CBO MEMORANDUM

THE ROLE OF FOREIGN AID IN DEVELOPMENT: COSTA RICA AND HONDURAS

December 1997

CONGRESSIONAL BUDGET OFFICE

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SECOND AND D STREETS, S.W.
WASHINGTON, D.C. 20515

NOTES

All years referred to in this memorandum are fiscal years unless otherwise noted.

All dollar amounts are expressed in 1997 dollars unless otherwise noted.

Numbers in text and tables may not add to totals because of rounding.

What role does foreign aid play in promoting the economic development and improving the social welfare of countries in Africa, Asia, and Latin America? That question is difficult to answer and has been the subject of much debate among development specialists as well as Members of Congress and the American public.

Drawing on the works of other scholars, this memorandum analyzes the role of foreign aid in the development of Costa Rica and Honduras between 1953 and 1993. It is one of three that are being published as background papers for *The Role of Foreign Aid in Development,* a Congressional Budget Office (CBO) study published in May 1997. These memorandums are intended to illustrate more fully the themes identified in the main study.

Eric J. Labs of CBO's National Security Division prepared the memorandum under the general supervision of Cindy Williams and R. William Thomas. Richard Fernandez and Julia Matson of CBO provided valuable assistance. Many officials of the Agency for International Development, the Inter-American Development Bank, and the Organization for Economic Cooperation and Development also provided information. In particular, the author would like to thank James Fox, Ellen Peterson, and Cheryl Warner. The author would also like to thank Nicholas Eberstadt of the American Enterprise Institute and Harvard University, for reviewing an earlier draft of the manuscript. The author and CBO, however, bear full responsibility for the final product.

Sherry Snyder edited the manuscript, and Melissa Burman proofread it. Judith Cromwell prepared it for publication.

Questions about the analysis may be addressed to Eric Labs at (202) 226-2900.

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SUMMARY

This memorandum is one of several to be published by CBO on various developing countries and the role that foreign aid has played in their development. CBO has published a study titled *The Role of Foreign Aid in Development*. Through a broad review of the academic and policy literature on development, that study attempts to identify the important conditions for development and the role that foreign aid plays in that process. It also highlights the general themes gleaned from the literature with illustrations from eight developing countries: South Korea and the Philippines, Costa Rica and Honduras, Botswana and Zambia, and Tunisia and Egypt. This memorandum examines the development history of Costa Rica and Honduras. Although both countries have received substantial amounts of foreign assistance, Costa Rica has been relatively more successful in achieving long-term economic and social development than Honduras.

The government of Costa Rica has run the country well. Politically, Costa Rica is the oldest democracy in Latin America. In 1948, the government abolished the army. The electorate has generally alternated the presidency between the two major political parties. The government has also invested heavily in education, health, and human welfare.

Costa Rica's economic policies between 1950 and 1980 led the country gradually toward increasingly higher degrees of trade protectionism, state-centered industrialization, and deficit spending. That strategy worked initially in promoting economic growth—in part because of the government's huge investment in human capital. But by the late 1970s, those economic policies contributed to a major economic crisis and dramatic declines in economic growth. Nonetheless, the willingness of the government to make reforms—reduce spending, lower tariff and nontariff barriers to trade, and liberalize the exchange rate—has returned Costa Rica to a strong growth track.

Foreign assistance, particularly U.S. assistance, has made a positive contribution in promoting education, health, and agriculture. The record is more mixed with respect to promoting economic growth. On the one hand, foreign aid tended to reinforce Costa Rica's economic mismanagement in the 1960s and 1970s. On the other hand, it assisted Costa Rica in making various reforms that returned the country to prosperity.

Honduras, however, is one of the poorest countries in Latin America. The government has been less stable and more corrupt. Between 1950 and 1980, the military took control of the government five times. Moreover, the Honduran government has invested less in human capital than has the Costa Rican government.

The economic policies of Honduras paralleled those of Costa Rica up through the economic crisis of the early 1980s. But unlike its neighbor, the Honduran government was far less willing to make necessary reforms to promote economic growth, partly because the United States continued to give it foreign aid, regardless of its economic policies, in return for support of U.S. foreign policy objectives in the region. The Honduran economy managed only lackluster growth through the 1980s.

