several, if not all, creditors agree to such an arrangement. Even if one creditor country were able and willing to make arrangements unilaterally to postpone debt service payments or to relieve the debt burden by some other method, it would be most reluctant to do so without some assurance that other creditor countries would not continue or resume lending on terms which would threaten to bring about another debt service crisis. Multilateral action is also needed to provide relief when a country experiences an unexpected shortfall in its export earnings. No single country would want to take on alone the financial burden of making up the shortfall. Moreover, it would run the risk that another country or a group of other countries would offset by their action the effect of its unilateral efforts.

It is true, of course, that these problems could be and often are solved by *ad hoc* international arrangements without the intervention of multilateral aid agencies. But it is clear that an objective evaluation of all relevant factors entering into such a situation is called for and that such an evaluation can be more appropriately made, and is more readily accepted if it is made, by a multilateral agency.

More generally, the rapid increase in the external indebtedness of a large number of developing countries and the persistence of fluctuations in their export earnings have made the system of development finance of the last 10 years, which relied largely on bilateral grants and loans, cumbersome and increasingly less effective. Today financial assistance to developing countries must take account of existing debt service obligations which have resulted from past borrowing operations. It must avoid the deleterious effects of inappropriate terms of lending and the effects of preference of aid-giving or creditor countries on the pattern of investment and the structure of the economies of aid-receiving countries. This cannot be accomplished by bilateral arrangements but requires multilateral action.

This need was recognised some years ago when consortia of governments were set up to provide development assistance to India and Pakistan. More recently several consultative groups have been established for the benefit of other developing countries. Their objectives and experience are the subject of another paper presented to this Conference.<sup>1</sup> In this context it is sufficient to point out that all but one of the consultative groups now in existence or in the process of formation are led by multilateral agencies. The creditor and donor countries which have joined these groups rely largely on the economic intelligence and analysis of such agencies. This enables them to evaluate their own development assistance in the broader framework of the recipient country's own activities and in relation to the commitments and contributions by other countries.

As far as multilateral aid agencies are concerned, the emergence of the debt problem and the persistence of the commodity problem have added a variety of new tasks to their original statutory functions. In the case of the World Bank, these tasks include, in addition to providing technical intelligence and organisational leadership to consultative groups and to the consortia for India and Pakistan, technical advice to UNCTAD on a number of development issues. In addition to the report on supplementary financing to which reference has already been made, the Bank submitted an analysis of the problem of primary commodity exports to the first UNCTAD Conference and prepared a study on the feasibility of the so-called Horowitz Proposal;<sup>2</sup> it is working on a study of supplier credits and their effects on the external debt of the poor countries. The Inter-American Development Bank organised one consultative group and has become directly concerned with the pace of progress of the Latin American Free Trade Area. There are indications that the African Development Bank and the Asian Development Bank, now in the process of formation, likewise will concern themselves with the broad development problems of their respective regions to a much greater extent than the soundness and safety of their lending activities will require. Thus it seems inevitable that multilateral aid agencies are bound to move from a position in which they concentrate on their primary function as sources of development finance, to a position in which they assume the role of development agencies with a scope of activities far beyond that of financial institutions.

In order to fulfil these broader functions effectively it is essential, however, that the multilateral aid agencies also expand their role as sources of development finance. In order to do this they must have access to the capital markets of the world to raise funds for their lending activities and they must obtain financial resources from their member governments to continue and expand their grant activities. It is generally recognised that the developing countries could make productive use of a substantially larger flow of financial assistance than they have received in the past. Last year's Annual Report of the World Bank suggested that an expansion of the flow of development finance to the developing countries of the order of \$3 to \$4 billion could be effectively absorbed.<sup>3</sup> For that reason it is clearly preferable

<sup>1</sup> Cf. also Michael L. Hoffman, "Aid Coordination;" Paper presented at the Ditchley Conference on Improving the Aid for Overseas Development. June 1966.

<sup>2</sup> *The Horowitz Proposal*. Staff report of the World Bank. Washington, D.C., 1965.

<sup>3</sup> International Bank for Reconstruction and Development, Annual Report 1964-65, p. 62.

that a strengthening of the financial resources of multilateral aid agencies should constitute an additional flow and not be at the expense of bilateral aid activities. Because of the debt service obligations resulting chiefly from bilateral lending operations of the past an increase in gross disbursements is called for even to maintain the net flow of development at current levels; a further increase is essential if the world is to come to grips with the development problems of the poor countries over the next decades.

TABLE I  
Net Disbursements of Official Loans and Grants to Developing Countries, 1960-1965  
(\$ billion)

	1960	1961	1962	1963	1964	1965
Bilateral Assistance from D.A.C. Countries:						
(a) Official loans ... ..	0.6	1.3	1.4	1.7	1.8	n.a.
(b) Grants ... ..	3.6	3.9	4.0	3.9	3.8	n.a.
Total ... ..	4.3	5.3	5.4	5.7	5.6	5.8
Bilateral Assistance from other countries <sup>1</sup> ... ..	0.4	0.5	0.6	0.6	0.7	0.7
Multilateral Assistance (from Table 2) ... ..	0.4	0.4	0.6	0.8	0.9	1.1
Not included ... ..						
Private capital, including guaranteed Export Credits ... ..	(2.8)	(3.1)	(2.2)	(2.4)	(3.0)	(3.6)

<sup>1</sup> Including assistance from Sino-Soviet countries.

N.B. Totals may differ from sum of components because of rounding.

Note: For definitions, coverage, and sources of data, see O.E.C.D., *Development Assistance Efforts and Policies*, 1965 Review. Report by Willard L. Thorp, Chairman of the Development Assistance Committee. Figures for 1965 were taken from 1966 Draft Report.

TABLE 2

## Net Disbursements of Loans and Grants by International Organizations to Developing Countries, 1946-1965

Organization	1946-59	1960	1961	1962	1963	1964	1965
World Bank (I.B.R.D.) <sup>1</sup> ...	(1,562)	251	204	278	334	320	297
International Development Association (I.D.A.) ...	—	—	1	25	104	148	277
International Finance Corporation (I.F.C.) <sup>2</sup> ...	16	13	8	16	6	10	13
Inter-American Development Bank (I.D.B.) ...	—	—	6	37	75	126	112
European Development Fund ...	—	4	16	53	65	84	104
European Investment Bank ...	—	—	—	—	—	6	12
Sub-total ...	1,578	268	235	409	584	694	815
United Nations Agencies <sup>3</sup> ...	(710)	111	184	162	216	243	260
Total ...	2,288	379	419	571	800	937	1,075
Minus: capital subscription, bond purchases, etc. ...	—	138	244	199	144	145	157
Adjusted Total <sup>4</sup> ...	n.a.	241	175	372	656	792	918

<sup>1</sup> The figures for 1960 to 1964 include repayments on the sold portions of I.B.R.D. loans of \$68 million; the allocation of these repayments to each year has been estimated.

<sup>2</sup> The figures include disbursements and repayments on 8 operations in advanced countries (Australia, Finland, Italy) involving total disbursements of \$5 million.

<sup>3</sup> U.N.K.R.A., U.N.E.P.T.A., U.N. Special Fund, U.N.I.C.E.F., U.N.W.R.A., U.N.H.C.R. and U.N.F.C., of contributions of developing countries.

<sup>4</sup> Part of the difference between the Total and the Adjusted Total is unexplained. The two series have been derived from different sources. But since the difference is due in part, to operations not related to development finance, the Total appears to be the more relevant figure in the context of this paper.

n.a. Not available.

Source: O.E.C.D. and I.B.R.D.

TABLE 3

## Commitments of Multilateral Agencies to Developing Countries (\$ million)

	Total 1946-59	1960	1961	1962	1963	1964	1965
World Bank (I.B.R.D.) ...	2,712	516	568	472	624	574	837
International Development Association (I.D.A.) ...	—	—	181	187	210	425	191
International Finance Corporation (I.F.C.) ...	44	19	13	18	14	22	21
Inter-American Development Bank (I.D.B.) ...	—	—	117	124	214	205	318
European Development Fund ...	40	81	148	180	49	59	225
European Investment Bank ...	—	—	—	—	23	19	52
Total ...	2,796	616	1,027	981	1,134	1,304	1,644

N.B. Commitments of U.N. agencies not available.

Source: O.E.C.D.

PROGRAMMING IN THE WORLD BANK GROUP

by

John H. Adler\*



Any understanding of the role of programming in the World Bank Group requires an appreciation of the fact that the Group consists of three rather different organizations. The World Bank itself, or more formally the International Bank for Reconstruction and Development (IBRD), is both the oldest and the largest of the three. Founded in the mid-forties to assist in the rebuilding of European economies devastated by war, it now lends almost exclusively to the countries of the developing world. Its membership includes 113 countries from all parts of the world outside the Soviet bloc, which have provided it with loanable resources of approximately \$1.9 billion. With earnings, this equity endowment has now grown to \$3.4 billion. The Bank's own capital must be supplemented by borrowings on the international capital markets. The member governments guarantee these borrowings but the Bank's lending rate must be high enough to cover the cost of its borrowing and to give it a reasonable return on its equity. As of March 31, 1970, the IBRD had lent a total of \$13,787 million, and held a portfolio of loans outstanding amounting to \$8,621 million.

The International Development Association, or IDA, is a close affiliate of the IBRD with an identical staff and Board of Executive Directors. It was founded in 1960 and now has a membership of 105 countries. It derives its loanable resources primarily from funds contributed by the governments of 18 rich ("Part I") countries. These funds are lent to developing countries

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which meet certain criteria--of poverty and lack of creditworthiness for conventional borrowing, on the one hand, and reasonable policy performance on the other--on an interest-free, 50-year repayment, basis. As of March 31, 1970, IDA had extended credits totaling \$2,436 million.

The smallest of the three main organizations in the Group is the International Finance Corporation, or IFC. Founded in 1956, IFC is unique in being the only international organization sponsored by governments which has as its primary objective the stimulation of the private sector in developing countries, not only by lending but also by taking equity positions. Like the IBRD and IDA, IFC is fundamentally concerned with the development impact of its operations, but it must also be concerned with the profitability of its operations to private foreign and domestic investors. Therefore the selection of projects for financial support by IFC is somewhat different than in the IBRD or IDA.

The Programming and Budgeting Department of the Bank Group is responsible for the programming of IFC operations, as for those of the IBRD and IDA. But because of the uncertainties involved--especially of timing--we are only now beginning a programming system for the IFC comparable with that already in existence for the IBRD and IDA. At any event, I am concerned today primarily with programming for the IBRD and IDA.

The Bank Group has had a programming system of sorts for a number of years. Until about two years ago, it consisted essentially of a list of projects which it was proposed to finance over the ensuing twelve months. This was almost certainly adequate for the Group at that stage: total lending by the IBRD and IDA was fairly stable at about \$1 billion annually,



and by far the greater part of this total was to sectors in which the Group had had very long experience (power and transportation). Group staff was expanding, but at a relatively modest rate. It was only in 1968, when it became clear that the Group was to embark on a very major expansion of its activities, that the need for a much more systematic approach to the planning of the Group's operations became evident.

Since the Group is essentially (though by no means exclusively) a source of finance, there are two possible starting points for a programming system. One is the volume of lending over a "plan period"; the other, the availability of resources. Because of the difference in the financial basis of the Bank and IDA, both approaches have to be used and combined into an effective work program, which in turn becomes the output framework for the IBRD/IDA administrative budget.

Management was confident from the outset that the capacity of the IBRD--as distinct from IDA--to raise funds in the capital market would not be a constraint on its lending operations, so that, for the IBRD, the relevant starting point was clearly the lending program.

The first step, therefore, was to extend the existing lending program to a meaningful extent into the future. Such an extension was not difficult up to about 30 months, which is the average time which elapses between the date on which a project first comes to the attention of the Bank and the date on which a loan for that project is signed. This "pipeline" formed a firm basis for developing a lending program for that period.

We also knew from experience that "one loan leads to another", that contacts built up during the appraisal and negotiation of one loan frequently lead to the extension of others. Thus, in the last five years, 25% of all loans were made to entities which had previously received at least one loan from the Bank Group, and a further 35% of the total were made to sectors--irrigation, highways, power, etc.--which had previously received at least one Bank Group loan in that country.

In some cases, the Bank's knowledge of a particular sector stems from intimate contact over a period of many years. Since 1949, for example, the Bank has made no fewer than 21 loans, totaling \$622 million, to the Brazilian power sector. Over the same period, the Bank and IDA together have lent \$632 million, in 13 separate operations, for the development of Indian railways. The kind of on-going working relationship implied by these examples, which could be duplicated in many other countries, substantially simplifies the task of estimating the effective absorptive capacity of the Bank's borrowers and thus developing a lending program for some years into the future. Five years is in fact the period covered by the Bank's lending program at present.

Thus, while it took only the application of experience and some imagination to push the lending program out towards the end of the "pipeline", and beyond, at least three constraints made their influence felt and had to be taken into account in preparing a meaningful program. One was the economic performance of borrowing countries. As I am sure you know, the Bank Group requires that two quite different sets of conditions be fulfilled before it will agree to lend for a project. One set concerns the project itself--it must be beneficial to the borrowing country's development, it must be financially viable, there must be adequate management available for it, and so on. But in addition to

these project-related conditions the Group must be satisfied that the country as a whole is making a reasonable effort to further its own development. There are obviously many enormously difficult problems involved in making an objective judgment on what constitutes "reasonable effort" but, if the Bank's loans are not simply to permit other resources to be squandered, the attempt must be made. And at any one time there are normally a number of countries whose performance is judged inadequate to qualify them for Group lending. And there are quite a few countries to which we lend only on the understanding that certain policies will be modified in due course, frequently in the framework of a tentative timetable.

Another constraint on lending is the creditworthiness of borrowers. Though creditworthiness is clearly not a sufficient condition for the Bank to lend to a country, it is obviously a necessary condition. The Bank's Articles of Agreement specifically enjoin the Board, in making a loan, to pay due regard to the prospects that the borrower will be in a position to meet its obligations under the loan.

Both economic performance and creditworthiness can change in short order, however, and this introduces an important element of uncertainty into the lending program. I will look a little later at the steps we are taking to reduce the uncertainty insofar as creditworthiness evaluations are concerned, but by the nature of the case estimates of future economic performance must inevitably be subject to considerable error and sudden changes.

A third factor which must be taken into account in formulating the lending program is the availability of Group staff. At present, the Bank

employs nearly 2,300 people, of whom about one-half are professionals. It is not impossible to expand this number at almost any rate required by the lending program: the problem lies not in the expansion of numbers but in the time needed to acclimatize new staff to the Bank's policies and procedures. A high rate of growth of staff not only yields a slower growth in operational capacity than the increase in numbers would suggest; it also in some measure reduces the effective capacity of middle and senior level management because of the increased demands on their time for training and supervision.

All these factors then--the "pipeline", economic performance, creditworthiness, and staff availability--are systematically considered in arriving at the Bank's lending program.

In formulating IDA's lending program, most of the same factors are also relevant, though there are some additional considerations. Creditworthiness is no longer a condition of lending--indeed, only countries which lack creditworthiness for borrowing on conventional terms, or have only limited capacity to service such debt, are eligible for IDA credits. And to be eligible countries must be among the poorest developing countries: in practice, with a per capita income of less than about \$300.

The problem of course is that the absorptive capacity of developing countries for IDA credits which meet these criteria--satisfactory economic performance, a lack of creditworthiness for borrowing on conventional terms, and poverty--is substantially greater than the funds available to IDA. India alone, for example, could make good use of all the resources currently available to IDA (about \$600 million annually), and both Indonesia and Pakistan could effectively absorb a large part of that total. Unlike the situation

in the Bank, therefore, there is a financial resource constraint operating on IDA's lending program which necessitates an element of rationing. Because of the desirability of having as wide a geographical spread as possible in IDA's operations, this rationing inevitably takes the form of placing some limits on IDA's lending to those countries whose absorptive capacity is greatest.

The lending programs of both the Bank and IDA have to be reviewed frequently if they are to have any operational significance. To date, three such reviews have been completed since the new programming system was introduced in 1968. The first and second reviews were really reviews of all countries in the lending program simultaneously. But it was quickly apparent that this approach was less than satisfactory: it imposed considerable strains on the operating departments of the Group, and, because of the adverse effects<sup>of</sup> the concentration of the review process on its thoroughness, substantially reduced the usefulness of the program itself.

As a result it was decided to spread the country reviews throughout the year, and formalize a procedure for introducing changes in the lending program between reviews. The vehicle for such reviews is a meeting of the President of the Group with senior operational staff to consider what we now call Country Program Papers. Normally, a Country Program Paper is prepared for each potential borrower among the Bank's membership once a year, and area departments, who are responsible for their preparation, are committed to a schedule of finalizing them as soon as possible after completion of an economic report on the country concerned.

The papers themselves are expected to cover four main topics, at both the macro-economic and sectoral levels: the development objectives of the country, the obstacles impeding the attainment of these objectives, the

recommended solutions, and the proposed Bank Group contribution. On the basis of these papers, senior management is able to decide on the most appropriate combination of Group assistance, both financial (amounts of Bank/IDA lending, terms of lending, sectoral composition of loans) and advisory (technical assistance, policy and institutional conditions of loans, sector studies, project-preparation work, etc.).

The Country Lending Program is thus a direct outgrowth of the review of the Country Program Paper, and becomes a part of the total lending program of the Group. The country lending program can be changed between annual reviews with the permission of the Chairman of the Bank's Loan Committee, and this means that at any point in time, management has an accurate, up-to-date view of the proposed total lending program. The broad characteristics of this total program are reviewed by management once a year.

Most of the other elements in the Group's programming system follow directly from the lending program. One element which obviously has a particularly close relationship to the lending program is the financial plan. In the early years of the Bank, financial planning could be of the most elementary kind. Because repayments were relatively unimportant, it was a simple matter to establish a relationship between available resources and those required for disbursement. Indeed, until the mid-fifties it was the practice to keep on hand, in cash and marketable securities, sufficient funds to meet fully the disbursement commitments on all outstanding loans. The relative size of these liquid balances has been gradually reduced since that time, both as a result of the increased importance of repayments on past Bank loans and as the average disbursement period has lengthened with the

shift in the emphasis of Bank lending from the developed countries of Europe, Japan, and Australia to the less developed of Asia, Africa, and Latin America.

In recent years, financial planning has been firmly based on detailed cash flow analysis using the best possible estimates of lending, disbursement, repayments, service payments due on the Bank's own funded debt, earnings, etc. Financial planning has to take into account a variety of considerations: the relation of the maturity profile of its loans to that of its debts, the prospects of movements of interest rates, the relation of long to medium and short-term rates, etc.

One integral part of financial planning is the borrowing program. Because of the highly unsettled conditions in world capital markets, it is also one of the most difficult aspects of the Bank's operations to program meaningfully. Early in 1970, for example, the Bank was able to borrow \$200 million in Yen in Japan because of the particularly favorable position of the Japanese balance of payments at that time. These were circumstances which would have been difficult if not impossible to predict with any certainty three months, let alone three years, in advance. At this stage we are expecting the Bank to borrow on a gross basis some \$3 billion over the next three years. Because of the Bank's substantial liquid assets (over \$2 billion at present), we have fortunately considerable leeway on the timing of our borrowing operations.

The lending program yields information not only on the financial resources required of course but also on the staff needed to conduct it. Because it gives detailed information on the sectoral, as well as on the

geographical, allocation of loans, it serves as a basis for assessing manpower needs for the functional projects departments (agriculture, transportation, utilities, education, etc.) and for the area departments, and for determining how many new staff, how many loan officers, engineers, economists and, as a result, how many research assistants, administrative officers, and secretaries should be hired. Like the lending program and the financial plan, the Bank Group's manpower planning now extends five years into the future, although for obvious reasons the staff requirements are firmly established for one year at a time only and become part of the annual budget documentation.

In our attempts to establish systematic relationships between manpower, i.e. professional time, inputs and outputs we ran into two types of difficulties which I assume are common to many public institutions and organizations which want to improve their budget making by relating manpower requirements to objectives. One is the problem of defining, or even devising, output concepts; the other is the problem of relating inputs to outputs over time.

As to the first, the final output of the IBRD and IDA is of course the number and amount of lending operations. The making of a loan involves a series of stages--identification, preparation, appraisal and negotiation of a loan project--to which inputs of various departments, chiefly the projects departments and the area departments, can be directly related. But other inputs are more difficult to relate to specific outputs. For instance while economic missions, the gathering of economic intelligence, and investigations and discussion of economic policies normally are closely related to lending operations, they may be just as valuable and important--



some observers may consider them even more important--if they result in postponement of a lending operation. Therefore the work of economic missions and the preparation of economic reports, which at any rate relate to countries and not to specific lending operations, cannot be considered an input to lending operations. They must be considered an intermediate output, which is used piecemeal in the preparation of the final output. This is also true for sector investigations and pre-investment studies, which also cannot be related to specific lending operations but have an important bearing on them.

The problem of relating inputs to outputs over time is not peculiar to the IBRD or IDA (or, for that matter, to international or national public administrations), but it has in the case of the IBRD and IDA certain operational consequences which are, I suggest, of interest to public administrators. Because of the time it takes to identify projects, to establish their feasibility, and when appropriate to complete preliminary, or final, engineering, a large proportion of inputs--in the case of the projects departments, some 80%--takes place in fiscal years prior to the year when outputs, i.e. lending operations, are completed. In operational terms that means that the work program of year 1 is to a very large extent determined by the lending program for year 2 and to some extent for year 3. In a period of rapidly expanding operations like the last two years in the Bank Group, the problem is compounded by the fact that allowance has to be made for new staff to be "broken in"--to acquaint themselves with the procedures and investigative techniques used in the Bank Group. This means that recruitment of new staff in year 1 should be based on a lending

program in year 3; needless to say, given the general uncertainty of future events and the special uncertainties besetting the sectoral and regional composition of the lending program, it is difficult indeed to be even reasonably accurate.

To return to the subject of country economic work and especially of economic missions: The Bank Group has long mounted such missions to its member countries but in frequency, timing, and focus they sometimes had little direct relationship to lending operations. On occasion, management found itself considering loans to countries for which there was no up-to-date economic information, while conversely, scarce manpower was being spent on economic missions to countries where there was little immediate prospect of a Bank lending program.

Since development of the five-year lending program, it has been possible to see more clearly where the priorities for the Bank's economic manpower lie, both as between countries and between sectors. We have categorized countries into three groups on this basis. The first, which at present includes 32 countries, includes all major developing countries in which the Group has an active lending program; countries in this group receive a Bank economic mission at least once a year. Countries in the second group, currently numbering 23, are those in which the Bank has a less active lending program and the Bank sends an economic mission to these countries only every second year. The third group includes 42 countries--all of them small or unlikely to receive a substantial volume of Bank or IDA lending in the near future--and these receive an economic mission only once in three years.

One of the most important consequences of the development of a meaningful programming system is the way it has made possible development of a program budget. Until a few years ago, the Bank Group had only a rather simple kind of budget, with no attempt to relate inputs to outputs in any operationally significant way. Except for personnel expenditures, no attempt was made to budget the various other expenditure categories by department; this arrangement made control of expenditures by departments impossible of course.

Recently, as a result of our programming of operations, we have been in a position to prepare a budget which is not only much more detailed than heretofore but which also makes it possible to relate inputs of staff time to "operations output." At this stage, the manpower coefficients we are using are crude and subject to quite considerable error. But they already enable us to see what kinds of operations are most expensive in terms of our scarcest resource and, of course, point to areas where staff performance needs improvement. They are also useful in assessing the reasonableness of the requests for additional staff which emanate from the various operating departments of the Group.

I need hardly say, perhaps, that the Bank is not able to apply these coefficients to the same extent as could a private organization to determine whether or not an operation, or certain type of operation, should take place. Though the Bank seeks to operate profitably, and has been notably successful in doing so throughout its history, it is not essentially a profit-making institution. If it were, it would concentrate its lending in the most developed countries and pay little heed to the least developed. At a

minimum, it would concentrate attention on the largest developing countries --such as Argentina, Brazil and Mexico--where the stage of development and the Bank's long experience make it possible to extend very substantial loans with a relatively small expenditure of staff time and effort. We do make substantial loans to countries of this kind and, by the end of FY1970, some 47% of the estimated total lending of the Bank and IDA this year will have been in the form of 19 loans of \$40 million or more. But because the Group's function is primarily the stimulation of economic development, many of its lending operations are to countries which require not only capital but also considerable assistance in the identification and preparation of suitable projects, in their appraisal and in their management and operation. They are to countries whose capacity to absorb large amounts of capital effectively is small, and as a result the majority of the Group's loans are small too. By the end of FY1970, it is expected that almost half of the 120 loan and credit operations approved this year will have been for amounts of \$10 million or less, and several of them are for amounts of less than \$1 million.

This, then, is where we are at present--with a gradually improving system for programming lending operations with derivative systems for planning the financial and personnel aspects of the Group's activities, and with a meaningful start on program budgeting.

We are also just beginning to build an information system covering the other flows of financial assistance to developing countries. In the first two years of our lending program, as previously, we virtually ignored the operations of other lending agencies except where we had some direct responsibility for coordinating them for particular countries (as in the

consortia for India and Pakistan and in consultative groups for some 10 other countries). This is in the process of changing and we are now gathering information not only on the past flows of aid but also on the organizations responsible for handling aid in the main donor countries, their commitment to development aid in the future (as reflected for example in their response to the report of the Pearson Commission), the factors affecting the allocation and terms of aid, and on the institutions responsible for channelling private capital to developing countries. In this way we are hoping to obtain indications as to what the future flow of resources to developing countries will look like--its magnitude, directions, and terms.

The construction of such an aid matrix will, we hope, serve two important functions in our own programming system. First, it will serve to provide a framework in which to view the Bank Group's own contribution to the total flow and may thereby suggest desirable changes in the Group's lending program. You will recall that the Commission on International Development, an eminent group of international citizens chaired by Mr. Lester Pearson (and including Germany's Dr. Wilfried Guth) specifically recommended that IDA should take other flows of development finance into account in its own lending operations; and the whole drive towards increased aid coordination, reflected in the meeting of the administrators of major aid agencies this very month in Heidelberg, can make sense only in the context of a full awareness on the part of each agency of the plans and operations of the others.

Secondly, we hope that this matrix will greatly improve the appraisal of our own lending program. Clearly, except in the declining proportion of cases where grants are concerned, aid flows involve repayment obligations--

and we are back once more at considerations of creditworthiness. The debt reporting system already operated by the Bank in conjunction with the Organization for Economic Co-operation and Development yields detailed information on the external debt of the great majority of developing countries though it still is in need of substantial improvement and expansion. From this information we can project with a fair degree of accuracy the debt service obligations of developing countries on the basis of their existing debt. What we are now attempting is to improve our projections of future growth in debt, and debt service obligations. The relevance of this effort to our own lending program is obvious.

It is still too early to get a clear impression of all the benefits which the Group's programming efforts have brought. But some are already obvious. One is the comparative ease with which the Bank and IDA have increased the volume of their lending to a whole new plane. Throughout most of the sixties, this remained at approximately \$1 billion annually; then, in FY1969, it increased by 87% to \$1,784 million. It will be approximately \$2,200 million in FY1970. Significantly, what is involved is not simply an expansion in volume. The geographical allocation of the Group's resources is shifting, with much greater emphasis being placed on Africa and on countries where, in the past, Bank Group activities have been non-existent (e.g. Indonesia) or very limited (e.g. the United Arab Republic). There is also a shift in the sectoral allocation, with relatively less weight being given to the Bank's traditional areas of emphasis (such as power and transportation) and more to newer areas: a threefold expansion in lending for education, and a fourfold increase in that for agriculture, are in

prospect for example, together with lending in the completely new fields of tourism and family planning. Both the geographical and the sectoral shifts imply somewhat smaller projects than in the past, and projects involving greater work on identification, preparation and supervision if they are to be successful.

To accomplish these goals has required a large increase in the Group's inputs. In FY1969 borrowing increased by 65% as compared with FY1968; the professional staff increased that year by 28% and in FY1970 will have increased by a further 22%. The staff of some departments, of course, has increased by substantially more than this: that of the two Africa departments is expected to have expanded by 98% between the end of FY1968 and the end of FY1970, for example, and over the same period the professional staff of the Education Projects Department will have grown by 150%.

This capacity to expand and simultaneously redirect the operations of the Group has been important for its own sake. It has also had some major ancillary benefits. For instance, the Bank has been asked by both bilateral and regional lending institutions for advice on its experience of programming, and has gladly shared this. Even more important, the demonstrated ability of the Group to handle a major increase in its operations with undiminished efficiency and concern for the development of its members was a significant consideration in the recent negotiations between the developed members of IDA over the resources to be made available to the Association over the next three-year period: though the final negotiations will take place only next week in Washington, it seems likely that these resources will at least double as compared with the resources made available

over the last three years. For the future, the Bank Group's increased capacity should enable it to make a major contribution to the flow of aid for developing countries; its systematic gathering of economic intelligence as a basis for its own lending operations and for those bilateral and regional sources of development finance with which it is associated in consortia and consultative groups, and its cooperation with international and national agencies providing technical assistance for development should go a long way to make development assistance an effective contribution to development.



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## AID AND INVESTMENT

John H. Adler<sup>1</sup>

### The theoretical framework: Investment

Some twenty years ago when the problems of growth and development of the poor countries began to attract the attention of political leaders and social scientists, two rather distinct sets of prescriptions to alleviate and ultimately eliminate the poverty of nations were conceived. One simple nostrum that was proposed—and widely accepted—was 'planning': the firm decisions of the central organs of the State were to take the place of the ineffective and complex decision-making process of the market mechanism and thereby provide the measures and resources for growth, for a more equitable distribution of income—and for all the other desiderata of collective well-being.

The second nostrum which some conceived as the antithesis of the first, but others thought perfectly compatible with it, was the proposition that capital formation-cum-entrepreneurship means development. (There is a striking resemblance between this tenet of 'capitalist' development and Lenin's pronouncement that 'electrification plus collectivization means socialism'.)

The first recipe for development, the planning cure-all, has become the point of departure of the continuous, meaningful, and by and large useful, discussion of the role of the State in the development process. The second, in spite of its naïve simplicity,

<sup>1</sup> The writer is Director of the Programming and Budget Department of the International Bank for Reconstruction and Development, Washington. The views expressed in this chapter are those of the author and not necessarily those of the Bank. The help of his colleague Mr. Horst H. Eschenberg is gratefully acknowledged.

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has led to the exploration of the role of capital formation in development.<sup>1</sup>

It was an historical accident that the first abstract formulation of the role of capital formation in the growth process was the result of concern with the problem of maintaining full employment in industrialized economies. The writings of Roy Harrod and Evsey Domar which dealt with the increase in output (i.e., economic development) resulting from a given level of investment were a reflection of their concern with the level of effective demand necessary to absorb the increased output flowing from a volume of investment required to 'accommodate' a given level of saving. In other words, they were worried about too much investment leading to excessive productive capacity, and about excessive saving leading to insufficient demand, and not about economic growth. In retrospect it appears that their contributions to the theory of variations in employment and resource utilization—to avoid the outmoded term of business cycles—were addressed to a problem which has not arisen to any significant extent since the thirties.

However, the Harrod-Domar formulation of a casual and quantifiable relationship between investment and additional output, the incremental capital/output ratio, was seized upon almost immediately by economists and other social scientists as a fundamental concept and useful tool for measurement and prediction of economic growth and for the formulation of economic policies. If all the finesses and caveats in its current use are scraped away and if all problems regarding the pattern of investment, the degree of effective utilization of existing productive capacity, and a host of other qualifications are left aside, the fundamental notion of the Harrod-Domar formulation has become accepted as a tool of analysis and a basis for policy prescription. In its simplest formulation it reads somewhat like

<sup>1</sup> To some readers, the 'proof' offered in the subsequent pages that capital formation—and, by extension, assistance in the provision of capital—is an important determinant of economic growth, may appear gratuitous since they consider the proposition self-evident. At present, this may well be so; but in view of the growing reluctance to provide capital assistance to developing countries, there is the distinct possibility that in the seventies the decline in capital assistance, especially through grants and loans on concessionary terms, will be rationalized by playing down and questioning the importance of capital formation as a *motive force* (as distinct from that of a passive mechanism) in development.

this: if the rate of investment of an economy is, say, 15 per cent and its rate of growth is 5 per cent per year, then an increase in the rate of investment from 15 to 18 per cent of the gross domestic product will raise the annual rate of growth from 5 to 6 per cent.<sup>1</sup> Therefore, if the poor countries want to accelerate their development (from 5 to 6 per cent per annum) they must increase their rate of investment from 15 to 18 per cent of GDP.

Although economic theorists engaged in the building of growth models and planners engaged in formulating development plans and 'selling' these plans to political leaders and to the public are all too frequently prone to make use of the capital/output ratio concept in its simplest and therefore most dangerous form, the fundamental notion that economic development can be accelerated by an increase in the rate of investment has become one of the main points of departure of the theory and practice of economic development. The question as to whether a high rate of investment is desirable has been resolved in the affirmative and the discussion and practice have shifted to subsidiary but more difficult and vexing problems: What policies are conducive to a high rate of investment? What measures can be taken to assure that any additional investment will make the greatest contribution to economic development? What is the best pattern of investment? How can a given rate and pattern of investment be made consistent with the pattern of external trade and payments of an economy which are at least in part beyond the control of the country itself? These are the problems to which theorists and practitioners of economic development address themselves with increasing frequency and with limited though growing success.

The rate of investment as a prime factor in determining the rate of growth was also emphasized from a somewhat different point of view by R. Nurkse. In his *International Trade and Economic Development* he expressed a view that investment in any particular sector or any particular enterprise was limited by the small size of the existing internal market. He argued that this limitation could be overcome if the output of all sectors would grow simultaneously so that the expanded output of each sector would find a ready market in all other sectors. His pre-

<sup>1</sup> This implies of course an incremental capital/output ratio of 3, and that the incremental capital/output ratio is equal to the average ratio.

scription thus was 'balanced growth', a process in which the income growth of one sector would balance the income growth of all other sectors. This prescription implied a major investment effort, a 'big push' through which the investment needs of all sectors could be satisfied.

Nurkse's argument partly follows in time and content the ideas first advanced by P. N. Rosenstein-Rodan<sup>1</sup> who stressed (a) the concentration of investment in developing countries in labour intensive industries to alleviate unemployment and underemployment—an objective which is receiving renewed emphasis at the beginning of the Second Development Decade, and (b) the complementarity of investment to be achieved by a *planned* 'big push'—in Rosenstein-Rodan's words 'a special case of external economies'. The external economies to be derived from the big-push complementarity in turn would create investment opportunities which because of their profitability would be exploited by private investors. Because of the need of 'bunching' investment in time he also concluded that foreign capital was required to finance a part of it.

The application of the Harrod-Domar model to developing countries and the more or less simultaneous development of the theory of the balanced growth by Nurkse, and of the external-economics strategy by Rosenstein-Rodan have become and remain, though with a growing degree of sophistication, the main theoretical basis for the role of investment in the development process.

A third strand of general investment strategy, which originated outside the Anglo-Saxon body of doctrine, is Francois Perroux's emphasis on development poles, or growth centres. This doctrine which has become the theoretical basis for development efforts in Southern Italy and Spain and has influenced the theory and practice of development efforts in a number of developing countries, especially in Latin America, stands conceptually between Nurkse and Rosenstein-Rodan. It rejects the notion of 'balanced' growth but relies heavily on external economies as a justification for concentrating investment in development poles.<sup>2</sup>

<sup>1</sup> In his famous article 'Problems of Industrialization of Eastern and Southeastern Europe', *Economic Journal*, June 1943.

<sup>2</sup> Cf. Francois Perroux, 'Note sur la nation de pole de croissance', *Economie Appliquee* 8, 1953, pp. 307-20; also 'Les pole de developpement

This does not mean, however, that the focal role of investment in the development and growth process is generally accepted. Until recently investment as a *prime mover* of the rate of economic advancement received scant attention in the writings on the growth experience in the nineteenth century of the countries which are now advanced. The economic progress which took place in the last two centuries or so was attributed to the advent of mechanical innovations<sup>1</sup> and to the activities of the innovating entrepreneur.<sup>2</sup> Advancements in technology, applied and commercially exploited by the innovating entrepreneur in the form of improvements in productive facilities—to which might be added improvements in techniques of marketing, organization, etc.—were considered the springboard of economic progress. Their exploitations lead to increased profits which in turn are used to finance investments for the expansion of productive facilities. Investment thus was conceived as part of the mechanism but not as the primary cause of economic development.

The importance of entrepreneurial decisions was reintroduced into the discussions on the factors determining the rate of economic growth by A. O. Hirschman in his *Strategy of Economic Development*.<sup>3</sup> Hirschman pointed out that the rate of investment in the developing countries was not limited by the autonomously determined rate of savings but by the limited ability of the entrepreneurial class (to which may be added the government in its role as an investing agent) to identify and exploit investment opportunities. Because there was no felt need for investable resources the savings potential was not fully utilized and at least part of savings was 'frustrated'. Thus, according to Hirschman, economic growth was not limited by the rate of savings but by the rate at which investment opportunities were identified and exploited; an effective strategy for accelerating economic growth was to stimulate investment by minimizing the entrepreneurial effort to make investment decisions.

et l'économie internationale', Symposium on *The Challenge of Development*, Jerusalem (Hebrew University), 1958.

<sup>1</sup> A. P. Usher, *A History of Mechanical Inventions*, revised edition, Cambridge, Mass., 1954.

<sup>2</sup> J. A. Schumpeter, *The Theory of Economic Development*, Cambridge, Mass., 1934. (The first German edition was published in 1911.)

<sup>3</sup> A. O. Hirschman, *Strategy of Economic Development*, New Haven, 1958.

H. C. Wallich<sup>1</sup> introduced an interesting and, in this context, relevant distinction between Schumpeter's concept of the innovating entrepreneur and the task of the entrepreneurs in the developing countries who are not faced with the problem of introducing innovations, but of *imitating* the innovating entrepreneur in the advanced countries. This implies that the entrepreneurial task in the developing countries is easier than Hirschman indicates.

Hirschman's proposition constitutes a modification but not an outright rejection of the role of investment in the development process. In contrast, the empirical work by Robert Solow<sup>2</sup> and Edward F. Denison have been used as a point of departure for the argument that the contribution of capital formation has been overemphasized in the theoretical writings based on the Harrod-Domar exposition of the causal relation between investment and growth. Theodore W. Schultz for example has claimed that the developing countries have overemphasized the importance of investment in physical capital and thus neglected efforts toward the formation of 'human capital' because the evidence presented by Solow—and before him by Solomon Fabricant and John W. Kendrick and after him by Denison—shows that improvements in factors of production, other than capital, such as the growing efficiency of the labour force, of the organization of production and distribution, have contributed more to the growth in output in the United States and other advanced economies than capital formation itself.<sup>3</sup> Therefore Schultz and others argue that the rate of economic development would be enhanced by devoting more attention and more resources to increasing the supply of factors of production other

<sup>1</sup> In a paper 'Notes on a Theory of Derived Development', presented at the Third Reunion of Central Bank Technicians of the American Continent, Havana, 1952.

<sup>2</sup> Robert Solow, Conference on Research in Income and Wealth, 'The Behaviour of Income Shares', Proceedings of the Conference on the Behavior of Income Shares, 1961, Princeton, 1964.

<sup>3</sup> Cf. Edward F. Denison, Conference on Research in Income and Wealth, 'Output, Input and Productivity Measurement', Princeton, 1961; 'Measuring the Contribution of Education to Economic Growth' in E. A. G. Robinson and J. E. Vaizey (editors), *The Economics of Education*, London, New York, 1966; Theodore W. Schultz, *The Economic Value of Education*, New York, 1963; Solomon Fabricant, *Basic Facts on Productivity Change*, New York, 1959; John W. Kendrick, *Productivity Trends: Capital and Labor*, New York, 1956.

than capital, especially to the development of skills and to the improvement of educational facilities which in turn would lead to an increased supply of 'efficiency' in production, entrepreneurship and management at all levels.<sup>1</sup>

In Gunnar Myrdal's monumental *Asian Drama*,<sup>2</sup> the distinction of the increases in the supply of the various factors determining the rate of economic growth, which underlies much of the argument developed by Solow, Denison and others, and applied first to the contemporary problems of development by Schultz, is criticized on the ground that this distinction constitutes excessive disaggregation since the relative importance of every individual input depends on the availability or expansion of the supply of all other inputs. Moreover the increase in the supply of such non-capital inputs as education or public health in turn requires the allocation of some capital resources (in the form of schools, medical facilities, etc.) and thus affects the rate of capital formation and determines its optimum pattern.

Furthermore, there is a question regarding the validity and applicability of the statistical interpretation of the experience of the developed countries to the state of underdevelopment in which the poor countries find themselves today. It may well be that in the countries which are now advanced technological changes and improvements in the quality of human resources through better education and better health and improvements in organization played an important role in the determination of the rate of economic growth. But technological improvements and the experience of the advanced countries are now readily available to the developing countries and it therefore takes primarily, though not exclusively, investment to make use of the technological advances in the developing countries.

All the contributions to the theory of the role of investment in the growth process mentioned in the preceding paragraphs—and their innumerable variants—have had a major influence on the theory and practice of economic development as it has emerged in the last twenty-five years. In order to present an

<sup>1</sup> The emphasis on improving and reorienting the objectives of public administration in developing countries may be considered a variant of the stress on human resources and productive efficiency.

<sup>2</sup> Gunnar Myrdal, *Asian Drama*, 'An Inquiry into the Poverty of Nations'. (New York, 1968.) Appendix 3, 'Economic Models and Their Usefulness for Planning', attributed in the Preface to Paul Streeten.

oversimplified but nevertheless meaningful formulation of the current state of the 'arts and sciences' of development, it may be useful to go back to the Harrod-Domar model. The causal relation between investment and the increase in output as formulated by Harrod and Domar implies that the supply of all other factors of production, other than capital, is adequate to make effective use of any increase in investment.

This assumption may be considered generally valid in the case of advanced economies where the other factors of production can be counted on to be readily forthcoming, at least as long as the level of employment is 'reasonably full' and not overfull. But it becomes highly questionable in the case of developing countries where the supply of skills, technical knowledge, and management is limited even if there is widespread underemployment of *some* factors of production. At least three aspects of the limitations on the supply of factors, other than capital, may be distinguished.

One is that the *stock* of these 'other' factors is small—the number of capable and experienced public administrators, of construction and production engineers, of managers of economic affairs (in the broadest sense) is limited.

Secondly, it is an important characteristic of underdevelopment that the *flow* of co-operant factors is slow; in other words, the response of the factors of production to changes in the demand for them is likely to be sluggish. The opportunities for increasing production and the further investment opportunities which result from one investment operation are not readily exploited.

Thirdly, the adaptation of techniques of production and distribution to local conditions may be difficult and imperfect because of lack of knowledge and experience.<sup>1</sup>

The combined result of these limitations on the supply of co-operant factors is a limitation on the absorptive capacity of developing economies. This does not mean that there exists an absolute limit on the amount of investment which a developing country can use at any one time. It only means that an increase in the rate of investment may result in a less than proportionate increase in the rate of economic growth, and that the rate of

<sup>1</sup> In technical terms, the point of optimum combination on a production function curve cannot be established with precision.

social return on each addition to the rate of investment declines—unless the initiative to increase investment is combined with efforts to overcome the deficiencies of the supply of those other factors which are essential to make effective use of additional capital.<sup>1</sup>

The practical implications of the proposition that the usefulness and the profitability of increased investment in developing countries depend on the adequate supply of all other factors of production have long been recognized in two ways. One is that the bulk of private foreign investment in developing countries is direct investment which supplies not only capital, but all those factors of production—such as management, technical skills, technology—which are necessary to assure success and profitability. The other is the growing emphasis on what is generically referred to as technical assistance, the objective of which is to stimulate and increase the supply of the factors of production other than capital and thus to bring about an increase in absorptive capacity and the rate of economic growth.

#### The theoretical framework: Aid

The preceding paragraphs already introduced—through the back door as it were—the role of foreign capital and technical assistance in the discussion. The issues pertaining to technical assistance are dealt with in several other chapters in this book; the focus of this section is on foreign aid and, more broadly, on the role of foreign capital from all sources in the development process.

Three reasons have been advanced for the importance of foreign capital as a means of accelerating the growth of developing countries. They are (1) that foreign capital helps to overcome the limits on domestic capital formation of the developing countries; (2) that foreign capital permits a more effective use of domestic capital formation; and (3) that foreign capital provides foreign exchange and thus supplies the most flexible resources for development.

<sup>1</sup> In neo-classical terminology, the difference between the marginal efficiency of capital and its average efficiency is substantially greater in developing than in advanced countries. Cf. my *Absorptive Capacity: The Concept and Its Determinants*, Washington, D.C., 1965.

As to the first point, it is self-evident, and reflected by statistical convention in national accounting, that an inflow of foreign capital permits a rate of investment in excess of the rate of national savings. The importance of increasing investment through capital inflows depends of course on the importance of the rate of investment as a determinant of the rate of economic growth and on the extent to which national savings can be increased. The role of investment in the development process has been dealt with in the preceding section, but nothing has been said so far about the feasibility of increasing national savings. On general theoretical grounds and on the basis of considerable empirical evidence it is clear that the rate of savings in developing countries is likely to be lower than in more advanced countries, simply because saving implies some sacrifice of foregoing current consumption in favour of more production and consumption in the future. This is true whether we think of personal savings, business savings, or public savings. As to personal savings, the low level of per capita income in developing countries makes it more difficult to save. As a matter of fact, the large majority of the population in developing countries does not save at all, but uses all personal income for consumption. There is also considerable evidence that any addition to income is devoted almost entirely to increased consumption.

The situation is somewhat less clear with regard to business savings because profits of private business firms in many underdeveloped countries are high and therefore it may be argued that it is likely that a large proportion of business profits can be set aside and saved and invested. On the other hand, business profits in developing countries may be adversely affected by the limited life expectancy of capital equipment due to lack of skill and experience in the physical maintenance of capital equipment, so that a larger proportion of gross profits has to be used for capital replacement than in advanced countries. Moreover, the limited development of financial institutions and the inadequacy of structural arrangements for safeguarding the interest of savers limits the flow of 'transferable' savings and thus may result in 'frustrated' savings which do not materialize because outlets for business savings in the form of readily accessible investment opportunities are limited. Finally, the general policy objective, common in many developing countries, of

combining economic growth with a more equitable distribution of income and wealth may limit the rate of business savings.

As to public savings, the need to expand current expenditures to satisfy the demands for providing more education, better health and medical services, and for improving communal services in general, limits the ability of government to increase public savings, i.e. to raise tax revenues over and above the level of current public expenditures. The inadequacy of public savings is aggravated further in those countries in which the need for pumpy public investment projects—which, as indicated before, have been emphasized by Rosenstein-Rodan—is acute.

The need for supplementing national savings by capital imports is reinforced further by the previously cited arguments that the economic growth of developing countries must be moved off dead centre (of stagnation or sluggish growth) by a 'big push' which will enhance growth in all sectors at the same time.

The theory of the big push (and the related theory of balanced growth) implies also that foreign capital is required for a transitional period—of rather unspecified duration—only. The theory suggests that foreign capital must provide the impetus to a high rate of income growth which in turn makes it possible to increase the rate of marginal savings, presumably largely in the form of public savings, so that the savings rate would sooner or later catch up with the rate of investment necessary to maintain a vigorous growth rate. The transitional nature of capital inflow requirements is also stressed in the widely publicized 'success stories' of the U.S. Agency for International Development (AID) which stress the connexion between a high rate of capital inflows, chiefly in the form of foreign aid, over a limited period, and the rapid acceleration of income growth associated with a sharp increase in marginal savings rates.

The need for capital inflows has also been argued on narrower grounds by staff members of the Economic Commission for Latin America (ECLA), especially Celso Furtado.<sup>1</sup> According to Furtado and others, an increase in foreign exchange receipts—through export earnings, or in the form of foreign capital—is essential if the rate of capital formation is to be in-

<sup>1</sup> Cf. Celso Furtado, 'El desequilibrio externo en las Economías Subdesarrolladas', *El Trimestro Económico*, April-June 1958.

creased because the import content of additional investment is much higher than the import content of additional consumption. If for example as a result of an increase in the gross national product, or as a result of an 'austerity programme', savings increase by, say, 2 per cent of the gross national product, then the demand for imported investment goods increases by as much as 1 per cent of the gross national product because the developing country does not have the facilities to produce such capital goods as machinery, equipment, and construction materials. The increase in the demand for capital goods imports is offset however only to a limited extent by a decrease in the demand for imported consumer goods because the proportion of consumption satisfied by imports is smaller than the import content of investment. Thus, the argument continues, any attempt to increase investment in a developing country is bound to put a strain on the balance of payments. But since the demand for primary commodities which make up the bulk of the exports of developing countries rises only at a slow rate, and export proceeds fluctuate widely because of frequent and rapid price variations, a steadily rising rate of capital formation is possible only if inflows of foreign capital supplement export earnings.

The ECLA analysis arrives at the policy conclusion that developing countries must make every effort to curtail their demand for imported consumer goods through the development of import substitution industries and thus set free foreign exchange for the acquisition of capital goods industries. But while the process of import substitution (of consumer goods) is going on, the demand for imported capital goods—to equip the import substitution industries—increases and accentuates the need for foreign capital.<sup>1</sup>

The ECLA argument is beset by a number of analytical and conceptual weaknesses. One is the difficulty of distinguishing between consumer goods and investment goods. The distinction

<sup>1</sup> In recent years the ECLA analysis has been extended to advocate the development of capital goods industries through the formation of a regional free trade area—the Latin American Free Trade Area—which would make possible the establishment of capital goods industries which are not viable on the basis of national markets. But the problem of providing foreign exchange to pay for the import content of the capital goods industries remains; if anything, it reinforces, at least for a transitional period, the argument for the need of foreign capital.

is easy and clear-cut for most final goods, but most intermediate goods and virtually all raw materials can be used in the production of consumer as well as investment goods. But its most serious deficiency is the proposition that the demand for exports is beyond the control of developing countries and thus must be considered as given. This has been disproved in recent years in a number of developing countries which have shifted their development strategy from the objective of import substitution toward the expansion of export industries and have met with considerable success. By the same token, the ECLA argument also considers the demand for imports (of all types of goods) as given thus fails to take account of the effects of changes in relative prices. It negates by implication the effects of monetary, fiscal and exchange rate policies on the demand for imports and the supply of exports. For that reason it has been called an exercise in 'priceless' economics.

Nevertheless, there is *prima facie* validity in the ECLA argument which rests on the absence of, and the difficulty of developing, capital goods industries in developing countries. Developing countries which attempt by appropriate policies to increase the rate of investment, even while maintaining price stability and avoiding an overvaluation of their currency, are likely to experience balance of payments difficulties because of the disproportionately large increase in the demand for imported capital goods associated with an increase in investment.

But by far the most important argument for supplementing the foreign exchange earnings of developing countries by foreign capital is the fact that the availability of foreign exchange permits greater freedom in the pattern of investment and in the direction of changes in the structure of the economy. Convertible foreign exchange permits the acquisition of goods and services not available from domestic sources and thus increases disproportionately the freedom of choice in the best possible allocation of resources. It is the resource with the most ubiquitous use because it gives access to the productive facilities of the whole world.

#### Foreign capital versus foreign aid

So far the discussion has not made any distinction between the

form in which the foreign exchange earnings of developing countries are supplemented, i.e. through foreign capital received either in the form of direct investment, or through loans on commercial terms, or through grants and loans on concessionary terms. In order to bring out the difference between aid and capital inflows on non-concessionary terms, two aspects of the flow of foreign resources to the developing countries must be distinguished. One is the effect of the inflows on the rate of economic development, the other on the balance of payments of the recipient country.

As to the first, what matters is not the cost of foreign capital which consists of interest and amortization payments, but the difference between the cost and the increase in total output resulting from the inflow of foreign resources.<sup>1</sup> It is generally assumed that aid in the form of grants provides greater benefits to the recipient country than foreign capital received on commercial terms or foreign direct investment. But this is by no means certain. It is true only if the increase in total output resulting from the receipt of foreign resources is the same irrespective of the cost of the foreign resources. It may be, however, that the 'yield'—in technical terms, the social rate of return—on a 'high-cost' foreign investment or foreign loan exceeds the yield associated with the receipt of a foreign grant by a greater margin than the cost. In that case foreign investment or foreign capital on commercial terms would be preferable to free aid.

But since there is no reason to assume—or to conclude from any evidence—that the social return on grant aid is lower than the social return on capital inflows on commercial terms, grant aid clearly contributes more to development than capital provided on commercial terms. Since there is in reality a continuous band ranging from free grants to supplier credits with an annual cost to the recipient (of interest and amortization) of 25 per cent or more, it follows that the contribution of foreign capital is the greater, the less onerous the terms of capital receipts. But since the terms of the bulk of development assis-

<sup>1</sup> In order to measure the net benefits of foreign resources to the developing country, the present value of interest and amortization payments which usually extend over long periods have to be compared with the present value of the increase in total output attributable to the receipt of foreign resources.

tance is provided to the developing countries on concessionary terms, i.e. at low rates of interest and with long maturities and grace periods, the net benefits to the developing countries are generally large if compared with the social yield, as measured by the inverse capital/output ratio. Table I shows that the capital/output ratio for countries with a per capita income (in 1965) of less than \$600 average 3.3. This implies that the average social rate on investment was 30 per cent. At the terms prevailing for external grants and loans received by developing countries in recent years,<sup>1</sup> this indicates that over 90 per cent of the face value of all capital receipts of developing countries constituted a net addition to their income flow.

The comparison of the burden imposed on developing countries by the terms of their capital receipts with the average social yield of investment<sup>2</sup> neglects, however, the fact that only part of the increase of the national product of the recipient country is saved and thus becomes available for servicing the debt, while another and normally the larger part of the increased output is used to increase consumption. Therefore it may be more appropriate to compare the terms of capital receipts with that part of the increase in total output which is saved. Since the average savings ratio exceeds 15 per cent of the gross national product only in a rather small number of developing countries, it may be surmised that the marginal savings rate is not likely to be larger than 25 per cent or 30 per cent of the increase in total output (of 30 per cent of investment), or of the order of 8 or 10 per cent of the investment financed by capital inflows. Using 8 or 10 per cent as the more appropriate measure of the thus more narrowly defined yield—which in the first instance will take the form of a financial or fiscal yield—of capital receipts of developing countries as a basis of comparison with the terms of these inflows, we find that in recent years the net contribution of grants and loans from bilateral sources were equivalent to 75 or 80 per cent of the face value of these grants and loans. Grants and loans from international organizations were 'worth' approximately 50

<sup>1</sup> Cf. Tables 12 and 13 of the 1968 Annual Report of the IBRD and IDA, p. 60.

<sup>2</sup> This comparison assumes that the average and marginal yields of investment are the same; this is an admittedly doubtful assumption although it cannot be assumed on *a priori* grounds that the marginal is necessarily smaller than the average yield.

to 60 per cent of their face value, depending on the assumption regarding their social yield, while the yield on privately placed debt such as supplier credits were equivalent to only 10 to 15 per cent of their face value.<sup>1</sup>

The difference between aid on 'concessionary' terms and 'ordinary' capital receipts with regard to their 'yield' in terms of increased savings becomes even more significant if account is taken of the fact that savings resulting from the foreign-financed increase in output have to take the form of foreign exchange in order to service the debt resulting from capital inflows. If the increases in savings resulting from the receipt of foreign resources could be readily converted into foreign exchange earnings, no further problem would arise. But, as indicated before, even if limitations on the ability of developing countries to increase their foreign exchange earnings have been exaggerated, it is clear that they are faced with serious constraints in this respect. The terms of capital inflows thus must be viewed against the recipient countries' balance of payments prospects. Given the existing balance of payments constraints, the debt service obligations resulting from capital receipts are bound to have an adverse affect on the donor countries' ability to meet the cost of their import requirements for current production and investment. The other side of the coin is that because of limited and uncertain balance of payments prospects of donor countries, lenders are concerned about their creditworthiness, i.e. their ability to service foreign debt.

Thus, the case for foreign aid on concessionary terms rests on three interrelated grounds. One is the limited ability of many developing countries to increase foreign exchange earnings sufficiently to meet their debt service obligations even if the receipt of foreign resources results in a significant acceleration of their economic growth.

The second is the desire, motivated by political, humanitarian

<sup>1</sup> Cf. Annual Report of IBRD and IDA, *ibid.* Data on the terms of private direct investment are inadequate to permit even the roughest measure of their social yield to the recipient country. On general grounds it may be argued, however, that foreign direct investments which are heavily taxed in the host country are likely to have a high yield in terms of national savings and therefore may provide large benefits to the host country even though their 'terms' in the form of gross profit rates after taxes may appear very high.



and moral considerations, to accelerate the development of the poor countries beyond the limitations imposed by their own ability to increase capital formation.