By the 1990s and the end of the Cold War, however, the United States was no longer willing to provide unconditional assistance and began cutting funding levels. The inability of the economy to generate sustained economic growth prompted the Honduran government to make some reforms such as liberalizing trade and devaluing the currency. As a result, the economy has achieved more vigorous growth in recent years. Those accomplishments look promising, but their sustainability remains uncertain.

INTRODUCTION

The Congressional Budget Office (CBO) is publishing several memorandums on various countries and the role that foreign aid has played in their development. In May 1997, CBO released a study titled *The Role of Foreign Aid in Development.* Through a broad review of the academic and policy literature on development, that study identifies the important conditions for development and the role that foreign aid plays in that process. It also highlights the general themes gleaned from the literature with illustrations from eight developing countries.

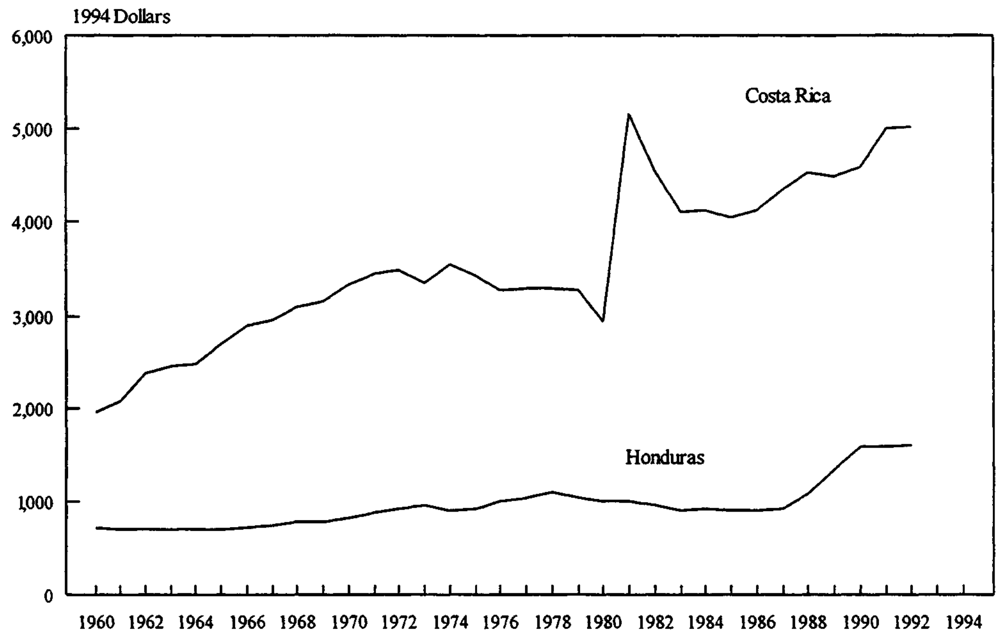
This memorandum provides a detailed comparison of the development history of Costa Rica and Honduras. It also distills and synthesizes what development specialists have written about them. CBO has not attempted to engage in original research on these two countries. Although both countries have received substantial amounts of foreign assistance, Costa Rica has been relatively more successful in achieving long-term economic and social development than Honduras. The other countries CBO has examined are South Korea and the Philippines, Botswana and Zambia, and Tunisia and Egypt.

Costa Rica is smaller than Honduras, with a population in 1994 of 3.3 million people and a land area of 50,700 square kilometers. Honduras has 5.3 million people and 112,100 square kilometers of land. The countries have roughly similar climate and terrain and about the same amount of usable coast line. Honduras has a larger and more diverse base of natural resources. More than 90 percent of the population in both countries share a similar religious background, though they have different ethnic compositions.

However, Costa Rica and Honduras have differed along various economic and social indicators. Since the 1960s, Costa Rica's economy has grown much more and faster than that of Honduras (see Figure 1). Costa Rica's infant mortality, illiteracy, and fertility rates have fallen faster than Honduras's (see Table 1).

Many different factors account for those disparities. Some are unique, such as cultural or societal idiosyncracies. In addition, as of the early 1950s, Costa Rica had a better foundation on which to build. Its economy and society were more advanced than that of Honduras. Nevertheless, the political and economic management of each country mattered as well. Foreign aid, for its part, tended to reinforce that management—both when it was favorable to development and when it was not.

FIGURE 1. GROSS NATIONAL PRODUCT PER CAPITA FOR COSTA RICA AND HONDURAS, 1960-1994



SOURCE: Congressional Budget Office based on data from the World Bank and the University of Pennsylvania.