The third is to leave the largest possible proportion of increased savings of the developing countries unencumbered by debt service obligations and thus available for an acceleration of their growth rate—with the 'strategic' objective of limiting the time span for which aid on concessionary terms is required and to enable them to meet sooner the cost of foreign capital available on non-concessionary terms.

#### Investment and aid: The statistical evidence

Although, as has been indicated in the earlier parts of this chapter, the rate of investment is only one of numerous determinants of the rate of economic growth and, it may be added, the relation between the rate of investment and the rate of economic growth varies widely among countries, there is considerable evidence that the rate of capital formation has an important bearing on the rate of economic growth. As the figures in Table I show, for countries arranged in groups by per capita income there is a definite positive correlation between the rate of gross investment and the rate of growth of the gross national product. The groups of countries which have the highest rates of gross investment also have shown, between 1950 and 1965, the highest rates of growth in total output.

The table also suggests that in the course of the last fifteen years (1950 to 1965) the rate of capital formation of the developing countries has generally increased, especially in the poorest countries (Group I) where it rose from an average of 9.5 per cent of GNP in 1950-55 to 14 per cent in 1960-65. The increase in investment was in part due to an increase in capital receipts but chiefly it was the result of the growth of gross savings which increased from 9 to 11 per cent in Group I and from 17 to 20 per cent in Group II. Unfortunately, this increase in investment has not led to a corresponding increase in GNP growth, which averaged 3.8 per cent in Group I and 6 per cent in Group II. The rate of growth of per capita income actually declined, largely as a result of a rising rate of population growth.

This development does not, however, invalidate the general conclusion, which clearly emerges from the data assembled in the table, that the rate of investment is an important determinant of the rate of growth. There is considerable evidence that in many of the developing countries the retardation of income growth between 1960 and 1965 was largely due to the slow growth—2.1 per cent per year—of agricultural production, the sector which until recently depended less on capital investment as conventionally defined than all other sectors. By contrast, the growth of manufacturing, which is largely determined by the rate of investment, showed vigorous growth—over 7 per cent for the developing countries taken together.<sup>1</sup>

The table also gives an indication of the role which capital receipts, from aid, commercial loans and direct investment, have played in increasing the flow of resources available for investment. For the group with the lowest per capita income, capital inflows have provided, between 1950 and 1965, 16 per cent of total resources available for investment.

This ratio, and even more the ratios (of 3.7 and 2.8 per cent) shown in Table I for the next higher income groups, undoubtedly understates by a wide margin the contribution of foreign capital and especially of foreign aid to the availability of investable resources of many of the developing countries. The increase in public investment, which has been largely responsible for the rise in total investment, was brought about chiefly by the increased availability of foreign resources obtained through foreign aid. There is already some evidence that the rise in public investment in the early sixties which is generally slower maturing and benefit-yielding than private investment, is paying off in the form of higher growth rates of total output. More generally, there is evidence that countries which received large amounts of foreign capital and/or foreign aid (e.g. Mexico, Israel, Taiwan, Korea) have experienced beneficial changes in the structure of their economies and are therefore now in a better position to cope with problems of further growth and growth-induced change than others.

<sup>1</sup> In some countries the disparity in the growth rates of industry and agriculture was also due to development policies favouring industry at the expense of agriculture.

**Investment and aid: Prospects**

It would be tempting indeed to proceed from the scanty but nevertheless telling statistical evidence of the role of investment and capital inflows in the development process to an attempt to quantify the 'needs' or 'requirements' of investment and capital inflows over the next decade. But it follows from the gist of the first two sections of this chapter, that any quantification would have to be subject to so many qualifications and *ceteris paribus* clauses as to make it platitudinous for the knowledgeable and dangerously misleading for the uninitiated.

This is not to deny that a quantitative assessment of development needs, either to accomplish what may be considered politically tolerable minimum objectives, or to attain a 'development breakthrough'—however defined—in the shortest possible time, is possible. But such a quantification appears feasible only on a country-by-country basis, taking into account the specific constellation of relevant circumstances, economic, social and political, prevailing in each country. Such an assessment of national needs would have to be based, first, on an evaluation of the prospects of internal resource mobilization, through public and private savings on the one hand, and the direction and composition of investment on the other, and secondly, on an assessment of the importance of capital formation (and especially of public capital expenditures) compared with non-capital development expenditures—for education, training, medical care and public health, 'planning', population control and so on. It would also be essential to speculate about the balance of payments prospects of each country, attempting if necessary to reconcile conflicts of compatibility among them, not only on the export side—which is relatively easy on the basis of some general heroic assumptions regarding the rate of income growth in the advanced countries—but also on the import side, which at our present state of knowledge of the fundamental response parameters to income and price changes is much more difficult. Only after that is done the hard way, country by country, would it be possible to arrive at some order of magnitude notion regarding the increase in the rate of domestic capital formation and the corresponding inflow of foreign resources essential to 'assure' a target rate of growth.

Thus, instead of coming up with another global estimate of investment and aid 'requirements' and of engaging in what by necessity must be an exercise in speculative futurity and but another addition to the growing literature of social science fiction, it may be more useful to put down, in the light of the general propositions advanced in the earlier sections of the chapter, some observations on the role which investment and foreign aid (and private capital flows) are likely to play in the next ten years or so.

1. The developments of the last twenty years and the political and social changes which economic progress has brought with it in the developing countries makes it most likely that economic growth will continue, probably at an accelerated rate. The rate of growth of per capita income will depend on the effectiveness of population control schemes. Several of these have shown promise of initial success in some Asian countries (e.g. Korea, Taiwan), but others still have a long way to go to become quantitatively effective (e.g. India, Pakistan). They are virtually absent in Africa and important parts of Latin America.

At this juncture the rate of population growth has become the most important single determinant of the rate of income growth per head. Therefore population control must become an integral part of any national development programme. This presupposes acceptance by the political leaders of the developing countries of the desirability of reducing the rate of population growth, together with the development of an appropriate machinery of public administration to assure the success of family planning programmes.

The overriding importance of a reduction in the population growth rate—which for obvious reasons is tantamount to a reduction in the birth-rate—can be put in simple quantitative terms. Given the aggregate rate of income growth, a reduction of the rate of income growth by one-tenth of 1 per cent is approximately equal to an increase in per capita income of one-tenth of 1 per cent. But this trivial observation acquires a somewhat different meaning if it is realized that the increase in income by one-tenth of 1 per cent in the countries with a per capita income of less than \$300 requires, or presupposes, other things being equal, total savings, or total foreign aid, of approxi-

mately \$650 million, a sum equivalent to 2.7 per cent of all savings in these countries, or some 25 per cent of all public foreign aid flowing to them. In other words,<sup>1</sup> a reduction, in the course of several years, of the current population growth rate of over 2.5 per cent to 2.0 per cent in the countries in the two lowest income groups, would free resources equivalent to aid grants of over \$3,000 million.

But this is not all. It is now generally recognized (and accepted as the main reason for the desirability of reducing population growth irrespective of the size of the population or population density) that the rate of population growth adversely affects aggregate capital formation—because of the priority which must be accorded to consumption needs, determined, in differing contexts, by the size of the family, the number of children of school age, etc. The larger the size of the family, the larger the felt consumption needs, and, other things being equal, the smaller the share of the income that can be saved; the larger the size of the school-age groups, the greater the pressure for more schools, and the less money left over to provide for better schools. Thus, a reduction in population growth rates has a more than equivalent effect on the growth of per capita income.

2. The rate of economic growth will depend more than ever on the rate of capital formation. Until recently the growth of agricultural production depended almost entirely on bringing additional land under cultivation, on the introduction of new techniques of production, or on changes in the economic framework of agricultural production such as price incentives, price floors, or subsidies for agricultural inputs. The use of additional capital, in the form of agricultural machinery, or irrigation works, played a significant role only in a small minority of countries.

Evidence is accumulating rapidly that the development of new high-yielding varieties of food grains, especially of rice, wheat and corn, which are, or can be, adapted to the climatic and soil conditions of tropical countries, is a major technological breakthrough. But to derive full benefits from them requires capital inputs in hitherto unexpected quantities. The increase in crop

<sup>1</sup> But neglecting the difference between total investable resources and foreign, or foreign exchange, resources.

yields, in some instances manifold, depends on a greatly expanded supply of water (throughout the year, i.e. in areas with wide seasonal variations in rainfall through irrigation works), fertilizers, insecticides and pesticides. Only a small proportion can be provided by imports; the large increase in these requirements must come from expanded domestic production.

In addition to the provision of new inputs, the expansion of agricultural production will also require investments in the distribution system—in the form of more and better farm-to-market roads, increased facilities for bulk shipments (railways and trucks) and bulk storage. Moreover, to provide incentives for increasing labour inputs—in order to engage in double and sometimes triple-cropping—an increased supply of consumer goods, which has to come from the industrial sector, is essential. Thus, something akin to the 'big push' referred to earlier, a substantial expansion of investment, is necessary—not, as the big push theory would have it, to stimulate private investment and to raise savings, but to exploit effectively the opportunities which the technological advance of the development of the new seed varieties offers.<sup>1</sup>

3. It should be possible to accomplish a significant further increase in the rate of domestic savings in the developing countries, chiefly because many of them have acquired in the last fifteen years or so considerable experience in the formulation and execution of policies aiming at higher rates of public and private savings.<sup>2</sup> The inevitable political and social conflicts between the competing objectives of higher rates of capital formation and rising *private* consumption at all income levels are being resolved more and more in favour of the former.

The conflict between investment and *public* consumption however remains and even become accentuated. In countries in

<sup>1</sup> For a most informative discussion of the impact of the new high-yielding seed varieties, see *Strategy For The Conquest Of Hunger*, Proceedings of a Symposium convened by the Rockefeller Foundation (New York, 1968), especially the presentation by W. David Hopper on 'Investment in Agriculture: The Essentials for Pay-Off', pp. 102-13. Lester R. Brown, 'A New Era in World Agriculture', paper presented at the Frank Carlson Symposium on World Population and Food Supply, Kansas State University, December 1968 (mimeo.).

<sup>2</sup> Other than policies arising at a reduction of birth-rates which, as indicated in the preceding page, also are likely to raise savings rates.

which current expenditures for education, public health and for other objectives with a high 'development content' have risen sharply in recent years, this conflict is likely to help rather than hinder development. It is bound to improve the utilization of existing productive resources and of additions to productive capital through current investment; thus the problem is to find the most productive balance between capital and current 'development outlays'. There is, however, a number—perhaps even a growing number—of countries where increased public current expenditures are devoted to military and para-military expenditures (and, to make matters worse, a large proportion of public 'investment' takes the form of military hardware and military installations). In the case of these countries—in the Middle East, in South East Asia and, inexorably, in Latin America and in Africa—the impediments to development are obviously not in the realm of economic policies and their elimination must be sought by means other than improvements in economic performance and increases in foreign aid.

The quantitative importance of an increase in domestic savings must not be underrated. A rough calculation, based on the data shown in Table I, indicates that a 10 per cent increase in domestic savings in the poor countries—with a per capita income of less than \$300—would amount to \$2,500 million, equivalent to almost one-fourth of the total flow of public and private capital, net of amortization, to *all* developing countries, or some 40 per cent of the capital and aid receipts of the countries with a per capita income of \$300 or less. A 10 per cent increase in aggregate savings is clearly not beyond the capabilities of the developing countries, notwithstanding the competing claim on resources stemming from the consumption requirements of growing populations and the desire—and the need—to expand public services and thus communal consumption. In the countries where military expenditures are high the increase in savings could be accomplished without a curtailment in private consumption.

4. The attempts at increasing domestic savings are likely to be helped by improvements in the use of capital through the better preparation of investment projects, frequently with the help of technical assistance from abroad, and the realization that capital

expenditures must be matched by the increased availability of co-operant factors of production—technical skills, managerial abilities, organizational talents, and so on. The effect of the improved application of capital would be a lowering of the capital/output ratio, or in countries where the capital/output ratio is already low, a continuation of the low ratio in the face of a rising rate of investment.

5. Since the prospects for continued high growth rates of aggregate output in the advanced countries in the seventies are good, prospects for a large flow of private capital for the exploitation of the mineral resources in the developing countries also may be considered good. Most developing countries have learned that they can live with the international corporations engaged in the capital intensive exploitation of mineral resources—of petroleum, iron ore, alloy and non-ferrous metals and fertilizer materials—and that their development efforts can derive great benefits from foreign direct investment in resource exploitation as well as in manufacturing, where the demonstration effect of foreign-owned enterprises is a major factor in directing domestic investment into untried lines of economic activity.

The flow of direct foreign investment into developing countries is likely to be enhanced by the growing attention which international agencies, especially the United Nations Development (UNDP)<sup>1</sup> and national agencies, both of developed and developing countries, have given to surveys of national resources, the identification of investment opportunities and the preparation of feasibility studies. These pre-investment activities, which in a sense constitute a global public subsidy to private venture capital, are beginning to pay off and, given a modicum of internal and external political stability hold promise of contributing appreciably to the rates of growth especially of the manufacturing and mining sectors of the developing countries.

6. Unfortunately, the flow of private investment, and more generally the growth prospects of many of the developing countries are dimmed by the uncertain balance of payments outlook

<sup>1</sup> Into which the activities of the UN Special Fund and of the Expanded Technical Assistance Programme have been merged.

of most of the developing countries. Aside from the oil countries, which are likely to enjoy a ready and expanding market for their petroleum exports as long as the internal combustion engine and thermal power generation based on fuel oil do not become obsolete, the developing countries are faced with a two-fold difficulty. On the one hand, the world demand for primary products (other than oil and, perhaps, some non-ferrous metals and ores) is likely to grow more slowly than world income because of the low income elasticity of demand for foodstuffs and the growing success of the technology of substitution;<sup>1</sup> on the other hand, the expansion of manufactured exports with a high income elasticity from low-income to high-income countries is made difficult, and in some cases impossible, by tariff protection and quantitative import restrictions. The situation is the same with regard to those foodstuffs, chiefly grains, which until recently were deficient in South Asia but which as a result of the expected rapid expansion of agricultural production in the region could become a major export and foreign exchange earner in the only remaining important food deficit area of the world. Western Europe, but which will be kept out of the area if present policies of fostering uneconomic domestic production tariffs and subsidies are continued.

In the last twenty years world trade has grown at an unprecedented and unexpected rate; in the last five years the rate exceeded 8 per cent annually and was thus substantially above the rate of income growth.<sup>2</sup> But the growth of exports of the developing countries, other than oil countries, has been much slower than that of the rich countries and thus the share of the developing countries in world trade has declined. It is difficult to discover any indication that this trend will be reversed in the immediate future—unless more developing countries follow the example set by a handful of countries (e.g. Korea, Taiwan, and, first in time and in accomplishment, Japan) that have success-

<sup>1</sup> Of synthetic for natural materials, e.g. synthetic rubber and synthetic fibres, and cheaper for more costly natural materials, e.g. paper for fibre bagging material, and vegetable fats and oils for butter.

<sup>2</sup> Cf. Table I and United Nations, *The Problems and Policies of Economic Development: An Appraisal of Recent Experience* (World Economic Survey 1967, Part I), pp. 40-4; United Nations, *Current Economic Developments* (World Economic Survey 1967, Part II), pp. 2-4 and Annex tables.

fully overcome the impediments to export expansion, chiefly by monetary and exchange policies conducive to the growth of exports. But aggressive export policies require not only the 'right' policies but also an endowment with entrepreneurial capabilities which many developing countries still lack.

7. This brings us back to the future role of private foreign investment which conceivably could provide the ingredients of entrepreneurship, technical skills and management which are inadequate in most developing countries. But direct foreign investment has shown, and will continue to show, very discriminating tastes in the choice of countries and sectors where it is willing to operate. A large part of private foreign capital is invested in the exploitation of mineral resources which are encountered only in a limited number of countries;<sup>1</sup> these countries undoubtedly will continue to derive large benefits from the presence of foreign investment. But as to foreign investment which is less resources-oriented, the experience of recent years offers rather clear-cut evidence that it prefers to move to countries in which its cost of operations are expected to be low because the size of operations is large enough to permit economies of scale, or because the local supply of technical and managerial personnel is adequate.

These conditions cannot be met except in a few countries, which already have made some progress in terms of per capita income and in the provision of technical, managerial and clerical skills. Moreover, private foreign capital demands on the availability of economic overhead such as the services of public utilities, and an institutional framework of a reasonably efficient and honest public administration and reasonable prospects for the maintenance of law and order. These are conditions which only a limited number of developing countries are able to meet. Therefore the contributions which private foreign investment (other than investment in material resources) is likely to make in the near future is inevitably limited in scope and confined to such countries as Mexico, India, Brazil, Argentina which either by the sheer size of their markets or the expanding supply of co-operant factors, or both, are considered especially attractive.

<sup>1</sup> Frequently with small populations, e.g. Kuwait, Saudi Arabia, Bahrain, South Yemen, Libya.

TAB  
LE I  
*World economic growth, 1950-65—selected indicators*

1950 GNP Per Capita: <sup>a</sup>	Group I				Group II				Group III			
	-\$100				\$101-200				\$201-400			
	1950-55	1955-60	1960-65	1950-65	1950-55	1955-60	1960-65	1950-65	1950-55	1955-60	1960-65	1950-65
1. Number of countries in sample	15				22				12			
2. Total number of countries	47				41				31			
3. Coverage of sample: <sup>†</sup>												
4. —per cent of population	82.0				88.6				79.2			
5. —per cent of GNP	82.7				88.9				79.0			
Growth rates												
6. GNP	3.8	4.0	3.6	3.8	6.0	6.1	5.9	6.0	6.8	7.0	7.8	7.2
7. Population	1.9	2.2	2.4	2.2	2.5	2.5	2.7	2.6	1.7	1.6	1.6	1.6
8. GNP per capita	1.9	1.7	1.2	1.6	3.4	3.5	3.1	3.3	5.0	5.3	6.1	5.5
9. Exports <sup>‡</sup>	2.8	1.9	4.5	3.0	3.7	5.6	7.2	5.5	10.3	7.9	12.1	10.1
10. Gross investment as % of GDP	9.5	12.3	13.9	11.9	18.0	18.7	20.1	18.9	21.0	24.6	30.5	25.4
11. Capital/output ratio (line 9 ÷ line 5)	2.5	3.1	3.9	3.1	3.0	3.1	3.4	3.2	3.1	3.5	3.9	3.5
12. Gross savings as % of GDP	9.1	9.8	11.2	10.0	16.8	17.8	20.2	18.2	21.0	23.4	29.6	24.7
13. Savings 'gap'—resources supplied from abroad as % of GDP	0.4	2.5	2.7	1.9	1.2	0.9	-0.1	0.7	-0.0	1.2	0.9	0.7
14. Foreign resources as % of gross investment	4.2	20.3	19.4	16.0	6.7	4.8	-0.5	3.7	-0.0	4.9	3.0	2.8

<sup>a</sup> 1950 per capita GNP at 1965 prices in U.S. \$. IBRD data. World total excluding Mainland China.

<sup>†</sup> Since 1950 data are available only for countries included in the sample, the coverage was determined on the basis of 1965 data, with limits of groups shifted as follows:

	Per capita income, in \$	
	1950	1965
Group I	-100	-150
Group II	101-200	151-300
Group III	201-400	301-600
Group IV	401-800	601-1,200
Group V	801-1,600	1,201-2,400
Group VI (U.S.)	1,601-	2,401-

The 50% increase corresponds roughly to the annual average increase of 2.9% for the entire sample—(15-year growth: 53.5%).

<sup>‡</sup> In current (undeflated) U.S. \$. Exports of sample countries represent approximately 90% of total world exports.

1950 GNP Per Capita: <sup>a</sup>	Group IV				Group V				Group VI				Total			
	\$401-800				\$801-1,600				\$1,601-							
	1950-55	1955-60	1960-65	1950-65	1950-55	1955-60	1960-65	1950-65	1950-55	1955-60	1960-65	1950-65	1950-55	1955-60	1960-65	1950-65
1. Number of countries in sample	12				13				1				75			
2. Total number of countries	18				18				2				157			
3. Coverage of sample: <sup>†</sup>																
4. —per cent of population	98.6				99.8				99.8				88.8			
5. —per cent of GNP	98.6				99.8				99.8				97.0			
Growth rates																
6. GNP	7.5	7.3	5.1	6.6	3.8	3.6	4.6	4.0	4.4	2.2	4.8	3.8	5.1	4.3	5.1	4.8
7. Population	1.4	1.4	1.3	1.4	0.9	1.1	1.2	1.1	1.7	1.7	1.5	1.7	1.8	1.9	2.0	1.9
8. GNP per capita	6.0	5.9	3.8	5.2	2.8	2.5	3.4	2.9	2.6	0.5	3.3	2.1	3.3	2.4	3.1	2.9
9. Exports <sup>‡</sup>	12.5	10.7	8.9	10.7	8.4	5.6	8.0	7.3	8.6	5.8	6.0	6.8	8.6	6.8	8.0	7.8
10. Gross investment as % of GDP	21.3	23.9	25.8	23.7	18.5	20.6	22.0	20.4	17.8	18.4	17.4	17.9	18.5	20.5	21.6	20.2
11. Capital/output ratio (line 9 ÷ line 5)	2.8	3.3	5.1	3.6	4.9	5.7	4.8	5.1	4.0	8.4	3.6	4.7	3.6	4.8	4.2	4.2
12. Gross savings as % of GDP	21.7	25.8	26.8	24.8	18.7	20.3	21.6	20.2	17.9	18.5	17.8	18.1	18.5	20.7	21.7	20.3
13. Savings 'gap'—resources supplied from abroad as % of GDP	-0.4	-1.9	-1.0	-1.1	-0.2	0.3	0.4	0.2	-0.1	-0.1	-0.4	-0.2	-0.0	-0.2	-0.1	-0.1
14. Foreign resources as % of gross investment	-1.9	-7.9	-3.9	-4.6	-1.1	1.5	1.8	1.0	-0.6	-0.5	-2.3	-1.1	-0.0	-1.0	-0.5	-0.5

See Explanatory Note on p. 218

*Explanatory Note to Table I*

Countries included in sample:

*Group I:* Malawi (1965 GNP per capita \$40), Burma (64), Congo (—), Kinshasa (65), Tanzania (68), Haiti (70), Nigeria (78), Indonesia (85), Kenya (85), Pakistan (85), India (88), Uganda (101), Thailand (117), Cambodia (119), U.A.R. (151), China—Taiwan (203).

*Group II:* Ceylon (140), Philippines (146), Morocco (179), Ecuador (188), Syria (191), Zambia (198), Honduras (201), Paraguay (201), Tunisia (201), Jordan (218), Rhodesia (221), Iraq (223), Brazil (224), Ghana (226), Iran (226), Dominican Republic (234), Turkey (234), Malaysia (262), Peru (305), Rumania (436), Yugoslavia (468), Bulgaria (478).

*Group III:* Algeria (211), Colombia (262), Guatemala (301), Nicaragua (317), Portugal (367), Costa Rica (387), Mexico (434), Panama (461), Spain (575), Greece (597), Japan (765), Poland (793).

*Group IV:* Chile (484), Cyprus (638), Argentina (764), Venezuela (828), Hungary (869), Czechoslovakia (905), Italy (962), U.S.S.R. (1,000), Austria (1,076), Israel (1,129), East Germany (1,255), Germany, Fed. Rep (1,625).

*Group V:* Netherlands (1,360), Belgium (1,536), Finland (1,548), U.K. (1,550), France (1,615), Norway (1,618), Iceland (1,630), Denmark (1,735), Australia (1,754), New Zealand (1,794), Canada (2,100), Sweden (2,127), Switzerland (2,150).

*Group VI:* U.S.A. (3,240).

It should be noted that the various sample Groups include some countries with a per capita GNP outside the sample limits. The reason for this apparent inconsistency is that in 1950 their per capita GNP fell within the sample limits, while in 1965 it was above or below.

<i>Coverage of Table:</i>	<i>Total 1965 GNP</i> (\$ million)	<i>Population</i> (million)
Group I—47 countries and territories	99,300	1,120.6
Group II—41 countries and territories	68,100	317.9
Group III—31 countries and territories	97,700	211.7
Group IV—18 countries and territories	443,400	484.4
Group V—18 countries and territories	429,800	262.3
Group VI—(U.S.A. and Kuwait)	632,000	195.0

*Source:* International Bank for Reconstruction and Development. Based on data obtained from various public and private national and international sources. The estimates are for gross national product at factor cost (excluding indirect taxes net of subsidies). They were originally computed for 1964 and converted into U.S. dollars at 1964 exchange rates, adjusted where appropriate for major under- and over-valuations. The 1965 estimates were obtained by applying to the 1964 estimates the estimated real growth rates for 1964/65 and by adjusting the results by the U.S. implicit GNP price index.

In most developing countries the contributions of private foreign capital to development are likely to remain marginal, and in the all-important provision of economic overhead they have to 'go it alone', by their efforts, supplemented by public development from bilateral and multilateral sources.

8. It is unfortunately also reasonably clear that all resolutions of international bodies, exhortations and moral commitments notwithstanding, the most important single factor limiting the rate of development in the seventies, at least in the first few years, will be the flow of grants and grant-like aid to the developing countries. The latest data published by the Development Assistance Committee (DAC) of the Organization for Economic Co-operation and Development (OECD) show that the total net receipts (receipts minus repayments) of developing countries from DAC member countries, 'other' industrial countries, socialist countries and multilateral agencies reached in 1967 \$10,670 million, a record level, with the official and private financial resource from DAC countries accounting for \$10,310 million, or 88 per cent. It is apparent however that because of the reduction in U.S. aid appropriation (for purposes other than food aid) and the limitations which other countries have imposed on their aid to developing countries, the flow of aid on concessional terms is likely to decline, probably in absolute amounts, but certainly relative to rising needs, even under optimistic assumptions regarding the flow of export earnings of developing countries. Several years ago the shortfall of development finance, the difference between the actual flow from all sources and the developing countries' absorptive capacity for foreign finance, was estimated as between \$3,000 to \$4,000 million.<sup>1</sup> Since then this 'gap' is likely to have increased for three reasons. The absorptive capacity of the third world has increased as a result of more and better investment studies and a better appreciation of the need to plan public investment on a rational basis; the burden of foreign debt services has risen as a consequence of hardened terms of foreign assistance; and an increased proportion of savings and foreign exchange earnings has been mortgaged by debt service obligations, requiring a growing gross flow of capital to maintain the net transfer of resources.

<sup>1</sup> IBRD, Annual Report 1965-66, p. 62.

In the case of some countries it may be possible to offset the reduction in bilateral aid by an increase of financial support from multilateral agencies. But since multilateral institutions depend for resources which they can lend on concessionary terms on government contributions, only countries with reasonably favourable balance of payments prospects will benefit to any significant extent from the expansion of lending activities of the World Bank and regional development banks as long as they have to lend on terms commensurate to the terms at which they can borrow in the capital markets. Thus, unless the preferences in the pattern of bilateral assistance on 'soft' terms which is based on political considerations and what has come to be called 'traditional ties', are changed to take account of economic and financial needs for concessionary aid, the inadequacy of financial assistance will be felt most by those countries (in Asia and Africa) whose need for such aid is the greatest.

9. There is, however, the possibility—but not more than the possibility—that by channelling a larger proportion of aid on concessionary terms through international institutions and by improving the machinery of co-ordination of bilateral aid and technical assistance, the overall pattern of aid will improve and the terms of aid (including existing debt service obligations) will be modified to assure a more equitable allocation of development aid among deserving claimants.

This is in brief the not very comforting or comfortable outlook for investment and development aid in the seventies, as it takes shape after two decades of solid accomplishments, intermingled with painful and sordid disappointments, but, on balance, with the results exceeding the pessimistic prognostication of the immediate post-war years by a wide margin. There can be no question that the economic advancement of the developing countries will continue, hopefully at an accelerated rate, stimulated and supported by a rising rate of their own capital formation. If the volume of development aid were determined by proofs of its (and the recipient countries') accomplishments it would greatly increase. But unfortunately decisions on the flow of aid are generally not made on rational economic grounds but subject to the vagaries of political consideration, only occa-

sionally mitigated by some measure of moral and humanitarian concern. There is no indication at present that the situation will change radically, or even perceptively, over the next few years. But only time can tell.



*Adler*

June 22, 1970

Mr. Clark:

I sent copies to Messrs. McNamara, Aldewereld and Rickett. Should we send copies to anybody else?

For your information (which I am also passing on to Mr. McNamara): When I mentioned his name in the presentation of the paper the audience applauded spontaneously, the only time during the entire meeting. It happened virtually at the same time when there were demonstrations in Heidelberg, 200 kilometers away.

*Summarized in  
F + O June 1971*

**John H. Adler**

6/16/70

PROGRAMMING IN THE WORLD BANK GROUP

by

John H. Adler\*



Any understanding of the role of programming in the World Bank Group requires an appreciation of the fact that the Group consists of three rather different organizations. The World Bank itself, or more formally the International Bank for Reconstruction and Development (IBRD), is both the oldest and the largest of the three. Founded in the mid-forties to assist in the rebuilding of European economies devastated by war, it now lends almost exclusively to the countries of the developing world. Its membership includes 113 countries from all parts of the world outside the Soviet bloc, which have provided it with loanable resources of approximately \$1.9 billion. With earnings, this equity endowment has now grown to \$3.4 billion. The Bank's own capital must be supplemented by borrowings on the international capital markets. The member governments guarantee these borrowings but the Bank's lending rate must be high enough to cover the cost of its borrowing and to give it a reasonable return on its equity. As of March 31, 1970, the IBRD had lent a total of \$13,787 million, and held a portfolio of loans outstanding amounting to \$8,621 million.

The International Development Association, or IDA, is a close affiliate of the IBRD with an identical staff and Board of Executive Directors. It was founded in 1960 and now has a membership of 105 countries. It derives its loanable resources primarily from funds contributed by the governments of 18 rich ("Part I") countries. These funds are lent to developing countries

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which meet certain criteria--of poverty and lack of creditworthiness for conventional borrowing, on the one hand, and reasonable policy performance on the other--on an interest-free, 50-year repayment, basis. As of March 31, 1970, IDA had extended credits totaling \$2,436 million.

The smallest of the three main organizations in the Group is the International Finance Corporation, or IFC. Founded in 1956, IFC is unique in being the only international organization sponsored by governments which has as its primary objective the stimulation of the private sector in developing countries, not only by lending but also by taking equity positions. Like the IBRD and IDA, IFC is fundamentally concerned with the development impact of its operations, but it must also be concerned with the profitability of its operations to private foreign and domestic investors. Therefore the selection of projects for financial support by IFC is somewhat different than in the IBRD or IDA.

The Programming and Budgeting Department of the Bank Group is responsible for the programming of IFC operations, as for those of the IBRD and IDA. But because of the uncertainties involved--especially of timing--we are only now beginning a programming system for the IFC comparable with that already in existence for the IBRD and IDA. At any event, I am concerned today primarily with programming for the IBRD and IDA.

The Bank Group has had a programming system of sorts for a number of years. Until about two years ago, it consisted essentially of a list of projects which it was proposed to finance over the ensuing twelve months. This was almost certainly adequate for the Group at that stage: total lending by the IBRD and IDA was fairly stable at about \$1 billion annually,

and by far the greater part of this total was to sectors in which the Group had had very long experience (power and transportation). Group staff was expanding, but at a relatively modest rate. It was only in 1968, when it became clear that the Group was to embark on a very major expansion of its activities, that the need for a much more systematic approach to the planning of the Group's operations became evident.

Since the Group is essentially (though by no means exclusively) a source of finance, there are two possible starting points for a programming system. One is the volume of lending over a "plan period"; the other, the availability of resources. Because of the difference in the financial basis of the Bank and IDA, both approaches have to be used and combined into an effective work program, which in turn becomes the output framework for the IBRD/IDA administrative budget.

Management was confident from the outset that the capacity of the IBRD--as distinct from IDA--to raise funds in the capital market would not be a constraint on its lending operations, so that, for the IBRD, the relevant starting point was clearly the lending program.

The first step, therefore, was to extend the existing lending program to a meaningful extent into the future. Such an extension was not difficult up to about 30 months, which is the average time which elapses between the date on which a project first comes to the attention of the Bank and the date on which a loan for that project is signed. This "pipeline" formed a firm basis for developing a lending program for that period.

We also knew from experience that "one loan leads to another", that contacts built up during the appraisal and negotiation of one loan frequently lead to the extension of others. Thus, in the last five years, 25% of all loans were made to entities which had previously received at least one loan from the Bank Group, and a further 35% of the total were made to sectors--irrigation, highways, power, etc.--which had previously received at least one Bank Group loan in that country.

In some cases, the Bank's knowledge of a particular sector stems from intimate contact over a period of many years. Since 1949, for example, the Bank has made no fewer than 21 loans, totaling \$622 million, to the Brazilian power sector. Over the same period, the Bank and IDA together have lent \$632 million, in 13 separate operations, for the development of Indian railways. The kind of on-going working relationship implied by these examples, which could be duplicated in many other countries, substantially simplifies the task of estimating the effective absorptive capacity of the Bank's borrowers and thus developing a lending program for some years into the future. Five years is in fact the period covered by the Bank's lending program at present.

Thus, while it took only the application of experience and some imagination to push the lending program out towards the end of the "pipeline", and beyond, at least three constraints made their influence felt and had to be taken into account in preparing a meaningful program. One was the economic performance of borrowing countries. As I am sure you know, the Bank Group requires that two quite different sets of conditions be fulfilled before it will agree to lend for a project. One set concerns the project itself--it must be beneficial to the borrowing country's development, it must be financially viable, there must be adequate management available for it, and so on. But in addition to

these project-related conditions the Group must be satisfied that the country as a whole is making a reasonable effort to further its own development. There are obviously many enormously difficult problems involved in making an objective judgment on what constitutes "reasonable effort" but, if the Bank's loans are not simply to permit other resources to be squandered, the attempt must be made. And at any one time there are normally a number of countries whose performance is judged inadequate to qualify them for Group lending. And there are quite a few countries to which we lend only on the understanding that certain policies will be modified in due course, frequently in the framework of a tentative timetable.

Another constraint on lending is the creditworthiness of borrowers. Though creditworthiness is clearly not a sufficient condition for the Bank to lend to a country, it is obviously a necessary condition. The Bank's Articles of Agreement specifically enjoin the Board, in making a loan, to pay due regard to the prospects that the borrower will be in a position to meet its obligations under the loan.

Both economic performance and creditworthiness can change in short order, however, and this introduces an important element of uncertainty into the lending program. I will look a little later at the steps we are taking to reduce the uncertainty insofar as creditworthiness evaluations are concerned, but by the nature of the case estimates of future economic performance must inevitably be subject to considerable error and sudden changes.

A third factor which must be taken into account in formulating the lending program is the availability of Group staff. At present, the Bank

employs nearly 2,300 people, of whom about one-half are professionals. It is not impossible to expand this number at almost any rate required by the lending program: the problem lies not in the expansion of numbers but in the time needed to acclimatize new staff to the Bank's policies and procedures. A high rate of growth of staff not only yields a slower growth in operational capacity than the increase in numbers would suggest; it also in some measure reduces the effective capacity of middle and senior level management because of the increased demands on their time for training and supervision.

All these factors then--the "pipeline", economic performance, creditworthiness, and staff availability--are systematically considered in arriving at the Bank's lending program.

In formulating IDA's lending program, most of the same factors are also relevant, though there are some additional considerations. Creditworthiness is no longer a condition of lending--indeed, only countries which lack creditworthiness for borrowing on conventional terms, or have only limited capacity to service such debt, are eligible for IDA credits. And to be eligible countries must be among the poorest developing countries: in practice, with a per capita income of less than about \$300.

The problem of course is that the absorptive capacity of developing countries for IDA credits which meet these criteria--satisfactory economic performance, a lack of creditworthiness for borrowing on conventional terms, and poverty--is substantially greater than the funds available to IDA. India alone, for example, could make good use of all the resources currently available to IDA (about \$600 million annually), and both Indonesia and Pakistan could effectively absorb a large part of that total. Unlike the situation

in the Bank, therefore, there is a financial resource constraint operating on IDA's lending program which necessitates an element of rationing. Because of the desirability of having as wide a geographical spread as possible in IDA's operations, this rationing inevitably takes the form of placing some limits on IDA's lending to those countries whose absorptive capacity is greatest.

The lending programs of both the Bank and IDA have to be reviewed frequently if they are to have any operational significance. To date, three such reviews have been completed since the new programming system was introduced in 1968. The first and second reviews were really reviews of all countries in the lending program simultaneously. But it was quickly apparent that this approach was less than satisfactory: it imposed considerable strains on the operating departments of the Group, and, because of the adverse effects<sup>of</sup> the concentration of the review process on its thoroughness, substantially reduced the usefulness of the program itself.

As a result it was decided to spread the country reviews throughout the year, and formalize a procedure for introducing changes in the lending program between reviews. The vehicle for such reviews is a meeting of the President of the Group with senior operational staff to consider what we now call Country Program Papers. Normally, a Country Program Paper is prepared for each potential borrower among the Bank's membership once a year, and area departments, who are responsible for their preparation, are committed to a schedule of finalizing them as soon as possible after completion of an economic report on the country concerned.

The papers themselves are expected to cover four main topics, at both the macro-economic and sectoral levels: the development objectives of the country, the obstacles impeding the attainment of these objectives, the



recommended solutions, and the proposed Bank Group contribution. On the basis of these papers, senior management is able to decide on the most appropriate combination of Group assistance, both financial (amounts of Bank/IDA lending, terms of lending, sectoral composition of loans) and advisory (technical assistance, policy and institutional conditions of loans, sector studies, project-preparation work, etc.).

The Country Lending Program is thus a direct outgrowth of the review of the Country Program Paper, and becomes a part of the total lending program of the Group. The country lending program can be changed between annual reviews with the permission of the Chairman of the Bank's Loan Committee, and this means that at any point in time, management has an accurate, up-to-date view of the proposed total lending program. The broad characteristics of this total program are reviewed by management once a year.

Most of the other elements in the Group's programming system follow directly from the lending program. One element which obviously has a particularly close relationship to the lending program is the financial plan. In the early years of the Bank, financial planning could be of the most elementary kind. Because repayments were relatively unimportant, it was a simple matter to establish a relationship between available resources and those required for disbursement. Indeed, until the mid-fifties it was the practice to keep on hand, in cash and marketable securities, sufficient funds to meet fully the disbursement commitments on all outstanding loans. The relative size of these liquid balances has been gradually reduced since that time, both as a result of the increased importance of repayments on past Bank loans and as the average disbursement period has lengthened with the

shift in the emphasis of Bank lending from the developed countries of Europe, Japan, and Australia to the less developed of Asia, Africa, and Latin America.

In recent years, financial planning has been firmly based on detailed cash flow analysis using the best possible estimates of lending, disbursement, repayments, service payments due on the Bank's own funded debt, earnings, etc. Financial planning has to take into account a variety of considerations: the relation of the maturity profile of its loans to that of its debts, the prospects of movements of interest rates, the relation of long to medium and short-term rates, etc.

One integral part of financial planning is the borrowing program. Because of the highly unsettled conditions in world capital markets, it is also one of the most difficult aspects of the Bank's operations to program meaningfully. Early in 1970, for example, the Bank was able to borrow \$200 million in Yen in Japan because of the particularly favorable position of the Japanese balance of payments at that time. These were circumstances which would have been difficult if not impossible to predict with any certainty three months, let alone three years, in advance. At this stage we are expecting the Bank to borrow on a gross basis some \$3 billion over the next three years. Because of the Bank's substantial liquid assets (over \$2 billion at present), we have fortunately considerable leeway on the timing of our borrowing operations.

The lending program yields information not only on the financial resources required of course but also on the staff needed to conduct it. Because it gives detailed information on the sectoral, as well as on the

geographical, allocation of loans, it serves as a basis for assessing manpower needs for the functional projects departments (agriculture, transportation, utilities, education, etc.) and for the area departments, and for determining how many new staff, how many loan officers, engineers, economists and, as a result, how many research assistants, administrative officers, and secretaries should be hired. Like the lending program and the financial plan, the Bank Group's manpower planning now extends five years into the future, although for obvious reasons the staff requirements are firmly established for one year at a time only and become part of the annual budget documentation.

In our attempts to establish systematic relationships between manpower, i.e. professional time, inputs and outputs we ran into two types of difficulties which I assume are common to many public institutions and organizations which want to improve their budget making by relating manpower requirements to objectives. One is the problem of defining, or even devising, output concepts; the other is the problem of relating inputs to outputs over time.

As to the first, the final output of the IBRD and IDA is of course the number and amount of lending operations. The making of a loan involves a series of stages--identification, preparation, appraisal and negotiation of a loan project--to which inputs of various departments, chiefly the projects departments and the area departments, can be directly related. But other inputs are more difficult to relate to specific outputs. For instance while economic missions, the gathering of economic intelligence, and investigations and discussion of economic policies normally are closely related to lending operations, they may be just as valuable and important--

some observers may consider them even more important--if they result in postponement of a lending operation. Therefore the work of economic missions and the preparation of economic reports, which at any rate relate to countries and not to specific lending operations, cannot be considered an input to lending operations. They must be considered an intermediate output, which is used piecemeal in the preparation of the final output. This is also true for sector investigations and pre-investment studies, which also cannot be related to specific lending operations but have an important bearing on them.

The problem of relating inputs to outputs over time is not peculiar to the IBRD or IDA (or, for that matter, to international or national public administrations), but it has in the case of the IBRD and IDA certain operational consequences which are, I suggest, of interest to public administrators. Because of the time it takes to identify projects, to establish their feasibility, and when appropriate to complete preliminary, or final, engineering, a large proportion of inputs--in the case of the projects departments, some 80%--takes place in fiscal years prior to the year when outputs, i.e. lending operations, are completed. In operational terms that means that the work program of year 1 is to a very large extent determined by the lending program for year 2 and to some extent for year 3. In a period of rapidly expanding operations like the last two years in the Bank Group, the problem is compounded by the fact that allowance has to be made for new staff to be "broken in"--to acquaint themselves with the procedures and investigative techniques used in the Bank Group. This means that recruitment of new staff in year 1 should be based on a lending

program in year 3; needless to say, given the general uncertainty of future events and the special uncertainties besetting the sectoral and regional composition of the lending program, it is difficult indeed to be even reasonably accurate.

To return to the subject of country economic work and especially of economic missions: The Bank Group has long mounted such missions to its member countries but in frequency, timing, and focus they sometimes had little direct relationship to lending operations. On occasion, management found itself considering loans to countries for which there was no up-to-date economic information, while conversely, scarce manpower was being spent on economic missions to countries where there was little immediate prospect of a Bank lending program.

Since development of the five-year lending program, it has been possible to see more clearly where the priorities for the Bank's economic manpower lie, both as between countries and between sectors. We have categorized countries into three groups on this basis. The first, which at present includes 32 countries, includes all major developing countries in which the Group has an active lending program; countries in this group receive a Bank economic mission at least once a year. Countries in the second group, currently numbering 23, are those in which the Bank has a less active lending program and the Bank sends an economic mission to these countries only every second year. The third group includes 42 countries--all of them small or unlikely to receive a substantial volume of Bank or IDA lending in the near future--and these receive an economic mission only once in three years.

One of the most important consequences of the development of a meaningful programming system is the way it has made possible development of a program budget. Until a few years ago, the Bank Group had only a rather simple kind of budget, with no attempt to relate inputs to outputs in any operationally significant way. Except for personnel expenditures, no attempt was made to budget the various other expenditure categories by department; this arrangement made control of expenditures by departments impossible of course.

Recently, as a result of our programming of operations, we have been in a position to prepare a budget which is not only much more detailed than heretofore but which also makes it possible to relate inputs of staff time to "operations output." At this stage, the manpower coefficients we are using are crude and subject to quite considerable error. But they already enable us to see what kinds of operations are most expensive in terms of our scarcest resource and, of course, point to areas where staff performance needs improvement. They are also useful in assessing the reasonableness of the requests for additional staff which emanate from the various operating departments of the Group.

I need hardly say, perhaps, that the Bank is not able to apply these coefficients to the same extent as could a private organization to determine whether or not an operation, or certain type of operation, should take place. Though the Bank seeks to operate profitably, and has been notably successful in doing so throughout its history, it is not essentially a profit-making institution. If it were, it would concentrate its lending in the most developed countries and pay little heed to the least developed. At a

minimum, it would concentrate attention on the largest developing countries --such as Argentina, Brazil and Mexico--where the stage of development and the Bank's long experience make it possible to extend very substantial loans with a relatively small expenditure of staff time and effort. We do make substantial loans to countries of this kind and, by the end of FY1970, some 47% of the estimated total lending of the Bank and IDA this year will have been in the form of 19 loans of \$40 million or more. But because the Group's function is primarily the stimulation of economic development, many of its lending operations are to countries which require not only capital but also considerable assistance in the identification and preparation of suitable projects, in their appraisal and in their management and operation. They are to countries whose capacity to absorb large amounts of capital effectively is small, and as a result the majority of the Group's loans are small too. By the end of FY1970, it is expected that almost half of the 120 loan and credit operations approved this year will have been for amounts of \$10 million or less, and several of them are for amounts of less than \$1 million.

This, then, is where we are at present--with a gradually improving system for programming lending operations with derivative systems for planning the financial and personnel aspects of the Group's activities, and with a meaningful start on program budgeting.

We are also just beginning to build an information system covering the other flows of financial assistance to developing countries. In the first two years of our lending program, as previously, we virtually ignored the operations of other lending agencies except where we had some direct responsibility for coordinating them for particular countries (as in the

consortia for India and Pakistan and in consultative groups for some 10 other countries). This is in the process of changing and we are now gathering information not only on the past flows of aid but also on the organizations responsible for handling aid in the main donor countries, their commitment to development aid in the future (as reflected for example in their response to the report of the Pearson Commission), the factors affecting the allocation and terms of aid, and on the institutions responsible for channelling private capital to developing countries. In this way we are hoping to obtain indications as to what the future flow of resources to developing countries will look like--its magnitude, directions, and terms.

The construction of such an aid matrix will, we hope, serve two important functions in our own programming system. First, it will serve to provide a framework in which to view the Bank Group's own contribution to the total flow and may thereby suggest desirable changes in the Group's lending program. You will recall that the Commission on International Development, an eminent group of international citizens chaired by Mr. Lester Pearson (and including Germany's Dr. Wilfried Guth) specifically recommended that IDA should take other flows of development finance into account in its own lending operations; and the whole drive towards increased aid coordination, reflected in the meeting of the administrators of major aid agencies this very month in Heidelberg, can make sense only in the context of a full awareness on the part of each agency of the plans and operations of the others.

Secondly, we hope that this matrix will greatly improve the appraisal of our own lending program. Clearly, except in the declining proportion of cases where grants are concerned, aid flows involve repayment obligations--



and we are back once more at considerations of creditworthiness. The debt reporting system already operated by the Bank in conjunction with the Organization for Economic Co-operation and Development yields detailed information on the external debt of the great majority of developing countries though it still is in need of substantial improvement and expansion. From this information we can project with a fair degree of accuracy the debt service obligations of developing countries on the basis of their existing debt. What we are now attempting is to improve our projections of future growth in debt, and debt service obligations. The relevance of this effort to our own lending program is obvious.

It is still too early to get a clear impression of all the benefits which the Group's programming efforts have brought. But some are already obvious. One is the comparative ease with which the Bank and IDA have increased the volume of their lending to a whole new plane. Throughout most of the sixties, this remained at approximately \$1 billion annually; then, in FY1969, it increased by 87% to \$1,784 million. It will be approximately \$2,200 million in FY1970. Significantly, what is involved is not simply an expansion in volume. The geographical allocation of the Group's resources is shifting, with much greater emphasis being placed on Africa and on countries where, in the past, Bank Group activities have been non-existent (e.g. Indonesia) or very limited (e.g. the United Arab Republic). There is also a shift in the sectoral allocation, with relatively less weight being given to the Bank's traditional areas of emphasis (such as power and transportation) and more to newer areas: a threefold expansion in lending for education, and a fourfold increase in that for agriculture, are in

prospect for example, together with lending in the completely new fields of tourism and family planning. Both the geographical and the sectoral shifts imply somewhat smaller projects than in the past, and projects involving greater work on identification, preparation and supervision if they are to be successful.

To accomplish these goals has required a large increase in the Group's inputs. In FY1969 borrowing increased by 65% as compared with FY1968; the professional staff increased that year by 28% and in FY1970 will have increased by a further 22%. The staff of some departments, of course, has increased by substantially more than this: that of the two Africa departments is expected to have expanded by 98% between the end of FY1968 and the end of FY1970, for example, and over the same period the professional staff of the Education Projects Department will have grown by 150%.

This capacity to expand and simultaneously redirect the operations of the Group has been important for its own sake. It has also had some major ancillary benefits. For instance, the Bank has been asked by both bilateral and regional lending institutions for advice on its experience of programming, and has gladly shared this. Even more important, the demonstrated ability of the Group to handle a major increase in its operations with undiminished efficiency and concern for the development of its members was a significant consideration in the recent negotiations between the developed members of IDA over the resources to be made available to the Association over the next three-year period: though the final negotiations will take place only next week in Washington, it seems likely that these resources will at least double as compared with the resources made available

over the last three years. For the future, the Bank Group's increased capacity should enable it to make a major contribution to the flow of aid for developing countries; its systematic gathering of economic intelligence as a basis for its own lending operations and for those bilateral and regional sources of development finance with which it is associated in consortia and consultative groups, and its cooperation with international and national agencies providing technical assistance for development should go a long way to make development assistance an effective contribution to development.

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John Adler speech

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**John H. Adler**



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# Development and Income Distribution

By

John H. Adler

## I.

In a paper published in 1955 which was, in his words, "5 per cent empirical information and 95 per cent speculation" and which bears — in spite or because of its speculative character — the marks of prophetic insight, Simon Kuznets advanced the proposition that "in the early phases of industrialization in the underdeveloped countries income inequalities will tend to widen before the leveling forces become strong enough first to stabilize and then reduce income inequalities." He then answered in the negative the question "Can the political framework of the underdeveloped societies withstand the strain which further widening of income inequality is likely to generate"<sup>1</sup>?

Since 1955, ample evidence has accumulated to bear out Kuznets' "speculation" that in the developing countries inequalities in income distribution are greater than they were in the industrialized countries before the trend toward growing inequalities was reversed — in some countries before the turn of the century, in others not until after the First World War — and that they have become more pronounced in most though perhaps not in all countries<sup>2</sup>.

What has come as a rather shocking surprise, however, is the extent of the inequality and the low absolute level of per capita income of the poorest quintile of the population. In 21 out of a total of 40 developing

*Remark:* The views expressed in this paper are those of the author and not necessarily of the International Bank for Reconstruction and Development with which he is associated.

<sup>1</sup> Simon Kuznets, "Economic Growth and Income Inequality", *The American Economic Review*, Vol. XLV, Menasha, Wisc., 1955, pp. 1 sqq., esp. pp. 24 sqq.

<sup>2</sup> Data on income distribution have in recent years become available for a surprisingly large number of developing countries; although for most countries their reliability is rather uncertain, especially since in many instances their coverage is limited, and their comparability is highly questionable. The most comprehensive data are given in I. Adelman and C. T. Morris, *An Anatomy of Patterns of Income Distribution in Developing Nations*, Final Report Prep. for the U. S. Agency for International Development, February 12, 1971. A short version has been published in *Development Digest*, Vol. IX, Washington, D. C., 1971, No. 4, pp. 24 sqq.

countries for which data are available, the average per capita income of the poorest 20% of the population is less than 28% of the national average<sup>1</sup>. That means that it is not only in the "hard core" least developed countries which have been singled out in various resolutions of the United Nations bodies<sup>2</sup> for special consideration, that the per capita income of the majority of the population is abysmally low (and therefore perennially in danger of falling below the threshold of physical needs); but that in a number of countries in which the national average per capita income has reached a level substantially above the bench mark of say, \$ 100, such as Brazil, Colombia, El Salvador, Jamaica, Lebanon, Mexico, Panama, Peru, and Tunisia, a substantial proportion of the population still has a per capita income below that international "poverty line."

There is another group of countries in which the low per capita income of the poorest quintile — or for that matter of the poorer half — of the population is a matter of special concern on humanitarian grounds and, in policy terms, of urgency. This group includes India and Pakistan in Asia and some of the major countries of Africa such as Kenya, Nigeria, and Tanzania. In these countries the relative share in the national income of the poorest quintile of the population is significantly higher than that in the first group, between 7% and 10%; but because of the low national average, the absolute amount is so low that it is clear that minimum requirements of caloric intake and nutritional balance are not met. According to the data, the per capita income of some 110 million Indians is \$ 38 compared with a national average of \$ 100; in Pakistan, the poorest 20% of the population — some 22 million — "enjoy" a per capita income of \$ 36; and so on<sup>3</sup>.

These figures are the more disconcerting since the experience of the last twenty years has shown that it is virtually impossible in developing countries to mitigate the plight of the lower income groups by redistributive fiscal operations. For a variety of reasons, of which the low national per capita income itself is presumably the most important one, efforts aiming at redistribution for the benefit of the poor do not work. Moreover,

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<sup>1</sup> Data given in Adelman and Morris, *op. cit.*, cover 44 countries, including Japan, Israel, Rhodesia and South Africa. These four countries have been excluded — because Japan and Israel can no longer be considered "developing" in the generally accepted meaning of the term, and because in Rhodesia and South Africa the income distribution may be considered chiefly the result of discriminatory legislation. If the four countries are included, the numbers in the text become 24 out of 44.

<sup>2</sup> U. N. General Assembly Resolution A/RES/2768 (Session XXVI), New York, November 22, 1971. The resolution also contains references to other U. N. resolutions and documents which pertain to the least developed countries.

<sup>3</sup> The data on Pakistan refer to years prior to the secession of Bangladesh.

there is evidence which suggests that in the great majority of developing countries the benefits of economic development accrue chiefly to the upper income groups — the highest 20% or 40% of the population — and that in some countries the poorest 20% or even a larger percentile do not participate in the process of economic advancement at all.

This state of affairs is in sharp contrast with the fundamental objectives of economic development — the diminution of poverty and human misery. It is, I suggest, indicative of the direction in which development theory and development policy has been moving — wandering may be a better term than moving — that it has become necessary to recall their basic aims. In the preoccupation with the means of development — to raise the rate of savings and investment, to achieve viability in the international accounts, to move from externally supported to self-sustained growth — sight has been lost of its ends. And the advocates and promoters of development and development aid have been so busy defending their cause against its detractors and proving its success — by impressive aggregate statistics and persuasive accounts of changes in institutions, attitudes and social values — that they have had no time, or inclination, to concern themselves with the imperfections of their accomplishments. True, national development efforts and international development assistance have been successful, and, in the face of formidable obstacles, successful beyond all reasonable expectations: unprecedented population growth rates notwithstanding, a growth in per capita GNP of some 2½% or better is a remarkable achievement. But unfortunately it is equally true that the achievements of the last twenty years do not form a solid foundation for further and faster advances from now on — because of the uneven distribution of the benefits of economic growth, which has adversely affected the social and political cohesiveness of many countries and made them more prone to interruptions of economic progress through social upheaval and political turmoil.

## II.

Against this background of facts and impressions, three sets of questions may be posed. One is: what are the causes of the inequalities in income in developing countries? The second: why has little or nothing been done to date to mitigate the inequalities? And the third: what, if anything, can be done about them?

The aim of this paper is to provide some tentative answers to the third question. But before doing so, a few comments on the first two seem in order. The causes of income inequality have been dealt with in a refreshing, imaginative, and comprehensive way by Adelman



and Morris<sup>1</sup>. Because of the complexity of their findings, it would be futile to attempt to summarize them here. Only four remarks which are relevant for a better understanding of the answers given below to the third question seem appropriate.

One is to underline the importance of what Adelman and Morris have called dualism in the structure of the many developing countries: the more pronounced the dualism, i. e., the existence side by side of a technologically and institutionally backward sector and a technologically advanced and well organized modern sector, the greater the incidence of high income inequality. But since the growth of a modern sector is an essential and unavoidable ingredient of the growth process itself, it becomes immediately clear that economic development itself is one of the prime causes, if not the prime cause, of income inequality — just as Kuznets had suggested. Conversely, low growth and low growth potential — i. e., the absence of favorable resource endowment such as mineral deposits or good climatic conditions — are associated with less income inequality.

The second one is to call attention to the close connection between income inequality on the one hand and unemployment and underemployment on the other, and to the rather obvious relation of both income inequality and unemployment/underemployment to social disenchantment and tension. It is unfortunate (though perhaps not surprising) that in recent years the prevalence and the growth of unemployment and underemployment in developing countries has received much attention<sup>2</sup> without, however, bringing out the fact that the lack of employment opportunities is but one of many causes of income inequality. It is doubtful whether the fully employed peasant who is unable to eke out a living for himself and his family from the land he owns or, more likely, rents is better off and less in need of help and attention than underemployed or unemployed casual urban workers<sup>3</sup>.