NOTES: Gross national product per capita is based on estimates of purchasing-power parity.

The spike in 1980-1981 for Costa Rica reflects a major devaluation of the currency.

TABLE 1. SOCIAL INDICATORS FOR COSTA RICA AND HONDURAS, 1967 AND 1992

	1967		1992	
Indicator	Costa Rica	Honduras	Costa Rica	Honduras
Infant Mortality Rate[a]	68	119	14	43
Literacy	88[b]	57[b]	93	73
Fertility Rate[c]	5.8	7.4	3.1	4.9
Calorie Consumption[d]	2,259	2,103	2,886	2,306

SOURCE: Congressional Budget Office based on data from the World Bank and the Agency for International Development.

a. Deaths of infants under 1 year of age per 1,000 live births.
b. Value for Costa Rica is for 1973; for Honduras, 1974. Those values are the most comparable numbers available.
c. Births per woman.
d. Per capita per day.

Costa Rica is a development success story. In 1996, the Agency for International Development (AID) closed its mission there and "graduated" the country from the ranks of U.S. foreign assistance. Several other country donors will follow suit, although multilateral organizations will continue to provide aid. Costa Rica's economic growth between the 1950s and today, while not always a smooth ride, is nevertheless real and impressive. Most of the success lies in the economic policies that Costa Rica pursued over the past 40 years and its stable, democratic political system. And its growth was accomplished without leaving the poor behind. All segments of the Costa Rican population were included in this period of growth.

One feature of Costa Rica that stands out in Central and South America is the stability of its political system. Costa Rica is the oldest continuously functioning democracy in Latin America. It is also a very stable democracy. Costa Rica is governed by a legislative assembly and an executive. In most elections since 1950, the presidency has alternated in elections between the two major political parties: the Partido Liberación Nacional (PLN), a social democratic party, and a loose coalition of forces opposed to the PLN (see Table 2).

In 1948, after a two-month civil war, the army was disbanded and was never reestablished. That fact alone freed more resources over a long period of time for investment in health, education, and infrastructure.

This political stability played an important role in promoting Costa Rica's economic growth because it favored investment and the strengthening of institutions. Costa Rica avoided the political upheaval that characterized much of Central and South America over the past 40 years, and that stability fostered sustained foreign investment. Costa Rica's political culture was and is oriented toward consensus, peaceful resolution of conflicts, and law and order. Unlike many of its neighbors, it was spared from a guerrilla war during the 1970s and 1980s.

The judicial system in Costa Rica is well established and provides a framework for defining and enforcing contracts.[1] Property rights are well defined and protected under the judicial system. In theory, that should make it easier for foreign and domestic entrepreneurs to invest and start businesses, profit from them, and create jobs and economic growth. Political stability in general, in the view of

1. Simon Rottenberg, ed., *Costa Rica and Uruguay: The Political Economy of Poverty, Equity, and Growth* (Washington, D.C.: World Bank, 1993), pp. 20-21. The discussion of Costa Rica's economic development relies heavily on this work.

TABLE 2. PRESIDENTIAL ADMINISTRATIONS OF COSTA RICA, 1948-1994

Year	President	Party	Percentage of Vote
1948-1949	José Figueres	Liberación (Junta)	n.a.
1949-1953	Otilio Ulate	Unión Nacional	55
1953-1958	José Figueres	Liberación	65
1958-1962	Mario Echandi	Unión Nacional	46
1962-1966	Francisco Orlich	Liberación	50
1966-1970	José J. Trejos	Unión Nacional	51
1970-1974	José Figueres	Liberación	55
1974-1978	Daniel Oduber	Liberación	43
1978-1982	Rodrigo Carazo	Unidad	51
1982-1986	Luis A. Monge	Liberación	59
1986-1990	Oscar Arias	Liberación	51
1990-1994	Rafael A. Calderón	Unidad	53

SOURCE: Simon Rottenberg, ed., *Costa Rica and Uruguay: The Political Economy of Poverty, Equity, and Growth* (Washington, D.C.: World Bank, 1993), p. 22.