The third comment is closely related to the second one. The rise in urban unemployment and rural underemployment which has become painfully evident in a large number of developing countries in recent years — although the existence of an oversupply of labor has been con-

<sup>1</sup> Adelman and Morris, *op. cit.*

<sup>2</sup> See for instance, two reports prepared under the auspices of the International Labor Organization: *Toward Full Employment: A Program for Colombia*, Geneva, 1970. — *Matching Employment Opportunities and Expectations: A Program of Action for Ceylon*, Geneva, 1971.

<sup>3</sup> The only reason for focussing on unemployment, rather than on inequality of income (i. e. poverty) may be the fact that unemployment, concentrated in urban areas is politically more dangerous than "simple" poverty.

sidered a structural characteristic of underdevelopment for a long time<sup>1</sup> — has been attributed largely to the increase in the rate of population growth. The rise in the rate of population growth must of course also be considered as a significant cause of the continuing and worsening unevenness of income distribution if, as is presumably the case, the increase in the birth rate is greater among the lower income groups than among the upper which practice birth control. This implies of course that family planning measures are likely to have a favorable impact, not only on the rate of income growth, but also on income distribution.

The fourth cause of inequality which deserves to be singled out — at least as a boon to those of us who have been brought up to believe that knowledge and education are the key to everything — is the rather close relation between education and the level of family income. On general grounds it is of course difficult to establish the direction of the causal relation because there is logic — and empirical evidence — to either of the two assertions that, one, a low level of education, or the absence of any formal education “causes”, or, more cautiously stated, is one of the causes of low income; or, two, low family income is one of the reasons why children do not go to school, or get only a minimum, and an inadequate minimum at that, of education.

As to the reasons why little attention has been paid so far to the problems of income distribution associated with the development process, several admittedly speculative explanations may be advanced. One is the fact that, although most of the intellectual and political leaders and proponents of development would readily embrace the proposition that the objective of development is to enhance human welfare, the aim of their “operational” concept of development is more output, preferably industrial output. The measure of their success is not the reduction of poverty, but a high growth rate of the national product. This essentially Victorian concept of development — or progress as it was called then — has been reinforced by the advice and guidance of the “development economists” of the rich countries who have brought their neo-classical professional training to bear on the problem of economic development. They understand the functioning of the price and market mechanism and can readily explain why in the conditions prevailing in developing countries the scarcity of entrepreneurial talent and professional skills makes the entrepreneur and the professional the chief beneficiary of the fruits of economic advancement, while the abundance of unskilled workers and peasants prevents their income from rising to any significant extent.

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<sup>1</sup> W. Arthur Lewis, “Economic Development with Unlimited Supplies of Labour”, *The Manchester School of Economic and Social Studies*, Vol. XXII, 1954, pp. 139 sqq.

More recently, intellectual leadership has been assumed by the builders of growth models who with mechanical precision apply a set of allegedly causal relations to any economy — on request or at their own initiative. The models then “prove” what has been assumed in their construction in the first place: that growth is faster if consumption does not grow, or grows only slowly, and that external accounts can be brought into balance more rapidly than otherwise would be the case if real wages in the export sector can be kept low.

This rather simplistic account of the essential features of growth models is only in part facetious. Its purpose is not to show that they are inevitably useless (although I would argue that in many instances their usefulness has been greatly exaggerated), but to point out that virtually without exception they do not concern themselves with the problems of income distribution as such, and their general emphasis on the importance of a rising savings function gives them if anything a bias in favor of an uneven income distribution.

Two standard policy prescriptions resulting from the mutual reinforcement of the mechanics of growth models and the politics of least resistance of the political leaders are an increase in the share of the public sector in the gross product through higher taxes and policies of import substitution. The increase in taxation can of course lead, as the experience of a number of advanced countries show, to a reduction in income inequality. But in the reality of the developing countries where institutions and the structure of political power effectively stand in the way of progressive taxation, increased taxes often mean in effect a more than proportionate reduction in the income of the lower and middle income groups. Conceptually, this accentuation of income inequality can be offset by a distribution of the benefits of public expenditure in favor of the lower and middle income groups; but in practice the need to allocate a large share of public expenditures for the support of the “dynamic” modern sector of the economy through the financing of economic overhead investment makes this difficult if not impossible<sup>1</sup>.

Moreover, the policy of import substitution, offering incentives for industrial production through protection — though perhaps justified as an inevitable phase of the process of development — is bound to impose additional burdens on the members of the lower and middle income groups, especially those whose income is derived from wages or self-employment (in agriculture) in the export sector.

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<sup>1</sup> Stanley Please, “Saving Through Taxation — Reality or Mirage?” *Finance and Development*, Vol. IV, Washington, D. C., 1967, pp. 24 sqq.

## III.

The preceding reference to the structure of the fiscal system — both on the receipts and on the expenditure side — and to the income effects of industrial protection leads directly to the last and main part of this paper, which addresses itself to the question: what can be done to mitigate the income inequalities and their deleterious effects on social stability in the developing countries?

For a number of reasons — and to nobody's surprise — the answer to this question is not easy. There is no single straight-forward answer. Although the phenomenon of income inequality which in some sense of social justice and humanitarian concern is excessive and virtually universal in the Third World, the constellation of circumstances, the social structure, and especially the locus of poverty, differ so widely from country to country that it is difficult to come up with a generally meaningful and operationally useful answer. For example, it is "generally true" that the per capita income in rural areas is lower than in urban areas; from this "generally true" observation it seems to follow that measures to raise agricultural income would automatically help to mitigate the rural-urban inequality of income. But it is also "generally true" that commercial farmers and rural landlords belong frequently to the highest income groups which because of the source of their income pay little or no taxes. Thus it would for instance be a mistake to attempt to alleviate rural poverty through tax relief or production subsidies on agricultural production — because it may well be that the rich rather than the destitute farmers would reap most of the benefits of such measures.

By the same token, it may be agreed that in many countries the redistribution of land would go a long way toward alleviating rural poverty; recently the general case for land reform has been strengthened by evidence that smaller holdings are by and large more intensively cultivated than larger ones and, given the abundant supply of rural labor, total production is likely to increase by a redistribution of land. However, differences in soil fertility, climatic conditions, production techniques, and a host of other relevant factors, make it virtually impossible to determine, in general terms, what the best pattern of land distribution should be and what rules and regulations have to be built into a system of land reform to prevent an open, or clandestine, reversion to the system of inequality. Every case is *sui generis*, and for every case new rules have to be developed.

These two examples, which could be supplemented by many more should suffice to bring out the diversity of the difficulties which beset any attempt to devise policies, or, more humbly, to take measures to

alleviate the unevenness of income distribution. But these difficulties notwithstanding, it is, I believe, possible to advance some general suggestions which are close enough to the practical issues of economic policy to form the basis for specific and concrete measures.

At this point a simple distinction may be useful. The problem of income inequality can be approached either at the macro-economic level by policies affecting the economy as a whole; or it can be dealt with at the micro-level, on a case-by-case basis, in the selection, evaluation and execution of individual development projects. This distinction is useful not only as an expositional device; its importance derives from the fact that a frontal attack on uneven income distribution by broad measures of economic policy is not likely except in a revolutionary situation. For in most countries the structure of income distribution is of course associated with the social structure which in turn determines the structure of political power. Therefore any attempt to bring about changes in the distribution of income is bound to run up against economically and politically powerful groups, even in countries in which the need for reforms to improve social justice is widely recognized. Resistance to reforms is likely to be stronger, and more effective, if the initiative toward policy changes comes from abroad, from foreign observers, or advisers, or from national or international sources of development finance. Therefore a strategy, or at least an initial strategy, of "nibbling" at the problems of income distribution through the direction of financial and technical assistance, subjects in which external bodies have considerable discretion may be more successful than advice on general policies giving preference to the economic advancements of the lower income groups.

As a first step, which involves research and intelligence rather than explicit policy advice and guidance, it should be possible to collect, analyze and publish data which measure and compare for a number of countries the rate of growth of income of the lower half (or the lowest third, or 40%) of the population. Information of this sort would constitute a salutary beginning in the move away from the preoccupation with aggregate growth — the international pastime of growthmanship — and substitute for it the more meaningful idea of growth with social justice. A comparison between rates of aggregate growth and growth of income of the lower income groups, defined in some consistent way, would show of course which country deserves a "premium rating" for its growth performance because the income of the low income groups (or sectors, or regions) was faster than the national average and which country's growth performance should be discounted for having been associated with a deterioration of the pattern of income distribution. Such a comparison would also drive home better than any other method the importance of what should be, or at

any rate should become, a basic rule of development policy, i. e., that as a minimum the existing distribution of income must not be allowed to deteriorate, and that every effort should be made to improve it.

I realize that the comparison between national growth rates and growth rates of the income of lower income groups raises a host of issues in welfare economics to which the answers are difficult and essentially inconclusive. For example: is it "better," in some objective way, to have a period of sustained economic growth during which per capita *national* income grows at 3% per year, and per capita income of the lower income groups at 4%, or a growth pattern in which the national average rate of growth is 7%, but the average of the lower income groups only 5%? Is a high growth rate of the income of the lower income groups more important than the deterioration of the pattern of income distribution which accompanies it (in the second example)? Or is it preferable to achieve a better income distribution with a growth rate, as illustrated in the first example? If I confess that I do not know, I am in good (and large) company — of the great majority of welfare economists. However, I have the feeling that the juxtaposition of the two growth patterns of a high growth rate with a low social justice performance and of a lower growth rate with a high social justice accomplishment, which implies the existence of a measurable trade-off, is in reality hardly ever the way in which the problem poses itself.

A more realistic and more practical way to put the question is to ask: could the higher national growth rate have been achieved without a deterioration in the income distribution? and what can be done to maintain the growth rate while at the same time correcting the distribution of income? In other words, it is doubtful whether the idea of a conscious choice among various combinations of income growth and income distribution is useful and whether the notion of a trade-off, while logically unassailable, has any operational significance. This implies that there is little or no connection between the pattern of income distribution and the rate of growth — a proposition which I suggest can be demonstrated as essentially correct<sup>1</sup>. If it is assumed that in developing countries the rate of private capital formation is favorably affected by a high degree of unevenness of income distribution (because the consumption levels of the poor are simply too low to expect them to save any part of their income), and if it is assumed further that public capital formation cannot adequately compensate for a reduction in private capital formation, except in a fully socialist economy in which all savings are "forced" — then

<sup>1</sup> William Cline, *Potential Effects of Income Redistribution on Economic Growth — Latin American Cases*, New York, 1972, *passim*.

the assertion that there is no direct relation between income growth and income distribution also implies that the rate of growth is determined not only by the rate of capital formation, but also by the supply of all other factors such as skill, work incentive and the prospects of economic and social rewards for special efforts. There is of course ample evidence in the analysis of the growth of the advanced countries<sup>1</sup> of the importance of these "other" factors to the growth performance, and the thesis that this is equally true in developing countries is at least a defensible and testable hypothesis.

But to return from the rather slippery road of welfare economics and speculations on the ultimate determinants of economic growth to the subject at hand: it follows from the short comments about the causes of income inequality that the chances are good that social justice objectives can be successfully pursued by public concern with, and public expenditures for, rural development, education, and the elimination of urban unemployment.

The suggestion that economic growth of the agricultural sector should receive increasing attention is based on ample evidence that in virtually all countries for which data are available, the average per capita income in the rural sector is significantly below the national average and that a very high proportion of the lower income groups consists of peasants. Moreover, data on income distribution are likely to underestimate the "welfare gap" between the rural poor and the by and large better off urban population, because income distribution data fail to take into account the scarcity of free public services — in education, public health, and medical services — in rural areas compared with the availability of such services in urban centers. The experience of the last twenty years has shown that the stimulation of agricultural development is difficult and costly — difficult because it requires a variety of services and institutional arrangements such as technical assistance through extension services, credit facilities and institutional changes in the supply of agricultural inputs and in marketing; and costly because the recurrent expenditures of providing these services are in most cases higher than initial capital expenditures which are more likely to become available through foreign aid or foreign loans than financial support of recurrent expenditures. Nevertheless, the breakthrough achieved in the development of seed varieties adapted to the climatic conditions of many developing countries and the prospects that the benefits of this "green revolution" can be adapted

<sup>1</sup> See Edward F. Denison, *Why Growth Rates Differ: Postwar Experience in Nine Western Countries*, Assisted by Jean-Pierre Poulhier, Washington, D. C., 1967, esp. Chaps. 5—9, 14, 19. — *Idem*, *The Sources of Economic Growth in the United States and the Alternatives Before Us*, Committee for Economic Development, Supplementary Paper, No. 13, New York, 1962.

and extended to meet the requirements of other countries open up the possibility that the lag in rural development which seems to be virtually universal and one of the main causes of the growing inequality between rural and urban income can be eliminated<sup>1</sup>.

In many countries the support of agriculture will especially require two sets of measures: one, a more even distribution of land and, two, rural public works to absorb some of the rural underemployment. But even without tackling the politically and administratively difficult tasks of land reform and rural public works, much can be accomplished simply by directing a larger share of development expenditures (which must include current as well as capital expenditures) into agriculture. A study of one of my colleagues at the World Bank<sup>2</sup> indicates rather conclusively that agricultural development projects, especially in the form of agricultural credit schemes, irrigation works, and mixed schemes, involving land clearance, the provision of improved seeds or nursery stock, storage facilities, and above all, much extension service, will go a long way toward the elimination of income inequalities. Preliminary results of the study show that in the case of 42 out of the 53 projects investigated the income of the beneficiaries was below the national per capita income when the project was undertaken; after completion of the project the number was expected to be reduced to 33. More significantly, the median income of the beneficiaries of all projects was expected to increase from 40% of the national average to 63%, and, incidentally, from 72% of the national average farm income to 165%. The last two figures indicate that these projects were selected without explicit regard to their income distribution effects. It is obvious that a conscious effort in the selection of projects to the distribution of income would have brought even better results in that respect.

Turning now to the provision of educational services as a means of attacking one of the apparently prime causes of the unevenness of income distribution, it is clear that considerations of income distribution indicate that rural primary education should receive highest priority, to be followed by the provision of education and training at the secondary level for the staff of agricultural extension services, and perhaps by non-formal adult education, aimed at the rural population. This suggestion runs

<sup>1</sup> There is on the other hand the distinct possibility that the "green revolution" will at least temporarily lead to a deterioration of the income distribution within the rural sector. There is already evidence in some countries that the richer farmers gain more readily access to the "miracle" seeds and the inputs that go with it than the poor peasants.

<sup>2</sup> Hans A. Adler, *The Impact of Agricultural Projects on Income Distribution*, IBRD Internal Memorandum, November, 1971.



counter to the preference which in recent years development economists and educational experts have given to secondary education and vocational training. This preference is a secondary reflection of the preoccupation of the development economists with output, irrespective of income distribution. There is no need to throw it overboard, but to balance it off, in terms of overall budgetary allocation, with increased expenditures for primary education in rural areas.

The third avenue of a direct attack on the unevenness of income distribution is a policy to alleviate urban unemployment, in most countries not only one of the major causes of poverty and misery but also a significant focal point of social tension and political dissatisfaction, especially if not only the urban poor but also members of the educated middle class are unemployed. Development economists have argued that the chief means of curbing urban unemployment must be the expansion of industrial production, if necessary through the persistent pursuit of import substitution policies. This argument overlooks one important drawback: import substitution policies, if they involve articles of mass consumption, might lead to a deterioration of the distribution of real income. More recently the expansion of industrial production for export is being promoted chiefly for the purpose of improving the balance of payments; but its employment creating effects are also emphasized. The promotion of export industries is of course preferable, on grounds of self-enforcing efficiency, to self-perpetuating import substitution. But in view of the almost insurmountable obstacles in the world markets to a rapid expansion of industrial exports of developing countries and the likelihood that only a few of them will be able to break through the barriers of protection and commercial inexperience, the growth of industrial exports can be relied upon at best as making only a small contribution to solving the problem of urban unemployment. For these reasons one of the major remedial measures of unemployment in developed countries, the provision of public housing, should also have a place, and perhaps an important place, in the economic policies of developing countries — provided architects and construction technologists come up with a revision of their ideas as to what constitutes minimum standards of housing for the lower income groups in developing countries.

However, irrespective of the specific measures, or combination of measures that are taken to alleviate the unevenness of income distribution, it should be clear that they should not involve outright redistributive measures which would be reflected in the price level. For example, price support schemes for agricultural products for the domestic or the export market for the purpose of increasing farm income, the common method of income equalization in the advanced countries, or the introduc-

tion of maximum prices for staple products to keep down the cost of living of the urban population should be avoided because of the effects of the resulting price distortions on the supply and the demand of the controlled products. On the other hand, there is a case for intervening in the price mechanism if the purpose of such an intervention is the stimulation of supply or demand, or the reduction of supply or demand for a limited, or perhaps even for a prolonged, period provided the income distribution effects of such measures are realized.

#### IV.

In the preceding section the suggestion has been advanced that the distribution of income can be influenced by the selection and preparation of specific development projects. The purpose of this final section of this paper is to propose the outlines of a method, or a set of methods, by which this can be done.

The simplest and in some sense most radical method is to base the selection of development projects not on the size of the *total* net social return (or total net benefits), but on that part of total returns that accrues to beneficiaries below a certain income level. Whether this approach is easy or difficult depends on the characteristics of the project. In the case of an irrigation project, for example, the evaluation of the project should not be based on the increase in income of all beneficiaries but only of the beneficiaries below a certain income level. Since usually much is known about the distribution of land that can be brought under irrigation and presumably there exists a close correlation between the size of holdings and farm income, the distinction between rich and poor farmers should not be too difficult to establish. If the suggested criterion is applied, the selection would be "warped" in favor of the lower income groups, as against the use of the available water resources for other projects with fewer poor beneficiaries. If it turns out, however, that for technical reasons such as topography or soil characteristics it is reasonable to include a large area of farm land owned by rich farmers and landlords, then the project should be undertaken only if provisions for its financing are combined with provisions for the distribution of lands, or, as a minimum, for the regulation of the land rent so as to assure the tenants of most of the benefits of the project.

In the case of industrial projects, to follow the suggestion to exclude from the evaluation the benefits of beneficiaries over and above a certain income level would in most cases mean that profits would be disregarded; and two other types of benefits would become more important. One is the increase in wage income associated with the project, assuming that workers

would not be bid away from other employment. This type of benefit is itself reflected in the net social return if shadow wages are introduced in the appraisal. The introduction of the increase in workers' income on account of employment in the proposed project is usually done as a reduction of cost, but it can of course be added with the same result on the benefit side. The second modification would be to take account of the increases in the wage bill in the sectors supplying inputs to the new industry previously not produced, or, more generally to include on the benefit side those additions to the income of the lower income groups associated with the project. For example, in the case of a fruit or vegetable cannery, the increased income of poor farmers supplying the fruit or vegetable should be considered a benefit<sup>1</sup>.

An alternative method of taking income distribution effects into account in the evaluation of projects would be to give different weights to the benefits accruing to different income groups and to determine total net benefits and the rate of social return on that basis. This would of course be a practical application of the concept of diminishing marginal utility of income to project evaluation. It could be argued that giving different weights to income at different levels would be less arbitrary than the use of the unweighted total of additional net income which is of course the essence of standard cost/benefit analysis.

A further modification of the second method would be to weigh benefits not by income groups but to use as a basis of distinguishing different groups of income recipients, geographic regions, or sectors, with weights reflecting differences in income among the various regions or sectors.

Finally, improvements in the distribution of income can be achieved by applying shadow cost significantly below money cost to determine the social cost of employing members of the low income groups — which for practical purposes would be the urban unemployed and the rural underemployed — and to use the social cost in the choice of technology in the physical construction of projects. The application of this method would of course result in the more extensive use of labor as against capital equipment wherever there is a technological possibility of such a substitu-

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<sup>1</sup> I am somewhat at a loss regarding the treatment of cost reductions of consumption goods generally purchased by the poor. Prima facie it makes sense to count the cost reductions accruing to the poor as a benefit, but I can envisage a number of complexities in concept and in practice which I am not sure can be sorted out on general grounds. (For example, the production of cheap footwear may lead to consumer benefits on the one hand but because of high profits to a deterioration of income distribution on the other; in that case the problem of a trade-off between an absolute increase in the net income of the poor and a deterioration of the distribution of income arises.)

tion. It must be realized, however, that this would increase the money cost of investment (by the difference of shadow wages and money wages) and that this difference should not be included in the capital cost of the project (and should be passed on the consumers of public facilities if a policy of full cost pricing is applied) but should be absorbed by the fiscal authorities as an exhaustive expenditure, similar to the cost of other welfare expenditures.

I fully realize that the preceding suggestions for the application of income distribution considerations are bound to run into all kinds of conceptual and practical difficulties. These difficulties should not, however, be considered as insurmountable, because even their rough and ready application would make a significant contribution to the solution of one of the major problems of development for which so far a solution seems to have eluded the development economists and the practitioners of development policy. After all, it must be remembered that the objective of development is not simply the increase in per capita income but the elimination or at least mitigation of poverty and human misery.

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Zusammenfassung: Entwicklung und Einkommensverteilung. — Wegen der ungleichen Einkommensverteilung in unterentwickelten Ländern können besonders drei Fragen gestellt werden: 1. Was sind die Ursachen der Ungleichheiten im Einkommen in Entwicklungsländern? 2. Warum wurde bis jetzt so wenig oder nichts getan, um die Ungleichheiten abzumildern? 3. Was, wenn überhaupt, kann in dieser Hinsicht getan werden? Der Verfasser kommentiert die beiden ersten Fragen, aber der Hauptzweck der vorliegenden Abhandlung besteht darin, einige vorläufige Antworten auf die dritte normative Frage zu geben. Er äußert die Vermutung, daß die Verteilung der Einkommen durch die Auswahl und Vorbereitung besonderer Entwicklungsprojekte beeinflußt werden könne, und skizziert die Umrisse von Methoden, mit denen dies bewerkstelligt werden kann.

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Résumé: Développement et distribution du revenu. — Vu la distribution inégale du revenu dans les pays à développer, on peut poser trois questions en particulier: 1. Quelles sont les causes des inégalités de revenu dans les pays à développer? 2. Pourquoi n'a-t-on, jusqu'à présent, rien fait, ou en tout cas très peu, pour mitiger ces inégalités? 3. Y a-t-il quelque chose — et quoi? — qu'on pourrait y faire? L'auteur fait quelques remarques à propos des deux premières questions, mais c'est son but principal de donner quelques réponses tentatives à la troisième question normative. Il suggère qu'on pourrait exercer une influence sur la distribution du revenu en choisissant et préparant des projets spéciaux de développement, et il donne l'ébauche des méthodes avec lesquelles cela pourrait se faire.

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Resumen: Desarrollo y distribución del ingreso. — En vista de la distribución desigual del ingreso en países subdesarrollados cabe preguntar, entre otras cosas, (1) ¿cuáles son las razones de las desigualdades en el ingreso en países en desarrollo? (2) ¿por qué se ha hecho hasta el momento tan poco o nada para reducir dichas desigualdades? (3) ¿qué se puede hacer realmente? El autor comenta las dos primeras preguntas, pero el objetivo principal del presente trabajo consiste en dar algunas contestaciones preliminares a la tercera pregunta. Opina que se podría influenciar la distribución del ingreso a través de la selección y preparación de proyectos especiales de desarrollo, y diseña los métodos que se prestarían a llevar ésto a cabo.

Riassunto: Sviluppo e distribuzione dei redditi. — A causa della disuguale distribuzione dei redditi nei Paesi in via di sviluppo, tre questioni possono essere specialmente poste: 1. Quali sono le cause delle disuguaglianze nel reddito nei Paesi in via di sviluppo? 2. Perché fino ad ora è stato fatto così poco o niente per attenuare le disuguaglianze? 3. Che cosa può essere fatto, se mai, sotto questo riguardo? L'autore commenta le prime due questioni, ma lo scopo principale del presente saggio consiste in questo, di dare alcune risposte provvisorie alla terza questione normativa. L'autore esprime l'ipotesi che mediante la scelta e la preparazione di speciali progetti di sviluppo possa essere influenzata la distribuzione del reddito e schizza le linee di metodi con cui ciò può essere realizzato.

DEVELOPMENT AND INCOME DISTRIBUTION

John H. Adler\*

I

In a paper published in 1955 which was, in his words, "5 per cent empirical information and 95 per cent speculation" and which bears -- in spite or because of its speculative character -- the marks of prophetic insight, Simon Kuznets advanced the proposition that "in the early phases of industrialization in the underdeveloped countries income inequalities will tend to widen before the leveling forces become strong enough first to stabilize and then reduce income inequalities." He then answered in the negative the question "Can the political framework of the underdeveloped societies withstand the strain which further widening of income inequality is likely to generate?"<sup>1/</sup>

Since 1955, ample evidence has accumulated to bear out Kuznets' "speculation" that in the developing countries inequalities in income distribution are greater than they were in the industrialized countries before the trend toward growing inequalities was reversed -- in some countries before the turn of the century, in others not until after the first World War -- and that they have become more pronounced in most though perhaps not in all countries.<sup>2/</sup>

What has come as a rather shocking surprise, however, is the extent of the inequality and the low absolute level of per capita income of the poorest quintile of the population. In 21 out of a total of 40

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\* The views expressed in this paper are those of the author and not necessarily of the International Bank for Reconstruction and Development with which he is associated.



developing countries for which data are available, the average per capita income of the poorest 20% of the population is less than 28% of the national average.<sup>3/</sup> That means that not only in the "hard core" least developed countries which have been singled out in various resolutions of the United Nations bodies<sup>4/</sup> for special consideration, the per capita income of the majority of the population is abysmally low (and therefore perennially in danger of falling below the threshold of physical needs); but that in a number of countries in which the national average per capita income has reached a level substantially above the bench mark of say, \$100, such as Brazil, Colombia, El Salvador, Jamaica, Lebanon, Mexico, Panama, Peru, and Tunisia, a substantial proportion of the population still has a per capita income below that international "poverty line."

There is another group of countries in which the low per capita income of the poorest quintile -- or for that matter of the poorer half -- of the population is a matter of special concern on humanitarian grounds and, in policy terms, of urgency. This group includes India and Pakistan in Asia and some of the major countries of Africa such as Kenya, Nigeria, and Tanzania. In these countries the relative share in the national income of the poorest quintile of the population is significantly higher than that in the first group, between 7% and 10%; but because of the low national average, the absolute amount is so low that it is clear that minimum requirements of caloric intake and nutritional balance are not met. According to the data, the per capita income of some 110 million Indians

is \$38 compared with a national average of \$100; in Pakistan, the poorest 20% of the population -- some 22 million -- "enjoy" a per capita income of \$36; and so on.

These figures are the more disconcerting since the experience of the last twenty years has shown that it is virtually impossible in developing countries to mitigate the plight of the lower income groups by redistributive fiscal operations. For a variety of reasons, of which the low national per capita income itself is presumably the most important one, efforts aiming at redistribution for the benefit of the poor do not work. Moreover, there is evidence which suggests that in the great majority of developing countries the benefits of economic development accrue chiefly to the upper income groups -- the highest 20% or 40% of the population -- and that in some countries the poorest 20% or even a larger percentile do not participate in the process of economic advancement at all.

This state of affairs is in sharp contrast with the fundamental objectives of economic development -- the diminution of poverty and human misery. It is, I suggest, indicative of the direction in which development theory and development policy has been moving -- wandering may be a better term than moving -- that it has become necessary to recall their basic aims. In the preoccupation with the means of development -- to raise the rate of savings and investment, to achieve viability in the international accounts, to move from externally supported to self-sustained growth -- sight has been lost of its ends. And the advocates



and promoters of development and development aid have been so busy defending their cause against its detractors and proving its success -- by impressive aggregate statistics and persuasive accounts of changes in institutions, attitudes and social values -- that they had no time, or inclination, to concern themselves with the imperfections of their accomplishments. True, national development efforts and international development assistance have been successful, and in the face of formidable obstacles, successful beyond all reasonable expectations: unprecedented population growth rates notwithstanding, a growth in per capita GNP of some 2-1/2% or better is a remarkable achievement. But unfortunately it is equally true that the achievements of the last twenty years do not form a solid foundation for further and faster advances from now on -- because of the uneven distribution of the benefits of economic growth, which has adversely affected the social and political cohesiveness of many countries and made them more prone to interruptions of economic progress through social upheaval and political turmoil.