NOTES: Liberación is the short form of Partido Liberación Nacional (PLN), the social democratic party in Costa Rica. Unión Nacional and Unidad represent a loose coalition opposed to the PLN.

n.a. = not applicable.

some experts, has reduced the risks and transaction costs of operating in the Costa Rican society and economy.[2]

The Costa Rican government chose to invest heavily in health, education, and infrastructure. As noted above, Costa Rica has by any measure a healthy and well-educated population. The country has over 35,000 kilometers (km) of highway, of which 5,600 km are paved. (In contrast, Honduras, which is twice Costa Rica's size, has only 8,950 km of highway, with 1,700 km paved.) These investments have created a well-educated and mobile labor force.[3]

INFLUENCE OF DOMESTIC ECONOMIC POLICY ON COSTA RICA'S DEVELOPMENT

Costa Rica's economy before 1948 was dominated by coffee and bananas. Those two products accounted for 97 percent of exports and 25 percent of gross domestic product (GDP). Agriculture employed 55 percent of the labor force. Together with the bankers and importers, the coffee and banana exporters formed the structure of society. Land was widely distributed. United Fruit (later United Brands) dominated the banana industry, which employed mostly unskilled labor.[4] Many coffee producers, however, were smaller landholders, though 5 percent of growers controlled half the coffee trees. Manufacturing was small and primitive. The government provided few services, and only 6 percent of the labor force worked in the public sector.

The junta that came to power after a two-month civil war in 1948 was motivated by a social democratic ideology. It immediately began transforming the economy, the state, and their relationship to each other. The social democrats wanted to use the public sector to build a much stronger infrastructure base, provide more services, and develop and promote exports other than coffee and bananas. Their goal was to modernize the state, diversify the economy, promote greater economic growth, and widen the entrepreneurial opportunities available to the middle class. The junta nationalized the banks in order to provide wider access to credit.[5] Construction of

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2. Ibid., p. 127.

3. See Rafael Celis and Eduardo Lizano, "Development in Costa Rica: The Key Role of Agriculture," in John W. Mellor, ed., *Agriculture on the Road to Industrialization* (Baltimore: Johns Hopkins University Press, 1995), p. 243.

4. Helen L. Jacobstein, *The Process of Economic Development in Costa Rica, 1948-1970: Some Political Factors* (New York: Garland Publishing, 1987), pp. 33-35.

5. Ibid., pp. 266-267.

Construction of new infrastructure—such as roads, electricity, and water systems—began. The junta also preserved the social security benefits first introduced in the early 1940s.

After the junta relinquished power in 1949, the conservative administration of Otilio Ulate (1949-1953) provided some fiscal restraint. It reduced the public debt, restored price stability, and created surpluses in the balance of payments, but it also preserved the reforms and activities begun by the junta. Rising coffee prices provided export earnings that helped support continued investment in the economy.[6]

The social democratic administration of José Figueres (1953-1958) continued and accelerated the institutional and economic changes begun during the junta period. The government used its tools and resources to promote economic diversification. New crops and activities included basic grains for domestic consumption, beef and dairy cattle, sugarcane, cotton, and fishing. The government emphasized more infrastructure development: highways, feeder roads, bridges, ports, airstrips, electricity-generating plants, industrial water supplies, and technological improvement through research and extension. Public-sector employment expanded. The government paid for many of those efforts with higher taxes on the coffee and banana industries and the additional earnings from the continuing boom in coffee prices.[7]

During the administration of Mario Echandi (1958-1962), a decline in coffee prices slowed economic growth, but expansion of the public sector and transformation of the economy continued. However, for the first time the government used some funds that had been borrowed abroad to provide subsidies and other advantages for certain segments of agriculture. Previously, such funds had always been used to build infrastructure.[8]

Overall, between 1950 and 1963, agriculture's share of GDP fell from 41 percent to 26 percent. The share of government and public-sector activities increased from 21 percent to 30 percent of GDP. Manufacturing remained the same. Central government expenditures increased 5.2 times, and public-sector employment doubled. By exploiting its coffee and banana resources while building infrastructure and promoting exports with the revenues generated by those products, Costa Rica transformed itself in little more than a decade.

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6. Rottenberg, *Costa Rica and Uruguay*, p. 133.

7. Ibid., pp. 134-135.

8. Ibid., pp. 135-136.

Import Substitution and Industrialization

Costa Rica's social democrats in the 1960s sought to promote further industrialization and manufacturing by joining the Central American Common Market (CACM), an idea that the United Nations' Economic Commission on Latin America had been recommending since the early 1950s.[9] The agricultural interests in Costa Rica, especially the coffee and banana growers, opposed that move, viewing it as a threat to their industries. But social democrats returned to the executive with the administration of Francisco Orlich (1962-1966), and Costa Rica joined the CACM.