## II

Against this background of facts and impressions, three sets of questions may be posed. One is: what are the causes of the inequalities in income in developing countries? The second: why has so far little or nothing been done to mitigate the inequalities? And the third: what if anything can be done about them?

The aim of this paper is to provide some tentative answers to the third normative question. But before doing so, a few comments on the

first two seem in order. The causes of income inequality have been dealt with in a refreshing, imaginative, and comprehensive way by Adelman and Morris.<sup>2/</sup> Because of the complexity of their findings, it would be futile to attempt to summarize them here. Only four remarks which are relevant for a better understanding of the answers given below to the third question seem appropriate.

One is to underline the importance of what Adelman and Morris have called dualism in the structure of the many developing countries: the more pronounced the dualism, i.e., the existence side by side of a technologically and institutionally backward sector and a technologically advanced and well organized modern sector, the greater the incidence of high income inequality. But since the growth of a modern sector is an essential and unavoidable ingredient of the growth process itself, it becomes immediately clear that economic development itself is one of the prime causes, if not the prime cause, of income inequality -- just as Kuznets had suggested. Conversely, low growth and low growth potential -- i.e., the absence of favorable resource endowment such as mineral deposits or good climatic conditions -- are associated with less income inequality.

The second one is to call attention to the close connection between income inequality on the one hand and unemployment and underemployment on the other, and to the rather obvious relation of both income inequality and unemployment/underemployment to social disenchantment and tension. It is unfortunate (though perhaps not surprising) that in recent years the prevalence and the growth of unemployment and underemployment in

developing countries has received much attention<sup>5/</sup> without, however, bringing out the fact that the lack of employment opportunities is but one of many causes of income inequality. It is doubtful whether the fully employed peasant who is unable to eke out a living for himself and his family from the land he owns or, more likely, rents is better off and less in need of help and attention than the underemployed or unemployed casual urban workers.<sup>6/</sup>

The third comment is closely related to the second one. The rise in urban unemployment and rural underemployment which has become painfully evident in a large number of developing countries in recent years -- although the existence to an oversupply of labor has been considered a structural characteristic of underdevelopment for a long time<sup>7/</sup> -- has been attributed largely to the increase in the rate of population growth. The rise in the rate of population growth must of course also be considered as a significant cause of the continuing and worsening unevenness of income distribution if it is assumed, presumably with ample justification, that the increase in the birth rate is greater among the lower income groups than among the upper which practice birth control. This implies of course that family planning measures are likely to have a favorable impact, not only on the rate of income growth, but also on income distribution.

The fourth cause of inequality which deserves to be singled out -- at least as a boon to those of us who have been brought up to believe that knowledge and education are the key to everything -- is the rather close relation between education and the level of family income. On general grounds it is of course difficult to establish the direction of the

causal relation because there is logic -- and empirical evidence -- to either of the two assertions that, one, a low level of education, or the absence of any formal education "causes," or, more cautiously stated, is one of the causes of low income; or, two, low family income is one of the reasons why children do not go to school, or get only a minimum, and an inadequate minimum at that, of education.

As to the reasons why little attention has been paid so far to the problems of income distribution associated with the development process, several admittedly speculative explanations may be advanced. One is the fact that although most of the intellectual and political leaders and proponents of development would readily embrace the proposition that the objective of development is to enhance human welfare, the aim of their "operational" concept of development is more output, preferably industrial output. The measure of their success is not the reduction of poverty, but a high growth rate of the national product. This essentially Victorian concept of development -- or progress as it was called then -- has been re-inforced by the advice and guidance of the "development economists" of the rich countries who have brought their neo-classical professional training to bear on the problem of economic development. They understand the functioning of the price and market mechanism and can readily explain why in the conditions prevailing in developing countries the scarcity of entrepreneurial talent and of professional skills make the entrepreneur and the professional the chief beneficiary of the fruits of economic advancement, while the abundance of unskilled workers and peasants prevents their income from rising to any significant extent.

More recently, intellectual leadership has been assumed by the builders of growth models who with mechanical precision apply a set of allegedly causal relations to any economy -- on request or at their own initiative. The models then "prove" what has been assumed in their construction in the first place: that growth is faster if consumption does not grow, or grows only slowly, and that external accounts can be brought into balance more rapidly than otherwise would be the case if real wages in the export sector can be kept low.

This rather simplistic account of the essential features of growth models is only in part facetious. Its purpose is not to show that they are inevitably useless (although I would argue that in many instances their usefulness has been greatly exaggerated), but to point out that virtually without exception they do not concern themselves with the problems of income distribution as such, and their general emphasis on the importance of a rising savings function gives them if anything a bias in favor of an uneven income distribution.

Two standard policy prescriptions resulting from the mutual reinforcement of the mechanics of growth models and the politics of least resistance of the political leaders are an increase in the share of the public sector in the gross product through higher taxes and policies of import substitution. The increase in taxation can of course lead, as the experience of a number of advanced countries show, to a reduction in income inequality. But in the reality of the developing countries where institutions and the structure of political power effectively stand in the way of progressive taxation, increased taxes means in effect a more

than proportionate reduction in the income of the lower and middle income groups. Conceptually, this accentuation of income inequality can be offset by a distribution of the benefits of public expenditure in favor of the lower and middle income groups; but in practice the need to allocate a large share of public expenditures for the support of the "dynamic" modern sector of the economy through the financing of economic overhead investment makes this virtually impossible.<sup>8/</sup>

Moreover, the policy of import substitution, offering incentives for industrial production through protection -- though perhaps justified as an inevitable phase of the process of development -- is bound to impose additional burdens on the members of the lower and middle income groups, especially those whose income is derived from wages or self-employment in the export sector.

### III

The preceding reference to the structure of the fiscal system -- both on the receipts and on the expenditure side -- and to the income effects of industrial protection leads directly to the last and main part of this paper, which addresses itself to the question: what can be done to mitigate the income inequalities and their deleterious effects on social stability in the developing countries?

For a number of reasons -- and to nobody's surprise -- the answer to this question is not easy. There is no single straight-forward answer. Although the phenomenon of income inequality which in some sense of social justice and humanitarian concern is excessive and virtually universal in

the Third World, the constellation of circumstances, the social structure, and especially the locus of poverty, differ so widely from country to country that it is difficult to come up with a generally meaningful and operationally useful answer. For example, it is "generally true" that the per capita income in rural areas is lower than in urban areas; from this "generally true" observation it seems to follow that measures to raise agricultural income would automatically help to mitigate the rural-urban inequality of income. But it is also "generally true" that commercial farmers and rural landlords belong frequently to the highest income groups which because of the source of their income pay little or no taxes. Thus it would for instance be a mistake to attempt to alleviate rural poverty through tax relief or production subsidies on agricultural production -- because it may well be that the rich rather than the destitute farmers would reap most of the benefits of such measures.

By the same token, it may be agreed that in many countries the redistribution of land would go a long way toward alleviating rural poverty; recently the general case for land reform has been strengthened by evidence that smaller holdings are by and large more intensively cultivated than larger ones and, given the abundant supply of rural labor, total production is likely to increase by a redistribution of land. However, differences in soil fertility, climatic conditions, production techniques, and a host of other relevant factors, make it virtually impossible to determine, in general terms, what the best pattern of land distribution should be and what rules and regulations have to be built into a system of land reform to prevent an open, or clandestine, reversion to the system

of inequality. Every case is sui generis, and for every case new rules have to be developed.

These two examples, which could be supplemented by many more, should suffice to bring out the diversity of the difficulties which beset any attempt to devise policies, or, more humbly, to take measures to alleviate the unevenness of income distribution. But these difficulties notwithstanding, it is, I believe, possible to advance some general suggestions which are close enough to the practical issues of economic policy to form the basis for specific and concrete measures.

At this point a simple distinction may be useful. The problem of income inequality can be approached either at the macro-economic level by policies affecting the economy as a whole; or it can be dealt with at the micro-level, on a case-by-case basis, in the selection, evaluation and execution of individual development projects. This distinction is useful not only as an expositional device; its importance derives from the fact that a frontal attack on uneven income distribution by broad measures of economic policy is not likely except in a revolutionary situation. For in most countries the structure of income distribution is of course associated with the social structure which in turn determines the structure of political power. Therefore any attempt to bring about changes in the distribution of income is bound to run up against economically and politically powerful groups, even in countries in which the need for reforms to improve social justice is widely recognized. Resistance to reforms is likely to be stronger, and more effective, if the initiative toward policy changes comes from abroad, from foreign observers, or advisers, or from



national or international sources of development finance. Therefore a strategy, or at least an initial strategy, of "nibbling" at the problems of income distribution through the direction of financial and technical assistance, subjects in which external bodies have considerable discretion, may be more successful than advice on general policies giving preference to the economic advancements of the lower income groups.

As a first step, which involves research and intelligence rather than explicit policy advice and guidance, it should be possible to collect, analyze and publish data which measure and compare for a number of countries the rate of growth of income of the lower half (or the lowest third, or 40%) of the population. Information of this sort would constitute a salutary beginning in the move away from the preoccupation with aggregate growth -- the international pastime of growthmanship -- and substitute for it the more meaningful idea of growth with social justice. A comparison between rates of aggregate growth and growth of income of the lower income groups, defined in some consistent way, would show of course which country deserves a "premium rating" for its growth performance because the income of the low income groups (or sectors, or regions) was faster than the national average and which country's growth performance should be discounted for having been associated with a deterioration of the pattern of income distribution. Such a comparison would also drive home better than any other method the importance of what should be, or at any rate should become, a basic rule of development policy, i.e., that as a minimum the existing distribution of income must not be allowed to deteriorate, and that every effort should be made to improve it.

I realize that the comparison between national growth rates and growth rates of the income of lower income groups raises a host of issues in welfare economics to which the answers are difficult and essentially inconclusive. For example: is it "better," in some objective way, to have a period of sustained economic growth during which per capita national income grows at 3% per year, and per capita income of the lower income groups at 4%, or a growth pattern in which the national average rate of growth is 7%, but the average of the lower income groups only 5%? Is a high growth rate of the income of the lower income groups more important than the deterioration of the pattern of income distribution which accompanies it (in the second example)? Or is it preferable to achieve a better income distribution with a growth rate, as illustrated in the first example? If I confess that I do not know, I am in good (and large) company -- of the great majority of welfare economists. However, I have the feeling that the juxtaposition of the two growth patterns of a high growth rate with a low social justice performance and of a lower growth rate with a high social justice accomplishment, which implies the existence of a measurable trade-off, is in reality hardly ever the way in which the problem poses itself.

A more realistic and more practical way to put the question is to ask: could the higher national growth rate have been achieved without a deterioration in the income distribution? and what can be done to maintain the growth rate while at the same time correcting the distribution of income? In other words, it is doubtful whether the idea of a conscious choice among various combinations of income growth and income distribution

is useful and whether the notion of a trade-off, while logically unassailable, has any operational significance. This implies that there is little or no connection between the pattern of income distribution and the rate of growth -- a proposition which I suggest can be demonstrated as essentially correct.<sup>9/</sup> If it is assumed that in developing countries the rate of private capital formation is favorably affected by a high degree of unevenness of income distribution (because the consumption levels of the poor are simply too low to expect them to save any part of their income), and if it is assumed further that public capital formation cannot adequately compensate for a reduction in private capital formation, except in a fully socialist economy in which all savings were "forced" -- then the assertion that there is no direct relation between income growth and income distribution also implies that the rate of growth is determined not only by the rate of capital formation, but also by the supply of all other factors such as skill, work incentive and the prospects of economic and social rewards for special efforts. There is of course ample evidence in the analysis of the growth of the advanced countries<sup>10/</sup> of the importance of these "other" factors to the growth performance, and the thesis that this is equally true in developing countries is at least a defensible and testable hypothesis.

But to return from the rather slippery road of welfare economics and speculations on the ultimate determinants of economic growth to the subject at hand: it follows from the short comments about the causes of income inequality that the chances are good that social justice objectives can be successfully pursued by public concern with, and public

expenditures for, rural development, education, and the elimination of urban unemployment.

The suggestion that economic growth of the agricultural sector should receive increasing attention is of course based on ample evidence that in virtually all countries for which data are available, the average per capita income is significantly below the national average and that a very high proportion of the lower income groups consists of peasants. Moreover, data on income distribution are likely to underestimate the "welfare gap" between the rural poor and the by and large better off urban population, because income distribution data fail to take into account the scarcity of free public services -- in education, public health, and medical services -- in rural areas compared with the availability of such services in urban centers. The experience of the last 20 years has shown that the stimulation of agricultural development is difficult and costly -- difficult because it requires a variety of services and institutional arrangements such as technical assistance through extension services, credit facilities and institutional changes in the supply of agricultural inputs and in marketing; and costly because the recurrent expenditures of providing these services are in most cases higher than initial capital expenditures which are more likely to become available through foreign aid or foreign loans than financial support of recurrent expenditures. Nevertheless, the breakthrough achieved in the development of seed varieties adapted to the climatic conditions of many developing countries and the prospects that the benefits of this "green revolution" can be adapted and extended to meet the requirements of other countries open up the

possibility that the lag in rural development which seems to be virtually universal and one of the main causes of the growing inequality of income distribution can be eliminated.

In many countries the support of agriculture will especially require two sets of measures: one, a more even distribution of land and, two, rural public works to absorb some of the rural underemployment. But even without tackling the politically and administratively difficult tasks of land reform and rural public works, much can be accomplished simply by directing a larger share of development expenditures (which must include current as well as capital expenditures) into agriculture. A study of one of my colleagues at the World Bank<sup>11/</sup> indicates rather conclusively that agricultural development projects, especially in the form of agricultural credit schemes, irrigation works, and mixed schemes, involving land clearance, the provision of improved seeds or nursery stock, storage facilities, and above all, much extension service, will go a long way toward the elimination of income inequalities. Preliminary results of the study show that in the case of 42 out of the 53 projects investigated the income of the beneficiaries was below the national per capita income when the project was undertaken; after completion of the project the number was expected to be reduced to 33. More significantly, the median income of the beneficiaries of all projects was expected to increase from 40% of the national average to 63%, and, incidentally, from 72% of the national average farm income to 165%. The last two figures indicate that these projects were selected without explicit regard to their income distribution effects. It is obvious that a conscious effort

in the selection of projects to the distribution of income would have brought even better results in that respect.

Turning now to the provision of educational services as a means of attacking one of the apparently prime causes of the unevenness of income distribution, it is clear that considerations of income distribution indicate that rural primary education should receive highest priority, to be followed by the provision of education and training at the secondary level for the staff of agricultural extension services, and perhaps by non-formal adult education, aiming at the rural population. This suggestion runs counter to the preference which in recent years development economists and educational experts have given to secondary education and vocational training. This preference is a secondary reflection of the preoccupation of the development economists with output, irrespective of income distribution. There is no need to throw it overboard, but to balance it off, in terms of overall budgetary allocation, with increased expenditures for primary education in rural areas.

The third avenue of a direct attack on the unevenness of income distribution is a policy to alleviate urban unemployment, in most countries not only one of the major causes of poverty and misery but also a significant focal point of social tension and political dissatisfaction, especially if not only the urban poor but also members of the educated middle class are unemployed. Development economists have argued that the chief means of curbing urban unemployment must be the expansion of industrial production, if necessary through the persistent pursuit of import substitution policies. This argument overlooks one important drawback:

import substitution policies, if they involve articles of mass consumption, might lead to a deterioration of the distribution of real income. More recently the expansion of industrial production for export is being promoted chiefly for the purpose of improving the balance of payments; but its employment creating effects are also emphasized. The promotion of export industries is of course preferable, on grounds of self-enforcing efficiency, to self-perpetuating import substitution. But in view of the almost insurmountable obstacles in the world markets to a rapid expansion of industrial exports of developing countries and the likelihood that only a few of them will be able to break through the barriers of protection and commercial inexperience, the growth of industrial exports can be relied upon at best as making only a small contribution to solving the problem of urban unemployment. For these reasons one of the major remedial measures of unemployment in developed countries, the provision of public housing, should also have a place, and perhaps an important place, in the economic policies of developing countries -- provided architects and construction technologists come up with a revision of their ideas as to what constitutes minimum standards of housing for the lower income groups in developing countries.

However, irrespective of the specific measures, or combination of measures that are taken to alleviate the unevenness of income distribution, it should be clear that they should not involve outright redistributive measures which would be reflected in the price level. For example price support schemes for agricultural products for the domestic or the export market for the purpose of increasing farm income, the common method

of income equalization in the advanced countries, or the introduction of maximum prices for staple products to keep down the cost of living of the urban population should be avoided because of the effects of the resulting price distortions on the supply and the demand of the controlled products. On the other hand, there is a case for intervening in the price mechanism if the purpose of such an intervention is the stimulation of supply or demand, or the reduction of supply or demand for a limited, or perhaps even for a prolonged, period provided the income distribution effects of such measures are realized.

#### IV

In the preceding section the suggestion has been advanced that the distribution of income can be influenced by the selection and preparation of specific development projects. The purpose of this final section of this paper is to propose the outlines of a method, or a set of methods, by which this can be done.

The simplest and in some sense most radical method is to base the selection of development projects not on the size of the total net social return (or total net benefits), but on that part of total returns that accrues to beneficiaries below a certain income level. Whether this approach is easy or difficult depends on the characteristics of the project. In the case of an irrigation project for example the evaluation of the project should not be based on the increase in income of all beneficiaries but only of the beneficiaries below a certain income level. Since usually much is known about the distribution of land that can be



brought under irrigation and presumably there exists a close correlation between the size of holdings and farm income, the distinction between rich and poor farmers should not be too difficult to establish. If the suggested criterion is applied, the selection would be "warped" in favor of the lower income groups, as against the use of the available water resources for other projects with fewer poor beneficiaries. If it turns out, however, that for technical reasons such as topography or soil characteristics it is reasonable to include a large area of farm land owned by rich farmers and landlords, then the project should be undertaken only if provisions for its financing are combined with provisions for the distribution of lands, or, as a minimum, for the regulation of the land rent so as to assure the tenants of most of the benefits of the project.

In the case of industrial projects, to follow the suggestion to exclude from the evaluation the benefits of beneficiaries over and above a certain income level would in most cases mean that profits would be disregarded; and two other types of benefits would become more important. One is the increase in wage income associated with the project, assuming that workers would not be bid away from other employment. This type of benefit is itself reflected in the net social return if shadow wages are introduced in the appraisal. The introduction of the increase in workers income on account of employment in the proposed project is usually done as a reduction of cost, but it can of course with the same result be added on the benefit side. The second modification would be to take account of the increases in the wage bill in the sectors supplying inputs to the new industry previously not produced, or, more generally to include

on the benefit side those additions to the income of the lower income groups associated with the project. For example, in the case of a fruit or vegetable cannery, the increased income of poor farmers supplying the fruit or vegetable should be considered a benefit.<sup>12/</sup>

An alternative method of taking income distribution effects into account in the evaluation of projects would be to give different weights to the benefits accruing to different income groups and to determine total net benefits and the rate of social return on that basis. This would of course be a practical application of the concept of diminishing marginal utility of income to project evaluation. It could be argued that giving different weights to income at different levels would be less arbitrary than the use of the unweighted total of additional net income which is of course the essence of standard cost/benefit analysis.

A further modification of the second method would be to weigh benefits not by income groups but <sup>to</sup> use as a basis of distinguishing different groups of income recipients, geographic regions, or sectors, with weights reflecting differences in income among the various regions or sectors.

Finally, improvements in the distribution of income can be achieved by applying shadow cost significantly below money cost to determine the social cost of employing members of the low income groups -- which for practical purposes would be the urban unemployed and the rural underemployed -- and to use the social cost in the choice of technology in the physical construction of projects. The application of this method would of course result in the more extensive use of labor as

against capital equipment wherever there is a technological possibility of such a substitution. It must be realized, however, that this would increase the money cost of investment (by the difference of shadow wages and money wages) and that this difference should not be included in the capital cost of the project (and should be passed on to the consumers of public facilities if a policy of full cost pricing is applied) but should be absorbed by the fiscal authorities as an exhaustive expenditure, similar to the cost of other welfare expenditures.

I fully realize that in the preceding suggestions for the application of income distribution, considerations are bound to run into all kinds of conceptual and practical difficulties. These difficulties should not, however, be considered as insurmountable; because their rough and ready application would make a significant contribution to the solution of one of the major problems of development for which so far a solution seems to have eluded the development economists and the practitioners of development policy. After all, it must be remembered that the objective of development is not simply the increase in per capita income but the elimination or at least mitigation of poverty and human misery.

3/20/72

- 1/ Simon Kuznets, "Economic Growth and Income Inequality" in American Economic Review, Volume XLV, No. 1 (March 1955), pp. 1-28, esp. pp. 24 and 25.
- 2/ Data on income distribution have in recent years become available for a surprisingly large number of developing countries; although for most countries their reliability is rather uncertain, especially since in many instances their coverage is limited, and their comparability is highly questionable. The most comprehensive data are given in I. Adelman and C. Morris, An Anatomy of Patterns of Income Distribution in Developing Nations. Report prepared for U.S. AID, February 1971. A short version has been published in Development Digest, Volume IX, No. 4 (October, 1971), pp 24-37.
- 3/ Data given in 2/ cover 44 countries, including Japan, Israel, Rhodesia and South Africa. Of these, 4 countries are excluded -- because Japan and Israel can no longer be considered "developing" in the generally accepted meaning of the term, and because in Rhodesia and South Africa the income distribution may be considered chiefly the result of discriminatory legislation. If the four countries are included, the number in the text become 24 out of 44.
- 4/ U.N. General Assembly Resolution A/RES/2768 (XXVI) of November 22, 1971. The resolution also contains references to other UN resolutions and documents which pertain to the least developed countries.
- 5/ See for instance, two reports prepared under the auspices of the International Labor Organization: Toward Full Employment: A Program for Colombia (Geneva: ILO, 1970); and Matching Employment Opportunities and Expectations: A Program of Action for Ceylon (Geneva: ILO, 1971).
- 6/ The only reason for focussing on unemployment, rather than on inequality of income (i.e. poverty) may be the fact that unemployment, concentrated in urban areas is politically more dangerous than 'simple' poverty.
- 7/ W. Arthur Lewis, "Economic Development with Unlimited Supplies of Labour," Manchester School of Economic and Social Studies. Volume XXII, No. 2 (May, 1954) pp.139-191.
- 8/ Stanley Please, "Saving Through Taxation -- Reality or Mirage?" Finance and Development, Volume IV, No. 1 (March, 1967) pp. 24-32.
- 9/ William Cline, Potential Effects of Income Redistribution on Economic Growth - Latin American Cases, New York; Praeger, 1972. passim
- 10/ See Edward F. Denison, Why Growth Rates Differ: Postwar Experience in Nine Western Countries (Washington: The Brookings Institution, 1967), esp. Chaps. 5-9, 14, 19 and, by the same author, The Sources of Economic Growth in the United States and the Alternatives Before Us. Supplementary Paper No. 13 (New York: Committee for Economic Development, 1962).

11/ Hans A. Adler, The Impact of Agricultural Projects on Income Distribution (IBRD internal memorandum, November, 1971).

12/ I am somewhat at a loss regarding the treatment of cost reductions of consumption goods generally purchased by the poor. Prima facie it makes sense to count the cost reductions accruing to the poor as a benefit, but I can envisage a number of complexities in concept and in practice which I am not sure can be sorted out on general grounds. (For example, the production of cheap footwear may lead to consumer benefits on the one hand but because of high profits to a deterioration of income distribution on the other; in that case the problem of a trade-off between an absolute increase in the net income of the poor and a deterioration of the distribution of income arises).

PRELIMINARY DRAFT

THE POLITICAL ECONOMY OF DEVELOPMENT  
WITH SOCIAL JUSTICE  
by  
John H. Adler<sup>1/</sup>



I. Introduction

The terms which the organizers of this conference have used to describe its subject indicate that they are fully aware of the social and political aspects, as distinct from the economic aspects, of social justice. This is as it should be; social justice -- the just and equitable distribution of income in a society with equal opportunity of all members for what the American Constitution calls the pursuit of happiness -- is only in part the result of economic policies and of the economic system which these policies shape. The prevalence of social justice, or, more modestly, the degree of social justice, is also determined by the constellation of political forces and beyond that, by social and cultural values which society has accepted and lives by. This is especially true if social justice -- as an end -- is related to economic development -- both as a means and as an end. Because -- and this seems to be the core idea of the conference -- the changes in economic structure which are an integral part of the process

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<sup>1/</sup> The views expressed in this paper are those of the author and not necessarily of the International Bank for Reconstruction and Development.

of economic growth will bring about an improvement in social justice only if political forces move in the same direction and social and cultural values are adjusted to the changing pattern and the changing goals of society.

In order to develop my comments in an orderly fashion I propose to take up first a number of measures of economic policy which may be considered conducive of economic justice; I shall then focus briefly on the political factors which are at least partial determinants of the success or failure of those economic policies. Thirdly, I shall discuss briefly the modification in the social structure and the system of cultural values which development compatible with social justice entails. Finally, I want to develop the notion of a dynamic balance between economic, political, social and cultural factors in order to throw some light on their interaction which sometimes accelerates, sometimes retards, and sometimes disrupts development and with it the attainment of increasing social justice.

## II. Economic Policies

The historical record of the relationship between income growth and income distribution is reasonably clear -- and disconcerting. The statistical evidence which the economic history of the countries of Western Europe and of the United States presents, indicates that during the period of rapid economic growth of the capitalist societies of

Western Europe and of the United States in the nineteenth century and the beginning of the twentieth income distribution worsened. It appears that by and large there was no deterioration of the per capita income of the lowest quintile, and almost certainly not in the lowest two quintiles, except perhaps intermittently in the lower half of the cyclical swings. There is ample evidence, however, that on the one hand the share in the total product of the lowest quintile declined and the incidence of human suffering rose -- through prolonged and widespread unemployment, exacting conditions of employment and the decline of whole sectors and regions in response to technological changes -- while on the other hand the concentration of income and wealth in the uppermost stratum increased.

But economic statistics do not convey an adequate picture of the state of social justice during the period of the take-off of Western Europe. The legislative history of the Poor Laws, of the laws limiting child labor, the prolonged disputes over the length of the work day, and the general acceptance of the Iron Law of Wages, and beyond that, the novels of Charles Dickens and the homily writings of Peter Rosegger, and, more recently, the impressive social and cultural history of Barbara Tuchman's "Proud Tower" are more comprehensive evidence of the fact that the distribution of income was deteriorating and that as a consequence poverty and misery were widespread. A permanent reversal of the trend toward a more even distribution and



greater social justice did not occur until well in the twentieth century.

To the economic historian and to the contemporary development economist the growing unevenness of income distribution during a period of sustained growth does not come as a surprise. Although there is nothing even faintly resembling a generally accepted theory of economic growth, most economic historians and development economists would agree on the proposition that in any process of economic growth, some parts of the economy grow faster than others. This is the essential meaning of the concepts of leading sectors (of Rostow), and of growth poles (of Perroux and Bye), and, in the broad context of the world economy, the logical consequence of differences in the income elasticities of demand for various goods and services (Engels' Law). Unless the theorist makes completely unrealistic assumptions (which are incompatible with the allocative role of the price mechanism), growth is bound to be imbalanced. As a consequence, the income in some sectors and in some regions must grow faster than in others and the distributive shares of the economic units in different sectors and regions must grow at disparate rates, and some of them are likely to decrease.

It is at this point where economic theory and analysis leave off and the political economy of development begins. Recognition of a tendency inherent in the mechanism of growth toward a greater

unevenness of income distribution does not mean that policies aiming at a greater evenness of income distribution are futile, or, beyond that, detrimental to the growth process itself. There is not necessarily any conflict between the impossibility of balanced growth of output, and the objective of greater balance in income distribution.

What, then are the measures of economic policy which in developing countries can be taken to offset the pressures of unbalanced growth on income distribution? In order to answer this question in a reasonably orderly fashion it may be useful to draw a distinction between macro-economic policy measures on the one hand, and more specific measures affecting only particular sectors, or even individual public investment projects on the other.

#### A. National Policies

Since there is little difference between the broad policies aiming at a better distribution of income in advanced and in developing countries, they can be discussed briefly.

The single most important over-all objective of economic policy is to achieve an economic system which has built-in incentives for the efficient use of resources. This means three things: (a) the avoidance of policies and practices interfering with the forces of competition; (b) an "outward" orientation of the economy; and (c) policies aiming at the use of resources reflecting relative scarcities. These three "sub-sets" of policies are of course interrelated and mutually reinforcing.