Costa Rica then adopted an industrialization strategy of mixed protectionism. The government opened the markets to the other states of Central America but maintained high protectionist tariffs on goods produced outside the CACM.[10] That strategy benefited the industrialists and thereby increased their power and privileges. But the government did not neglect agriculture. It still provided most of Costa Rica's export income. The government adopted measures to encourage larger coffee yields and provided credit and subsidies to new entrepreneurs who wanted to enter the lucrative banana industry. The government continued to promote other export products, such as beef and sugar.[11]

Initially, the CACM had the desired effect. Between 1960 and 1970, industry grew at more that twice the rate of agriculture. Agriculture's share of GDP dropped (see Table 3). As a share of the labor market, agriculture declined to 38 percent (from 55 percent around 1950). Exports continued to be the engine of growth. The revenue derived from the agricultural exports was used to support the more capital-intensive manufacturing sector. Agricultural productivity improved as a result of augmented land yields, greater skills, and more efficient use of labor in the economy.[12] The public sector continued to grow as well. Between 1960 and 1970, government grew from 9 percent to 11 percent of GDP.

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9. Victor Bulmer-Thomas, *The Political Economy of Central America Since 1920* (New York: Cambridge University Press, 1987), p. 172.

10. Celis and Lizano, "Development in Costa Rica," p. 251.

11. Rottenberg, *Costa Rica and Uruguay*, p. 137-138.

12. Ibid., p. 138.

TABLE 3. COMPOSITION OF COSTA RICA'S GROSS DOMESTIC PRODUCT BY SECTOR, 1950-1980 (In percent)

Sector	1950	1960	1970	1980
Agriculture	41	26	22	18
Manufacturing[a]	13	14	18	19
General Government[a]	5	9	11	15
Construction	b	5	5	6
Commerce	19	21	21	20
Other	21	25	23	22

SOURCE: Congressional Budget Office based on data from Simon Rottenberg, ed., *Costa Rica and Uruguay: The Political Economy of Poverty, Equity, and Growth* (Washington, D.C.: World Bank, 1993), p. 162.

a. The available data do not indicate how the state-owned enterprises are being accounted for—in government or in manufacturing. They are probably recorded in "Manufacturing."

b. Included in "Other."

State-Centered Development

By the 1970s, Costa Rica's economy had become much larger, more diversified, and complex. The society and state had modernized significantly. Agriculture no longer dominated the economy or the society. The rise of industry led to greater urbanization. Public-sector employment now accounted for 15 percent of total employment. The economy, despite significant protection through the CACM, had become more open. Coffee and bananas accounted for barely half of Costa Rica's growing export sector. Continued government investment in education, training, and health care helped alleviate poverty as rising wages accompanied economic growth. The average Costa Rican was able to take advantage of new economic opportunities as they arose, rather than simply subsisting in poverty and lacking education or skills.[13]

But by the mid-1970s, the protectionism of the CACM was beginning to serve as a drag on the economy. The inefficiencies that it created—reduced competition and loss of access to changes in technology—were reducing the competitiveness of Costa Rica's industry, particularly in markets outside the CACM. Productivity growth slowed. The economic and political groups that benefited from this protection sought to strengthen it by diverting more government resources to unproductive activities.[14]

The size of the public sector as a percentage of GDP continued to grow. Between 1970 and 1980, general government rose from 11 percent to 15 percent of GDP (see Table 3). During those years, the government created a number of institutions to promote economic growth and industry and established state-owned industrial enterprises.[15] Those organizations, however, became interest groups that wanted to maintain and expand the subsidies and protection provided by the government. Transfer payments continued to grow and were being extended to almost every segment of society. In essence, a class of politician-entrepreneurs arose in which individuals who ran the state enterprises benefited from privileged access to credit and wielded enormous influence over government policy to create more benefits for themselves or the groups they represented. The more productive elements in society suffered as a result.[16]

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13. Rottenberg, *Costa Rica and Uruguay*, p. 140.