In order to achieve a vigorous competitive system in the economy in which success is determined by entrepreneurial talent and technical competence, and not by inherited wealth or social privilege, it is essential to avoid the discriminatory advantages of monopoly or oligopolistic collusion. This is not always easy, especially in countries in which because of their small size, or because of the low level of per capita income, markets are small. The small size of markets in turn makes it necessary to limit the size of productive units in those industries in which economies of scale have an important bearing on production cost. I have a suspicion that the importance of economies of scale, a factor determining cost of production, has been exaggerated, especially in economies where wage costs are low and therefore the use of capital equipment -- and with it the importance of economies of scale -- can be limited. But there is no doubt that in some industries economies of scale are important (and are likely to remain important as long as technological advancements are made chiefly in response to the requirement of advanced countries with high wage costs) and tend to favor monopolistic or, at best, oligopolistic patterns of production.

But even in such unfavorable circumstances the benefits of the fresh winds of competition can be maintained through trade policies which restricts the level of effective protection in size and in time -- to overcome the undeniable difficulties of starting new industries.

The close connections between trade restrictions and monopolistic practices has been recognized for a long time -- ever since Robert Liefman wrote his famous book on International Cartels, Combines and Trusts. But what needs reviewed emphasis is the detrimental effect of monopolistic production made possible by tariffs or outright import prohibitions on the distribution of income. Protection given to producers of agricultural machinery and implements makes the poor peasant even poorer than he would otherwise be; protection for the producers of bodies of trucks and buses, a common feature in countries which do not have their own automobile industry, hurts the poor man who depends on mass transportation; and protection for the producers of drugs -- common in Latin America -- which in most instances consists of little more than simple packaging and pill pressing may push the cost of medical care beyond the reach of the poor who are likely to need it most.

Advice to developing countries to avoid the fostering of industries behind walls of high protective tariffs or outright prohibition of imports have been given for many years; but in many countries it has not been heeded, not because it has been found wrong, but because it has been considered impossible to follow in view of the limitations of export earnings, the need to reserve foreign exchange to pay for imported capital equipment, and the argument, well founded on theoretical grounds, that protection is costless -- or at least less costly than it may appear -- since labor (and conceivably also land) employed

in protected industries may otherwise be unemployed. Thus, it is argued, the gross national product rises even if the addition to output is corrected for excessive cost of production.

Underlying this line of reasoning is of course the assertion (or the tacit assumption) that limitations on imports are unavoidable because of the high import content of investment expenditures on the one hand, and the difficulty, or, even impossibility, of increasing export earnings reflecting the low income and price elasticities of many of the traditional exports of developing countries, on the other. This line of reasoning overlooks two important aspects of the trade problem of developing countries: one, that there exist -- as the experience of such countries as Korea, Taiwan, Mexico, Brazil, and Colombia, have shown -- unexpectedly large and diverse possibilities of developing non-traditional exports, both of manufactured goods and agricultural exports; and two, that exchange rate policies can, and frequently do, aggravate the difficulties of expanding exports. If the currency of a developing country is over-valued, it becomes of course more difficult to develop new lines of export production; foreign exchange becomes scarce and must be rationed through exchange controls or some system of allocation to importers, with importers or users of capital goods usually getting preferential treatment. A regime of policies of this type has several adverse effects on the distribution of income: it benefits in the first instance the owners

of industrial enterprises whose income and wealth goes up; it increases the use of imported capital equipment (because the greater the use of capital equipment the greater the benefit of cheap foreign exchange to the entrepreneur) and reduces the use of labor and employment opportunities;<sup>1/</sup> and, as mentioned already, it increases the cost of output to the ultimate consumers, who in the case of mass consumption articles are likely to be poor.

Finally, the fact that in an outward-oriented economy producers have to compete in export markets with producers from other countries provides constant pressure on the former to maintain and increase the efficiency of their operations, in contrast with producers for the domestic market whose inefficiency can be made up by increased protection. Similarly, the pressures of trade unions for wage increases in excess of productivity gains is likely to be resisted more effectively in the export sectors than in the sectors producing for the domestic market because increases in wage cost can be passed on to domestic consumers, especially in a protected market, but not to consumers abroad.

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<sup>1/</sup> The foreign exchange cost advantage may also have secondary effects on income distribution. For instance, in countries which subsidize through the undervaluation of foreign exchange the cost of imported tractors, the large scale agricultural producer who can use a tractor while the small producer cannot, derives a competitive advantage over the small producer and has an incentive to acquire more land thus accentuating the uneven distribution of land holdings.

While the preceding remarks have been focused on the direct and indirect effects of trade and exchange rate policies, it must be emphasized that even without reference to the external accounts of an economy, the policies determining the allocation of resources have an important bearing on the distribution of income, on social justice and on the incidence (and the eradication) of poverty. Two examples, based largely on studies by the staff of the World Bank, should suffice to illustrate the point.

Example One: Normally, one does not think of power rates as having any significant bearing on the distribution of income. However, an IBRD study argues convincingly that the failure of a municipal power company in a major city in Latin America to increase charges for the residential use of electricity to a level at which they would reflect total cost (including the scarcity of capital available for public investment) resulted in a subsidy for the most important group of users, i.e. the well-to-do owners of electrical appliances, and in more rapid growth of the demand for power than would have occurred if full cost had been charged. As a consequence, the authorities found themselves compelled to divert a greater proportion of resources to investment in power, thereby reducing the availability of resources for such other uses, as the extension of public water supply, improved mass transportation, or farm-to-market roads -- investment expenditures which are more likely to have a favorable impact on the distribution of income.

Example Two: In a number of countries in Latin America (but presumably also elsewhere) highways have been constructed to standards much higher than those necessary to accommodate and foster truck and bus transportation. As a result, the use of passenger cars has been encouraged -- and with it the importation of cars (or, in countries in which automobiles are produced, the importation of car components), and the consumption of gasoline. The use of foreign exchange (or the frustration of foreign exchange earnings through the reduction of gasoline or oil exports) for the purchase and the use of passenger cars, whose ownership in developing countries is concentrated in the highest income brackets and a most important status symbol, reduces the availability of foreign exchange to finance development expenditures which would benefit lower income groups. In at least one Latin American country with which I am familiar, excessively high standards of road construction were encouraged by a well-organized and vociferous lobby of cement producers. In others they were the result of the application of engineering standards recommended by foreign consultants on the basis of their experience in advanced countries where the ownership and use of cars is no longer confined to members of the upper income groups.

These two examples, which could be supplemented by innumerable others, point toward a more general conclusion: the tendency inherent in the process of income growth to concentrate the benefits of economic advancement in upper and middle income groups and in certain areas



-- usually urban -- and to discriminate against lower income strata and rural areas, is self-reinforcing, with the needs (and preferences) of the fast growing sectors absorbing a large, and sometimes growing share of attention, resources and policy-making ability -- unless it is recognized and resisted while the process of growth goes on. This has been emphasized on numerous occasions, most recently in the address of Mr. McNamara at the Annual Meeting of the World Bank who advocated that development programs explicitly stipulate as one of their objectives that the share of the 40% of the population with the lowest income must at least be maintained. But what is not generally recognized and needs to be recognized by policy makers is that broad national economic policies -- the "economic philosophy" of a regime -- is just as important, or presumably more important a determinant of the distribution of income and the degree of social justice as policies usually considered directly related to income distribution and the alleviation of poverty and distress.

B. Fiscal Policies and Public Expenditures

Since in advanced countries, especially in Great Britain, the United States, Canada, and the Scandinavian countries, shifts toward a greater evenness of income distribution were associated with the advent of highly progressive income taxes and a rapid growth of public expenditures for social welfare objectives, it is not surprising that in most developing countries the quest for greater economic equality has led in many

countries of Latin America to the introduction of both progressive income taxes and social security legislation -- generally with disappointing results as far as the distribution of income is concerned. Although income taxes now account in virtually all countries for a much larger share of total fiscal revenues than, say, twenty years ago, and the coverage of social security systems has been greatly extended, the contribution of fiscal measures to bring about a more even distribution of income must be considered negligible. Income taxes have become a reasonably effective instrument for taxing wages and salaries, in some countries in periods of rapid inflation perhaps too much so. But because of a pernicious combination of administrative inefficiency, compounded by the widespread acceptance of bribery as a way of life, and legal loopholes of exemptions, tax holidays and special favors of one form or another, the income of self-employed and unearned income have remained virtually unaffected by income taxation. Inheritance taxes also have been unimportant as an instrument for the redistribution of wealth.

Social Security taxes also have become important sources of fiscal revenue but they have done little to enhance social security and social welfare, in some countries because of the limited coverage of the social security system, in others because social security benefits have been wiped out by inflation, and in some countries because of a combination of both factors. It has even been charged, with some

justification, that social security taxes may have had adverse effects on income distribution because they increase the cost of the employment of labor while at the same time tax reductions or exemptions, low import duties or the low cost of foreign exchange favor the increased use of capital. As a result, employment and income derived from wages is reduced, and income derived from the ownership of capital is increased.

The preceding negative comments about the effectiveness of progressive taxation must not be interpreted as suggesting that attempts to make the tax structure progressive should be abandoned. To the contrary; attempts to reduce the inequality of income through the fiscal system should be continued and reinforced. It must be realized, however, that progressive tax rates do not make the tax structure progressive as long as the incidence of high tax rates does not fall on the highest income brackets because of inefficient and corrupt administration of the tax laws and the numerous exemptions which have been introduced, ostentatiously to stimulate savings and productive investment although there is no evidence that they have been a significant determinant of the rate of economic development.

Similarly, the observation that social security taxes may have adversely affected the level of employment and the distribution of income does not imply that social welfare expenditures should be curtailed. There is much to be said, not only on humanitarian grounds,

for public concern and public expenditures to enhance social welfare. The real practical problem is to make sure that public social welfare expenditures benefit the members of those income brackets which need public support most -- the urban unemployed, the slum dwellers, and, above all, the faceless and inarticulate masses of the rural underemployed. Moreover, public expenditures for social welfare need not be at the expense of public expenditures for development purposes even if development is measured in GNP growth rates. The core issues of development with social justice is to make fuller use of the unemployed and the underemployed and to enhance the productivity of those members of the economy whose income is low because their productivity is low. The reservoir of underutilized manpower which makes up the lowest income group provides the most important basis for growth.

The idea of expanding production and income through the mobilization of underutilized manpower has been recognized almost twenty years ago by W. Arthur Lewis in his article "Economic Development with Unlimited Supplies of Labor". But as a result of (a) the application of capital theory which did not allow for the prevalence of idle manpower; (b) the acceptance of bottlenecks (of technical skills, planning ability and managerial ability at all levels) as static, not to say permanent, constraints; (c) the direction of public expenditures to meet the felt needs and preferences of the upper income brackets, especially the owners of land and reproducible capital; and (d) the

indiscriminate application of factor combinations appropriate to advanced economies in which prices of inputs reflect different relative scarcities, development proceeded -- and progressed -- without even beginning to make use of the reservoir of underemployed and therefore poverty-stricken manpower.

It follows directly from this line of reasoning that the direction of public expenditure is a matter of vital importance in achieving the twin objectives of development and social justice. Specifically, what the conditions prevailing in most Latin American countries and in developing countries elsewhere call for is a rearrangement of the priorities of public expenditures along the following lines:

- (a) Rural public works to make use of the underemployed rural population for the creation of additional economic overhead which increase productivity and production -- farm-to-market roads, reforestation, minor irrigation, drainage and flood control works, municipal improvements, including health and birth control facilities;
- (b) urban public works, including site and service improvements in slum areas;
- (c) improvements in mass transportation (as against the provision of facilities for travel by private car);  
and

- (d) expansion of education and vocational training, including informal education, especially in rural areas.

It should be obvious that this is a very partial (and excessively general) list of the priority objectives of public expenditures. What is perhaps less obvious is that in such a rearrangement of priorities the distinction between current and investment expenditures become rather meaningless -- what matters is the effect of all public expenditures on the growth of income, especially in those income groups where it immediately alleviates poverty.

The re-direction of public expenditures in favor of the low income groups, combined as much as possible with a more equitable distribution of the tax burden, does not mean that the income of the members of the upper income groups will be necessarily reduced. An increase in income of the lower income groups (or in the sectors and regions in which family income is lowest) constitutes an expanded market for producers and merchants; it offers new investment opportunities, and is therefore likely to increase entrepreneurial income. A reduction in the inequality of income does not require a reduction in the absolute amount of income of the rich. It only requires that the growth of their income should be at a lower rate than that of the poor, and that as a consequence the share in total income of the rich is reduced.

### III. Political Factors

The preceding section conveys the impression that it is not particularly difficult to devise a set of policy prescriptions designed to set into motion a process which will bring about both increased production and a better distribution of income. If it appears easy why, one must ask, has it not happened in Latin America or elsewhere? The answer is of course that it is one thing to devise a set of policies and quite another to adopt them. Whether or not policies conducive to growth with social justice are promoted and adopted and ultimately made to succeed depends on the political will of those who can make policy decisions and their power to do what they want to do.

The preceding proposition makes a distinction between the will of political leaders to foster development with social justice, and their power to carry out their intentions. The will presupposes the recognition that development with social justice is a desirable objective. This is nowadays taken for granted on humanitarian and economic welfare grounds by economists and political scientists and accepted for granted by political leaders.

#### Competing Objectives

However, although governments may be committed, through policy pronouncements, ideology and ideological tradition, to the pursuit of development objectives and social justice, they may be similarly

committed to competing objectives such as an increase in military strength, or the elimination of foreign control over natural resources, or more generally, foreign interference with matters considered essential to the effective assertion of national sovereignty. In such situations, development objectives and especially objectives of social justice may be considered postponable and having to give way to objectives of greater urgency.

In reality every body of policy makers is faced with a wide array of desiderata from which it has to chose its priority objectives. To ask for singlemindedness of purpose and to propose to pursue the twin objectives of development and social justice to the exclusion of all other objectives is to ask for the impossible. There are always other claims competing for financial resources and for the attention of policy makers which must be taken into account in the process of decision making.

#### The Power of Government and the Role of Opposition

To what extent competing claims can be deferred, or satisfied with a smaller share of resources, depends largely on the power of the government, and of the leadership within the government. A government that is faced with well organized opposition must heed the views and voices of its opponents, and compete for popular support. The existence of an effective opposition does not necessarily interferes with the pursuit of development and social justice objectives. To the



contrary; an effective opposition may stimulate a government into more vigorous action on the one hand, and to avoid the pitfalls of arbitrariness and recklessness which are the characteristics of absolute regimes, on the other. What is required is an understanding in principle on the objectives of development and social welfare policies; within such an understanding there is much room for disagreement and debate. It is this understanding in principle which makes the difference between a political system with a responsible, constructive opposition, and one that suffers the consequences of irresponsible and destructive opposition. The former helps the process of development and improving social justice, the latter impedes and retards it.

There is considerable evidence, in the form of formal declarations, and statements of ideological objectives, and the attitude toward specific policy measures that in Latin America and most developing countries elsewhere such an understanding in principle exists -- at least on the surface. There is no political movement or organization which does not favor economic advancement and social justice. Differences arise, however, in the emphasis -- in contemporary jargon, the "policy mix" -- of the two objectives. Much contemporary economic analysis of the development process is concerned with the compatibility of the objectives of growth and social equity; it is fashionable to discuss the problem in terms of a "trade-off" of growth against greater social justice. Although this juxtaposition of growth and the promotion

of equity may be wrong, not only in practice but also in theory, it does point to the issues on which disagreement may arise even if there is a basic understanding of opposing political forces with regard to development and the desirability of greater social justice. Disagreement can easily arise on such tactical issues as the promotion of urban development as against the support of the agricultural sector; the stimulation of private capital formation (and employment creation) through tax concession as against effective progressivity in taxation; the public support of "poles" of economic growth, as against the promotion of regional balance; and so on.

It is in the resolution of such bona fide disagreements and conflicts where the existence of a political opposition may force more thorough and therefore better decision making and bring about better balance between the objectives of growth and social equity. In Latin America, as elsewhere, progress toward development and social equity has been least in countries where the ruling regimes have succeeded in eliminating effective opposition, or where the regime has been too weak to assert itself against irresponsible opposition. Conversely, countries with governments which are strong enough to stand up against their political opposition and at the same time sufficiently circumspect to take account of the effects of their policies on their popular support, have had the greatest success in promoting development while providing at least a modicum of social justice.

Political Preponderance of Development

The experience of the last twenty years indicates that economic development, as measured by the conventional yardstick of per capita GNP, has fared much better in Latin America than the promotion of social justice: per capita measure has risen while the distribution of income has remained unchanged and deteriorated in others. Even the most ardent supporters of the proposition that it is inherent in the process of economic growth that at least in the initial phase income distribution must become more skewed are ready to admit that measures to offset the tendency toward greater inequality of income can be taken and presumably should be taken on simple humanitarian and welfare grounds. Therefore the reason for neglecting the problems of income distribution in most countries of Latin America must be sought in the constellation of political forces. It seems that the novel objective of economic development has enjoyed more effective political support than the objective of social justice. True, no political leader will ever omit social justice from the list of priority objectives which he advocates, but more likely than not he will propose measures to stimulate economic development not only as a means of a general increase in per capita income but also, explicitly or by implication, as a means of relieving, and ultimately eliminating, poverty.

In this failure to distinguish between the objectives of growth and social justice the political leaders have enjoyed for a long time

the intellectual and advisory support of the great majority of development economists who have been concerned and fascinated with the mechanics of growth as represented in growth models as complex as their mathematical ingenuity, reinforced by the capabilities of computers, will permit. By advancing the proposition that economic development, like moral behavior, is good in itself and good for everybody, political leaders eliminate any conceivable opposition and avoid the politically more difficult issue of the distribution of the benefits of development. True, the issue of social justice can never be completely avoided, especially in countries which poverty is visible and appalling. But it can be disposed of, with ease and even with grace, with the assertion that "ultimately" everybody benefits from development; and demands for more equity and social justice become indications of impatience (while patience is a political virtue), of "selfishness" and opposition to economic advancement. It is the political philosophy of "develop now, distribute later" which is the chief cause of the growing unevenness of income in many Latin American countries, not the concentration of growth in leading sections, or in growth poles.

The Politics of Income Distribution: Urban vs. Rural

Practical political considerations, chiefly the need to maintain popular support of the political leadership in control, make it of course necessary to mitigate the growing disposition of income and economic opportunity.

Thus income distribution becomes a matter of political concern in those sectors and among those groups whose political support for the regime is important. Usually these politically important and actually or potentially powerful groups are concentrated in urban areas and in the industrial sector. It is for that reason that industrial workers, especially those who manage to organize themselves into trade unions, and white collared workers, and in some countries the military officer class as well, have been able to maintain, or even increase their share in the national income. For the same reason, government authorities have been reluctant to take measures which are opposed by members of the lowest income groups in urban areas -- the shanty-town dwellers, the users of local mass transportation, the taxi drivers. Their political importance is disproportionately large because of their immobility and concentration in major cities.

By the same token the political power of the rural poor -- the small farmers, the share croppers, the rural workers -- is small. They are dispersed in the countryside and thus less visible. Their organization into an effective political force is difficult, chiefly because communication among them is difficult. Conversely, the power of the rural landowners is great. They have close contacts with the urban industrial and commercial elite; in some countries where absentee ownership is common they are part of it. This explains why so little has been done in Latin America to let the rural poor share the benefits of

economic advancement, why land reform measures have failed in so many countries and why the owners of large rural properties have benefited so much from such development policies and projects as the provision of agricultural credits, extension services and improved transport facilities -- although these policies were ostensibly designed to benefit the rural poor. It also explains the absence, or at least scarcity, of government services in rural areas which continue to be undersupplied with schools, hospitals, and pure water. Rural electrification and irrigation also apparently have largely benefited the large-scale commercial producers.

The failure, for political reasons, to mitigate rural poverty has also had adverse effects on the incidence of poverty in urban centers. The disparity between rural and urban levels of living -- which are not by any stretch of the imagination offset by differences in the quality of life -- is unquestionably the chief cause of the drift of the rural underemployed into urban centers where they join the ranks of the underemployed casual workers and slumdweller, and contribute to the perpetual lag between the supply and the demand for urban public services and, thus, on balance, increase the cost of economic development.

#### IV. Social Structure and Cultural Values

The preceding reference to the political impotence of the small farmer and landless peasant provides an example, perhaps the most important example, of the significance of the social structure as a determinant of the distribution of the benefits of economic advancement. The schematic distinction between the "dynamic" urban industrial entrepreneurs who favor innovation and modernization and become the leading proponents and supporters of economic development on the one hand, and the conservative landlord, feudal and paternalistic in outlook and opposed to economic as well as social change on the other, is not only a gross oversimplification but essentially not meaningful in the Latin American context. For one, the new entrepreneurial class (which also is a combination with the social group of professionals provides the political leadership of most Latin American countries) has its family ties and social roots in the classes of both commercial entrepreneurs and rural landlords. Secondly, it is nothing but a piece of convenient and, by now, conventional social science fiction to assume that the landlord is opposed to technical innovations. Latin America offers innumerable examples of agricultural producers who have successfully adopted -- and even adapted to local conditions -- modern techniques of agricultural production, including management and marketing.

There is, however, one important element of truth in the distinction between rural and urban entrepreneurs: while in urban

industrial society the relationship between employer and employee has undergone profound changes from paternalism and unquestioned authority to a relationship based on bargaining about wages and other conditions of employment, paternalism and authority have remained unchanged in rural societies. There is not much evidence of class consciousness among industrial workers, the occasional acceptance of Marxist terminology by some political and union leaders notwithstanding; but there is mutual respect for the political and economic strength of the other side. In rural society the respect is likely to be one-sided. To use a term commonly used in England: The tenant farmer and farm worker "knows his station in life," as well as that of his landlord, and normally considers any attempt on his side to change it as futile. In situations of extreme provocation -- a crop failure, a price collapse of the peasant's cash crop -- this passivity may change abruptly. But normally it will continue, and with it the acceptance of rural poverty as a way of life that can be changed only by the young men who dares to migrate to the city.

The acceptance of the difference in income, wealth and social status in rural areas is but one aspect of the social structure which underlies and reinforces the political factors which bear on the relation of economic development to social justice. Another one which is an important determinant of the social structure as well as an essential component of the set of cultural values which may be considered



characteristic of Latin America, is the ready acceptance of public authority. Any official, any policeman, any soldier who represents the state, demands and receives respect -- even when his action is arbitrary and unjust. The reluctance to oppose authority and the willingness to accept it presumably is deeply rooted in the tradition and heritage of the cultures of Spain and Portugal; it is also said to reflect the relation between conquerors and conquered (of different racial origin) which characterized centuries of colonial rule. But whatever the root and origin of this attitude and cultural trait, its effect on the distribution of the benefit of development are profound. It is bound to weaken the pressures for a more equitable distribution of income and to reduce the willingness to give in to such pressures when they arise. Beyond that, in a period of political tension and breakdown of social peace, it makes the possibility of compromise more remote, and increases the probability of lawlessness and violence.

V. Interaction of Economic, Political and Social Factors

The preceding discussion of the prospects of development with social justice has distinguished between economic forces, political factors and social institutions. This has facilitated the exposition of an exceedingly complex problem. It must be realized however that the clearcut distinction between the three sets of factors determining

the relation between development and social justice is in reality much less clear than in the exposition -- for two reasons. First, economic and political consideration and social attitudes are constantly interacting on each other; second, the description and analysis of the three sets of factors have run in static terms, as if they were immutable and unchanging in time, while in reality they are constantly undergoing change.

In order to round out the discussion and to arrive at conclusions which are not too remote from reality, it is essential to modify the two expositional devices and to discuss their interaction over time. Assuming that the social factors move more slowly than the others, we may conceive the following standard causal sequences: social institutions and social attitudes (and cultural values reflecting them) determine the composition and strength of political forces which in turn determine economic policies. Economic policies are designed to bring about increases in total output, changes in its composition and modifications in the distribution of income. These economic changes affect the structure of society and result in changes in the constellation of political forces directly, and indirectly through changes in the social structure.

#### A Dynamic Balance

The success or fortune of economic development and the extent to which development enhances or reduces social justice depend in

essence on the functioning of this interaction. Peaceful economic development -- i.e. economic development which is not disrupted by social upheaval, political repression or revolutionary political change -- can take place only if there develops what may be called a dynamic balance between economic growth, non-violent political change and the adaptation of the social structure. If such a dynamic system leads and lags between economic advances, changes in political forces and adaptation of the social structure are inevitable. But as long as the leads and lags remain within reasonable limits and do not overtax the tolerance of the system, breakdowns can be avoided. Short-term disparities in the growth rates of the income of the various income groups, or temporary disparities between the exercise of political power and popular support, or short lags between changes in political strength and the adaptation of the social structure are normally within the bounds of the tolerance of a system, especially when the disparities are reversible. If, however, the disparate movements become cumulative and appear to be irreversible, such as a prolonged or pronounced decline in the share of income of a sector, or an income group, without a change in the constellation of political forces, or with the threat of a decline of political influence of the sector experiencing an economic decline, then the stresses of society become intolerable and are bound to result in social upheaval and violent disruption.

At this juncture it is uncertain whether the constellation of economic, political and social forces in the various countries of Latin America is such that the disparities within the economic system, and the disparities between the needs for political action to redress the balance of social justice in the economic system, and the will and the power to take the needed political action will be reversed or become unavoidably cumulative and explosive. It may well be that the future will bring both peaceful solutions and uninterrupted growth associated with growing social justice in some countries, and violent disruptions in others.

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**John H. Adler**

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# **Development and Income Distribution**

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# Development and Income Distribution

By

John H. Adler

## I.

In a paper published in 1955 which was, in his words, "5 per cent empirical information and 95 per cent speculation" and which bears — in spite or because of its speculative character — the marks of prophetic insight, Simon Kuznets advanced the proposition that "in the early phases of industrialization in the underdeveloped countries income inequalities will tend to widen before the leveling forces become strong enough first to stabilize and then reduce income inequalities." He then answered in the negative the question "Can the political framework of the underdeveloped societies withstand the strain which further widening of income inequality is likely to generate"<sup>1</sup>?

Since 1955, ample evidence has accumulated to bear out Kuznets' "speculation" that in the developing countries inequalities in income distribution are greater than they were in the industrialized countries before the trend toward growing inequalities was reversed — in some countries before the turn of the century, in others not until after the First World War — and that they have become more pronounced in most though perhaps not in all countries<sup>2</sup>.

What has come as a rather shocking surprise, however, is the extent of the inequality and the low absolute level of per capita income of the poorest quintile of the population. In 21 out of a total of 40 developing

*Remark:* The views expressed in this paper are those of the author and not necessarily of the International Bank for Reconstruction and Development with which he is associated.

<sup>1</sup> Simon Kuznets, "Economic Growth and Income Inequality", *The American Economic Review*, Vol. XLV, Menasha, Wisc., 1955, pp. 1 sqq., esp. pp. 24 sqq.

<sup>2</sup> Data on income distribution have in recent years become available for a surprisingly large number of developing countries; although for most countries their reliability is rather uncertain, especially since in many instances their coverage is limited, and their comparability is highly questionable. The most comprehensive data are given in I. Adelman and C. T. Morris, *An Anatomy of Patterns of Income Distribution in Developing Nations*, Final Report Prep. for the U. S. Agency for International Development, February 12, 1971. A short version has been published in *Development Digest*, Vol. IX, Washington, D. C., 1971, No. 4, pp. 24 sqq.

countries for which data are available, the average per capita income of the poorest 20% of the population is less than 28% of the national average<sup>1</sup>. That means that it is not only in the "hard core" least developed countries which have been singled out in various resolutions of the United Nations bodies<sup>2</sup> for special consideration, that the per capita income of the majority of the population is abysmally low (and therefore perennially in danger of falling below the threshold of physical needs); but that in a number of countries in which the national average per capita income has reached a level substantially above the bench mark of say, \$ 100, such as Brazil, Colombia, El Salvador, Jamaica, Lebanon, Mexico, Panama, Peru, and Tunisia, a substantial proportion of the population still has a per capita income below that international "poverty line."

There is another group of countries in which the low per capita income of the poorest quintile — or for that matter of the poorer half — of the population is a matter of special concern on humanitarian grounds and, in policy terms, of urgency. This group includes India and Pakistan in Asia and some of the major countries of Africa such as Kenya, Nigeria, and Tanzania. In these countries the relative share in the national income of the poorest quintile of the population is significantly higher than that in the first group, between 7% and 10%; but because of the low national average, the absolute amount is so low that it is clear that minimum requirements of caloric intake and nutritional balance are not met. According to the data, the per capita income of some 110 million Indians is \$ 38 compared with a national average of \$ 100; in Pakistan, the poorest 20% of the population — some 22 million — "enjoy" a per capita income of \$ 36; and so on<sup>3</sup>.

These figures are the more disconcerting since the experience of the last twenty years has shown that it is virtually impossible in developing countries to mitigate the plight of the lower income groups by redistributive fiscal operations. For a variety of reasons, of which the low national per capita income itself is presumably the most important one, efforts aiming at redistribution for the benefit of the poor do not work. Moreover,

<sup>1</sup> Data given in Adelman and Morris, *op. cit.*, cover 44 countries, including Japan, Israel, Rhodesia and South Africa. These four countries have been excluded — because Japan and Israel can no longer be considered "developing" in the generally accepted meaning of the term, and because in Rhodesia and South Africa the income distribution may be considered chiefly the result of discriminatory legislation. If the four countries are included, the numbers in the text become 24 out of 44.

<sup>2</sup> U. N. General Assembly Resolution A/RES/2768 (Session XXVI), New York, November 22, 1971. The resolution also contains references to other U. N. resolutions and documents which pertain to the least developed countries.

<sup>3</sup> The data on Pakistan refer to years prior to the secession of Bangladesh.

there is evidence which suggests that in the great majority of developing countries the benefits of economic development accrue chiefly to the upper income groups — the highest 20% or 40% of the population — and that in some countries the poorest 20% or even a larger percentile do not participate in the process of economic advancement at all.

This state of affairs is in sharp contrast with the fundamental objectives of economic development — the diminution of poverty and human misery. It is, I suggest, indicative of the direction in which development theory and development policy has been moving — wandering may be a better term than moving — that it has become necessary to recall their basic aims. In the preoccupation with the means of development — to raise the rate of savings and investment, to achieve viability in the international accounts, to move from externally supported to self-sustained growth — sight has been lost of its ends. And the advocates and promoters of development and development aid have been so busy defending their cause against its detractors and proving its success — by impressive aggregate statistics and persuasive accounts of changes in institutions, attitudes and social values — that they have had no time, or inclination, to concern themselves with the imperfections of their accomplishments. True, national development efforts and international development assistance have been successful, and, in the face of formidable obstacles, successful beyond all reasonable expectations: unprecedented population growth rates notwithstanding, a growth in per capita GNP of some 2½% or better is a remarkable achievement. But unfortunately it is equally true that the achievements of the last twenty years do not form a solid foundation for further and faster advances from now on — because of the uneven distribution of the benefits of economic growth, which has adversely affected the social and political cohesiveness of many countries and made them more prone to interruptions of economic progress through social upheaval and political turmoil.

## II.

Against this background of facts and impressions, three sets of questions may be posed. One is: what are the causes of the inequalities in income in developing countries? The second: why has little or nothing been done to date to mitigate the inequalities? And the third: what, if anything, can be done about them?

The aim of this paper is to provide some tentative answers to the third question. But before doing so, a few comments on the first two seem in order. The causes of income inequality have been dealt with in a refreshing, imaginative, and comprehensive way by Adelman

and Morris<sup>1</sup>. Because of the complexity of their findings, it would be futile to attempt to summarize them here. Only four remarks which are relevant for a better understanding of the answers given below to the third question seem appropriate.

One is to underline the importance of what Adelman and Morris have called dualism in the structure of the many developing countries: the more pronounced the dualism, i. e., the existence side by side of a technologically and institutionally backward sector and a technologically advanced and well organized modern sector, the greater the incidence of high income inequality. But since the growth of a modern sector is an essential and unavoidable ingredient of the growth process itself, it becomes immediately clear that economic development itself is one of the prime causes, if not the prime cause, of income inequality — just as Kuznets had suggested. Conversely, low growth and low growth potential — i. e., the absence of favorable resource endowment such as mineral deposits or good climatic conditions — are associated with less income inequality.

The second one is to call attention to the close connection between income inequality on the one hand and unemployment and underemployment on the other, and to the rather obvious relation of both income inequality and unemployment/underemployment to social disenchantment and tension. It is unfortunate (though perhaps not surprising) that in recent years the prevalence and the growth of unemployment and underemployment in developing countries has received much attention<sup>2</sup> without, however, bringing out the fact that the lack of employment opportunities is but one of many causes of income inequality. It is doubtful whether the fully employed peasant who is unable to eke out a living for himself and his family from the land he owns or, more likely, rents is better off and less in need of help and attention than underemployed or unemployed casual urban workers<sup>3</sup>.

The third comment is closely related to the second one. The rise in urban unemployment and rural underemployment which has become painfully evident in a large number of developing countries in recent years — although the existence of an oversupply of labor has been con-

<sup>1</sup> Adelman and Morris, *op. cit.*

<sup>2</sup> See for instance, two reports prepared under the auspices of the International Labor Organization: *Toward Full Employment: A Program for Colombia*, Geneva, 1970. — *Matching Employment Opportunities and Expectations: A Program of Action for Ceylon*, Geneva, 1971.

<sup>3</sup> The only reason for focussing on unemployment, rather than on inequality of income (i. e. poverty) may be the fact that unemployment, concentrated in urban areas is politically more dangerous than "simple" poverty.

sidered a structural characteristic of underdevelopment for a long time<sup>1</sup> — has been attributed largely to the increase in the rate of population growth. The rise in the rate of population growth must of course also be considered as a significant cause of the continuing and worsening unevenness of income distribution if, as is presumably the case, the increase in the birth rate is greater among the lower income groups than among the upper which practice birth control. This implies of course that family planning measures are likely to have a favorable impact, not only on the rate of income growth, but also on income distribution.

The fourth cause of inequality which deserves to be singled out — at least as a boon to those of us who have been brought up to believe that knowledge and education are the key to everything — is the rather close relation between education and the level of family income. On general grounds it is of course difficult to establish the direction of the causal relation because there is logic — and empirical evidence — to either of the two assertions that, one, a low level of education, or the absence of any formal education "causes", or, more cautiously stated, is one of the causes of low income; or, two, low family income is one of the reasons why children do not go to school, or get only a minimum, and an inadequate minimum at that, of education.

As to the reasons why little attention has been paid so far to the problems of income distribution associated with the development process, several admittedly speculative explanations may be advanced. One is the fact that, although most of the intellectual and political leaders and proponents of development would readily embrace the proposition that the objective of development is to enhance human welfare, the aim of their "operational" concept of development is more output, preferably industrial output. The measure of their success is not the reduction of poverty, but a high growth rate of the national product. This essentially Victorian concept of development — or progress as it was called then — has been reinforced by the advice and guidance of the "development economists" of the rich countries who have brought their neo-classical professional training to bear on the problem of economic development. They understand the functioning of the price and market mechanism and can readily explain why in the conditions prevailing in developing countries the scarcity of entrepreneurial talent and professional skills makes the entrepreneur and the professional the chief beneficiary of the fruits of economic advancement, while the abundance of unskilled workers and peasants prevents their income from rising to any significant extent.

<sup>1</sup> W. Arthur Lewis, "Economic Development with Unlimited Supplies of Labour", *The Manchester School of Economic and Social Studies*, Vol. XXII, 1954, pp. 139 sqq.



More recently, intellectual leadership has been assumed by the builders of growth models who with mechanical precision apply a set of allegedly causal relations to any economy — on request or at their own initiative. The models then “prove” what has been assumed in their construction in the first place: that growth is faster if consumption does not grow, or grows only slowly, and that external accounts can be brought into balance more rapidly than otherwise would be the case if real wages in the export sector can be kept low.

This rather simplistic account of the essential features of growth models is only in part facetious. Its purpose is not to show that they are inevitably useless (although I would argue that in many instances their usefulness has been greatly exaggerated), but to point out that virtually without exception they do not concern themselves with the problems of income distribution as such, and their general emphasis on the importance of a rising savings function gives them if anything a bias in favor of an uneven income distribution.

Two standard policy prescriptions resulting from the mutual reinforcement of the mechanics of growth models and the politics of least resistance of the political leaders are an increase in the share or the public sector in the gross product through higher taxes and policies of import substitution. The increase in taxation can of course lead, as the experience of a number of advanced countries show, to a reduction in income inequality. But in the reality of the developing countries where institutions and the structure of political power effectively stand in the way of progressive taxation, increased taxes often mean in effect a more than proportionate reduction in the income of the lower and middle income groups. Conceptually, this accentuation of income inequality can be offset by a distribution of the benefits of public expenditure in favor of the lower and middle income groups; but in practice the need to allocate a large share of public expenditures for the support of the “dynamic” modern sector of the economy through the financing of economic overhead investment makes this difficult if not impossible<sup>1</sup>.

Moreover, the policy of import substitution, offering incentives for industrial production through protection — though perhaps justified as an inevitable phase of the process of development — is bound to impose additional burdens on the members of the lower and middle income groups, especially those whose income is derived from wages or self-employment (in agriculture) in the export sector.

<sup>1</sup> Stanley Please, “Saving Through Taxation — Reality or Mirage?” *Finance and Development*, Vol. IV, Washington, D. C., 1967, pp. 24 sqq.

### III.

The preceding reference to the structure of the fiscal system — both on the receipts and on the expenditure side — and to the income effects of industrial protection leads directly to the last and main part of this paper, which addresses itself to the question: what can be done to mitigate the income inequalities and their deleterious effects on social stability in the developing countries?

For a number of reasons — and to nobody’s surprise — the answer to this question is not easy. There is no single straight-forward answer. Although the phenomenon of income inequality which in some sense of social justice and humanitarian concern is excessive and virtually universal in the Third World, the constellation of circumstances, the social structure, and especially the locus of poverty, differ so widely from country to country that it is difficult to come up with a generally meaningful and operationally useful answer. For example, it is “generally true” that the per capita income in rural areas is lower than in urban areas; from this “generally true” observation it seems to follow that measures to raise agricultural income would automatically help to mitigate the rural-urban inequality of income. But it is also “generally true” that commercial farmers and rural landlords belong frequently to the highest income groups which because of the source of their income pay little or no taxes. Thus it would for instance be a mistake to attempt to alleviate rural poverty through tax relief or production subsidies on agricultural production — because it may well be that the rich rather than the destitute farmers would reap most of the benefits of such measures.

By the same token, it may be agreed that in many countries the redistribution of land would go a long way toward alleviating rural poverty; recently the general case for land reform has been strengthened by evidence that smaller holdings are by and large more intensively cultivated than larger ones and, given the abundant supply of rural labor, total production is likely to increase by a redistribution of land. However, differences in soil fertility, climatic conditions, production techniques, and a host of other relevant factors, make it virtually impossible to determine, in general terms, what the best pattern of land distribution should be and what rules and regulations have to be built into a system of land reform to prevent an open, or clandestine, reversion to the system of inequality. Every case is *sui generis*, and for every case new rules have to be developed.

These two examples, which could be supplemented by many more should suffice to bring out the diversity of the difficulties which beset any attempt to devise policies, or, more humbly, to take measures to

alleviate the unevenness of income distribution. But these difficulties notwithstanding, it is, I believe, possible to advance some general suggestions which are close enough to the practical issues of economic policy to form the basis for specific and concrete measures.

At this point a simple distinction may be useful. The problem of income inequality can be approached either at the macro-economic level by policies affecting the economy as a whole; or it can be dealt with at the micro-level, on a case-by-case basis, in the selection, evaluation and execution of individual development projects. This distinction is useful not only as an expositional device; its importance derives from the fact that a frontal attack on uneven income distribution by broad measures of economic policy is not likely except in a revolutionary situation. For in most countries the structure of income distribution is of course associated with the social structure which in turn determines the structure of political power. Therefore any attempt to bring about changes in the distribution of income is bound to run up against economically and politically powerful groups, even in countries in which the need for reforms to improve social justice is widely recognized. Resistance to reforms is likely to be stronger, and more effective, if the initiative toward policy changes comes from abroad, from foreign observers, or advisers, or from national or international sources of development finance. Therefore a strategy, or at least an initial strategy, of "nibbling" at the problems of income distribution through the direction of financial and technical assistance, subjects in which external bodies have considerable discretion may be more successful than advice on general policies giving preference to the economic advancements of the lower income groups.

As a first step, which involves research and intelligence rather than explicit policy advice and guidance, it should be possible to collect, analyze and publish data which measure and compare for a number of countries the rate of growth of income of the lower half (or the lowest third, or 40%) of the population. Information of this sort would constitute a salutary beginning in the move away from the preoccupation with aggregate growth — the international pastime of growthmanship — and substitute for it the more meaningful idea of growth with social justice. A comparison between rates of aggregate growth and growth of income of the lower income groups, defined in some consistent way, would show of course which country deserves a "premium rating" for its growth performance because the income of the low income groups (or sectors, or regions) was faster than the national average and which country's growth performance should be discounted for having been associated with a deterioration of the pattern of income distribution. Such a comparison would also drive home better than any other method the importance of what should be, or at

any rate should become, a basic rule of development policy, i. e., that as a minimum the existing distribution of income must not be allowed to deteriorate, and that every effort should be made to improve it.

I realize that the comparison between national growth rates and growth rates of the income of lower income groups raises a host of issues in welfare economics to which the answers are difficult and essentially inconclusive. For example: is it "better," in some objective way, to have a period of sustained economic growth during which per capita *national* income grows at 3% per year, and per capita income of the lower income groups at 4%, or a growth pattern in which the national average rate of growth is 7%, but the average of the lower income groups only 5%? Is a high growth rate of the income of the lower income groups more important than the deterioration of the pattern of income distribution which accompanies it (in the second example)? Or is it preferable to achieve a better income distribution with a growth rate, as illustrated in the first example? If I confess that I do not know, I am in good (and large) company — of the great majority of welfare economists. However, I have the feeling that the juxtaposition of the two growth patterns of a high growth rate with a low social justice performance and of a lower growth rate with a high social justice accomplishment, which implies the existence of a measurable trade-off, is in reality hardly ever the way in which the problem poses itself.

A more realistic and more practical way to put the question is to ask: could the higher national growth rate have been achieved without a deterioration in the income distribution? and what can be done to maintain the growth rate while at the same time correcting the distribution of income? In other words, it is doubtful whether the idea of a conscious choice among various combinations of income growth and income distribution is useful and whether the notion of a trade-off, while logically unassailable, has any operational significance. This implies that there is little or no connection between the pattern of income distribution and the rate of growth — a proposition which I suggest can be demonstrated as essentially correct<sup>1</sup>. If it is assumed that in developing countries the rate of private capital formation is favorably affected by a high degree of unevenness of income distribution (because the consumption levels of the poor are simply too low to expect them to save any part of their income), and if it is assumed further that public capital formation cannot adequately compensate for a reduction in private capital formation, except in a fully socialist economy in which all savings are "forced" — then

<sup>1</sup> William Cline, *Potential Effects of Income Redistribution on Economic Growth — Latin American Cases*, New York, 1972, *passim*.

the assertion that there is no direct relation between income growth and income distribution also implies that the rate of growth is determined not only by the rate of capital formation, but also by the supply of all other factors such as skill, work incentive and the prospects of economic and social rewards for special efforts. There is of course ample evidence in the analysis of the growth of the advanced countries<sup>1</sup> of the importance of these "other" factors to the growth performance, and the thesis that this is equally true in developing countries is at least a defensible and testable hypothesis.

But to return from the rather slippery road of welfare economics and speculations on the ultimate determinants of economic growth to the subject at hand: it follows from the short comments about the causes of income inequality that the chances are good that social justice objectives can be successfully pursued by public concern with, and public expenditures for, rural development, education, and the elimination of urban unemployment.

The suggestion that economic growth of the agricultural sector should receive increasing attention is based on ample evidence that in virtually all countries for which data are available, the average per capita income in the rural sector is significantly below the national average and that a very high proportion of the lower income groups consists of peasants. Moreover, data on income distribution are likely to underestimate the "welfare gap" between the rural poor and the by and large better off urban population, because income distribution data fail to take into account the scarcity of free public services — in education, public health, and medical services — in rural areas compared with the availability of such services in urban centers. The experience of the last twenty years has shown that the stimulation of agricultural development is difficult and costly — difficult because it requires a variety of services and institutional arrangements such as technical assistance through extension services, credit facilities and institutional changes in the supply of agricultural inputs and in marketing; and costly because the recurrent expenditures of providing these services are in most cases higher than initial capital expenditures which are more likely to become available through foreign aid or foreign loans than financial support of recurrent expenditures. Nevertheless, the breakthrough achieved in the development of seed varieties adapted to the climatic conditions of many developing countries and the prospects that the benefits of this "green revolution" can be adapted

<sup>1</sup> See Edward F. Denison, *Why Growth Rates Differ: Postwar Experience in Nine Western Countries*, Assisted by Jean-Pierre Poullier, Washington, D. C., 1967, esp. Chaps. 5—9, 14, 19. — *Idem*, *The Sources of Economic Growth in the United States and the Alternatives Before Us*, Committee for Economic Development, Supplementary Paper, No. 13, New York, 1962.

and extended to meet the requirements of other countries open up the possibility that the lag in rural development which seems to be virtually universal and one of the main causes of the growing inequality between rural and urban income can be eliminated<sup>1</sup>.

In many countries the support of agriculture will especially require two sets of measures: one, a more even distribution of land and, two, rural public works to absorb some of the rural underemployment. But even without tackling the politically and administratively difficult tasks of land reform and rural public works, much can be accomplished simply by directing a larger share of development expenditures (which must include current as well as capital expenditures) into agriculture. A study of one of my colleagues at the World Bank<sup>2</sup> indicates rather conclusively that agricultural development projects, especially in the form of agricultural credit schemes, irrigation works, and mixed schemes, involving land clearance, the provision of improved seeds or nursery stock, storage facilities, and above all, much extension service, will go a long way toward the elimination of income inequalities. Preliminary results of the study show that in the case of 42 out of the 53 projects investigated the income of the beneficiaries was below the national per capita income when the project was undertaken; after completion of the project the number was expected to be reduced to 33. More significantly, the median income of the beneficiaries of all projects was expected to increase from 40% of the national average to 63%, and, incidentally, from 72% of the national average farm income to 165%. The last two figures indicate that these projects were selected without explicit regard to their income distribution effects. It is obvious that a conscious effort in the selection of projects to the distribution of income would have brought even better results in that respect.

Turning now to the provision of educational services as a means of attacking one of the apparently prime causes of the unevenness of income distribution, it is clear that considerations of income distribution indicate that rural primary education should receive highest priority, to be followed by the provision of education and training at the secondary level for the staff of agricultural extension services, and perhaps by non-formal adult education, aimed at the rural population. This suggestion runs

<sup>1</sup> There is on the other hand the distinct possibility that the "green revolution" will at least temporarily lead to a deterioration of the income distribution within the rural sector. There is already evidence in some countries that the richer farmers gain more readily access to the "miracle" seeds and the inputs that go with it than the poor peasants.

<sup>2</sup> Hans A. Adler, *The Impact of Agricultural Projects on Income Distribution*, IBRD Internal Memorandum, November, 1971.

counter to the preference which in recent years development economists and educational experts have given to secondary education and vocational training. This preference is a secondary reflection of the preoccupation of the development economists with output, irrespective of income distribution. There is no need to throw it overboard, but to balance it off, in terms of overall budgetary allocation, with increased expenditures for primary education in rural areas.

The third avenue of a direct attack on the unevenness of income distribution is a policy to alleviate urban unemployment, in most countries not only one of the major causes of poverty and misery but also a significant focal point of social tension and political dissatisfaction, especially if not only the urban poor but also members of the educated middle class are unemployed. Development economists have argued that the chief means of curbing urban unemployment must be the expansion of industrial production, if necessary through the persistent pursuit of import substitution policies. This argument overlooks one important drawback: import substitution policies, if they involve articles of mass consumption, might lead to a deterioration of the distribution of real income. More recently the expansion of industrial production for export is being promoted chiefly for the purpose of improving the balance of payments; but its employment creating effects are also emphasized. The promotion of export industries is of course preferable, on grounds of self-enforcing efficiency, to self-perpetuating import substitution. But in view of the almost insurmountable obstacles in the world markets to a rapid expansion of industrial exports of developing countries and the likelihood that only a few of them will be able to break through the barriers of protection and commercial inexperience, the growth of industrial exports can be relied upon at best as making only a small contribution to solving the problem of urban unemployment. For these reasons one of the major remedial measures of unemployment in developed countries, the provision of public housing, should also have a place, and perhaps an important place, in the economic policies of developing countries — provided architects and construction technologists come up with a revision of their ideas as to what constitutes minimum standards of housing for the lower income groups in developing countries.

However, irrespective of the specific measures, or combination of measures that are taken to alleviate the unevenness of income distribution, it should be clear that they should not involve outright redistributive measures which would be reflected in the price level. For example, price support schemes for agricultural products for the domestic or the export market for the purpose of increasing farm income, the common method of income equalization in the advanced countries, or the introduc-

tion of maximum prices for staple products to keep down the cost of living of the urban population should be avoided because of the effects of the resulting price distortions on the supply and the demand of the controlled products. On the other hand, there is a case for intervening in the price mechanism if the purpose of such an intervention is the stimulation of supply or demand, or the reduction of supply or demand for a limited, or perhaps even for a prolonged, period provided the income distribution effects of such measures are realized.

#### IV.

In the preceding section the suggestion has been advanced that the distribution of income can be influenced by the selection and preparation of specific development projects. The purpose of this final section of this paper is to propose the outlines of a method, or a set of methods, by which this can be done.

The simplest and in some sense most radical method is to base the selection of development projects not on the size of the *total* net social return (or total net benefits), but on that part of total returns that accrues to beneficiaries below a certain income level. Whether this approach is easy or difficult depends on the characteristics of the project. In the case of an irrigation project, for example, the evaluation of the project should not be based on the increase in income of all beneficiaries but only of the beneficiaries below a certain income level. Since usually much is known about the distribution of land that can be brought under irrigation and presumably there exists a close correlation between the size of holdings and farm income, the distinction between rich and poor farmers should not be too difficult to establish. If the suggested criterion is applied, the selection would be "warped" in favor of the lower income groups, as against the use of the available water resources for other projects with fewer poor beneficiaries. If it turns out, however, that for technical reasons such as topography or soil characteristics it is reasonable to include a large area of farm land owned by rich farmers and landlords, then the project should be undertaken only if provisions for its financing are combined with provisions for the distribution of lands, or, as a minimum, for the regulation of the land rent so as to assure the tenants of most of the benefits of the project.

In the case of industrial projects, to follow the suggestion to exclude from the evaluation the benefits of beneficiaries over and above a certain income level would in most cases mean that profits would be disregarded; and two other types of benefits would become more important. One is the increase in wage income associated with the project, assuming that workers

would not be bid away from other employment. This type of benefit is itself reflected in the net social return if shadow wages are introduced in the appraisal. The introduction of the increase in workers' income on account of employment in the proposed project is usually done as a reduction of cost, but it can of course be added with the same result on the benefit side. The second modification would be to take account of the increases in the wage bill in the sectors supplying inputs to the new industry previously not produced, or, more generally to include on the benefit side those additions to the income of the lower income groups associated with the project. For example, in the case of a fruit or vegetable cannery, the increased income of poor farmers supplying the fruit or vegetable should be considered a benefit<sup>1</sup>.

An alternative method of taking income distribution effects into account in the evaluation of projects would be to give different weights to the benefits accruing to different income groups and to determine total net benefits and the rate of social return on that basis. This would of course be a practical application of the concept of diminishing marginal utility of income to project evaluation. It could be argued that giving different weights to income at different levels would be less arbitrary than the use of the unweighted total of additional net income which is of course the essence of standard cost/benefit analysis.

A further modification of the second method would be to weigh benefits not by income groups but to use as a basis of distinguishing different groups of income recipients, geographic regions, or sectors, with weights reflecting differences in income among the various regions or sectors.

Finally, improvements in the distribution of income can be achieved by applying shadow cost significantly below money cost to determine the social cost of employing members of the low income groups — which for practical purposes would be the urban unemployed and the rural underemployed — and to use the social cost in the choice of technology in the physical construction of projects. The application of this method would of course result in the more extensive use of labor as against capital equipment wherever there is a technological possibility of such a substitu-

<sup>1</sup> I am somewhat at a loss regarding the treatment of cost reductions of consumption goods generally purchased by the poor. *Prima facie* it makes sense to count the cost reductions accruing to the poor as a benefit, but I can envisage a number of complexities in concept and in practice which I am not sure can be sorted out on general grounds. (For example, the production of cheap footwear may lead to consumer benefits on the one hand but because of high profits to a deterioration of income distribution on the other; in that case the problem of a trade-off between an absolute increase in the net income of the poor and a deterioration of the distribution of income arises.)

tion. It must be realized, however, that this would increase the money cost of investment (by the difference of shadow wages and money wages) and that this difference should not be included in the capital cost of the project (and should be passed on the consumers of public facilities if a policy of full cost pricing is applied) but should be absorbed by the fiscal authorities as an exhaustive expenditure, similar to the cost of other welfare expenditures.

I fully realize that the preceding suggestions for the application of income distribution considerations are bound to run into all kinds of conceptual and practical difficulties. These difficulties should not, however, be considered as insurmountable, because even their rough and ready application would make a significant contribution to the solution of one of the major problems of development for which so far a solution seems to have eluded the development economists and the practitioners of development policy. After all, it must be remembered that the objective of development is not simply the increase in per capita income but the elimination or at least mitigation of poverty and human misery.

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Zusammenfassung: Entwicklung und Einkommensverteilung. — Wegen der ungleichen Einkommensverteilung in unterentwickelten Ländern können besonders drei Fragen gestellt werden: 1. Was sind die Ursachen der Ungleichheiten im Einkommen in Entwicklungsländern? 2. Warum wurde bis jetzt so wenig oder nichts getan, um die Ungleichheiten abzumildern? 3. Was, wenn überhaupt, kann in dieser Hinsicht getan werden? Der Verfasser kommentiert die beiden ersten Fragen, aber der Hauptzweck der vorliegenden Abhandlung besteht darin, einige vorläufige Antworten auf die dritte normative Frage zu geben. Er äußert die Vermutung, daß die Verteilung der Einkommen durch die Auswahl und Vorbereitung besonderer Entwicklungsprojekte beeinflußt werden könne, und skizziert die Umrisse von Methoden, mit denen dies bewerkstelligt werden kann.

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Résumé: Développement et distribution du revenu. — Vu la distribution inégale du revenu dans les pays à développer, on peut poser trois questions en particulier: 1. Quelles sont les causes des inégalités de revenu dans les pays à développer? 2. Pourquoi n'a-t-on, jusqu'à présent, rien fait, ou en tout cas très peu, pour mitiger ces inégalités? 3. Y a-t-il quelque chose — et quoi? — qu'on pourrait y faire? L'auteur fait quelques remarques à propos des deux premières questions, mais c'est son but principal de donner quelques réponses tentatives à la troisième question normative. Il suggère qu'on pourrait exercer une influence sur la distribution du revenu en choisissant et préparant des projets spéciaux de développement, et il donne l'ébauche des méthodes avec lesquelles cela pourrait se faire.

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Resumen: Desarrollo y distribución del ingreso. — En vista de la distribución desigual del ingreso en países subdesarrollados cabe preguntar, entre otras cosas, (1) ¿cuáles son las razones de las desigualdades en el ingreso en países en desarrollo? (2) ¿por qué se ha hecho hasta el momento tan poco o nada para reducir dichas desigualdades? (3) ¿qué se puede hacer realmente? El autor comenta las dos primeras preguntas, pero el objetivo principal del presente trabajo consiste en dar algunas contestaciones preliminares a la tercera pregunta. Opina que se podría influenciar la distribución del ingreso a través de la selección y preparación de proyectos especiales de desarrollo, y diseña los métodos que se prestarían a llevar ésto a cabo.

Riassunto: Sviluppo e distribuzione dei redditi. — A causa della disuguale distribuzione dei redditi nei Paesi in via di sviluppo, tre questioni possono essere specialmente poste: 1. Quali sono le cause delle disuguaglianze nel reddito nei Paesi in via di sviluppo? 2. Perché fino ad ora è stato fatto così poco o niente per attenuare le disuguaglianze? 3. Che cosa può essere fatto, se mai, sotto questo riguardo? L'autore commenta le prime due questioni, ma lo scopo principale del presente saggio consiste in questo, di dare alcune risposte provvisorie alla terza questione normativa. L'autore esprime l'ipotesi che mediante la scelta e la preparazione di speciali progetti di sviluppo possa essere influenzata la distribuzione del reddito e schizza le linee di metodi con cui ciò può essere realizzato.