14. Ibid., p. 141.

15. Celis and Lizano, "Development in Costa Rica," p. 257.

16. Rottenberg, *Costa Rica and Uruguay*, p. 143.

One important illustration of these developments was the creation of the Costa Rican Development Corporation (CODESA). Spawned from the social democratic ideology that increasingly blended protectionism, nationalism, and government planning, the CODESA provided the means by which the state engaged in production that competed directly with the private sector.[17] But it never became profitable. It was given preferred credit by the nationalized banks, absorbing 18 percent of domestic credit while producing only 1.8 percent of GDP and 0.3 percent of total employment in the mid-1970s. The CODESA not only contributed to the deterioration of public finances but also reduced the available savings for more productive investment.

In short, according to one study, before the economic crisis of the early 1980s, a class of politician-entrepreneurs arose as the bureaucracy, autonomous institutions, and state-owned enterprises expanded. That group used its political and economic power to set up state-run businesses that competed with the private sector. A bureaucratic middle class also arose that benefited from the direction of the Costa Rican economy and government spending. In contrast, a more productive, private-sector middle class languished as a result of government regulation, which was sometimes politically motivated, and a lack of credit. The more the public sector grew and the more the government granted privileges to particular groups, the more powerful the public sector became and the more benefits it extended to still more groups.[18]

None of that was a serious problem for Costa Rica initially for two reasons. First, the international economy continued to grow, and there was an international demand for Costa Rica's traditional exports of coffee and bananas. Although they made up only half of Costa Rica's total exports, they remained the bulk of exports sold outside the CACM. Indeed, every time there was a boom in coffee prices, such as the one in 1976, more benefits and entitlements were extended to ever-greater segments of the society. Second, foreign savings continued to flow in. The revenues from exports and foreign savings financed public-sector spending and Costa Rica's growth.[19]

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17. Mylena Vega, "CODESA, Autonomous Institutions, and the Growth of the Public Sector," in Marc Edelman and Joanne Kenen, eds., *The Costa Rica Reader* (New York: Grove Weidenfeld, 1989), pp. 141-144.

18. Rottenberg, *Costa Rica and Uruguay*, pp. 142-143.

19. Ibid., pp. 143-144. See also Bulmer-Thomas, *Political Economy of Central America*, pp. 214-215.

Economic Crisis

Costa Rica's successful development path was sidetracked in the early 1980s. High government spending, uncompetitive state-owned firms, and an increasingly inefficient, protected private sector contributed ultimately to a financial collapse. A decline in coffee prices in the late 1970s (following the boom in 1976) reduced government revenues, but powerful public-sector unions prevented a reduction in government spending. Even though revenues fell, those entitlements were politically impossible to stop, and public finances were strained. Costa Rica is a small country, and some presidential elections have been won by only a few thousand votes. Cutting 200 people from the government payroll or scaling back entitlements, for example, might reduce the margin of victory in the next election by a noticeable percentage. The government thus postponed putting its finances in order by borrowing abroad, hoping that better prices for the country's exports were just around the corner.

Ultimately, foreign lenders refused to let Costa Rica borrow any more money. Inflation and devaluation of the currency ensued. As one study noted, "inflation and devaluation reflected income entitlements that added up to a total well above the available income from productive activities and the country's importing capacity. As a result, the exchange rate and the financial system collapsed."[20] Real per capita GNP declined by 21 percent between 1979 and 1982. The investments the government had made and continued to make in human capital, however, permitted nearly continuous improvement in other social indicators. Infant mortality and fertility rates maintained their decades-long decline.[21]

Political stability, strong export growth, and substantial investments in human capital provided the foundation for economic growth. But the seeds of Costa Rica's economic problems in the early 1980s lay in the economic policies the government pursued: mixed protectionism, the growth of the public sector and government bureaucracy, high levels of government spending, and the extensive benefits conveyed to the groups that wielded political power.

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20. Rottenberg, *Costa Rica and Uruguay*, pp. 143-144.

21. For a general discussion of the issues, see Sheldon Annis, "Debt and Wrong-Way Resource Flows in Costa Rica," *Ethics and International Affairs*, vol. 4 (1990), pp. 107-121; and Marvin Taylor-Dormond, "The State and Poverty in Costa Rica," *Cepal Review*, no. 43 (April 1991), pp. 131-148.

Recovery

The severity of the economic crisis and the inability of the government to borrow abroad to cover its fiscal and balance-of-payments deficits convinced many policymakers that major reforms of the economy and the government were necessary. The reforms meant moving away from protectionist, import-substitution policies and toward liberalizing the economy, privatizing state-owned enterprises, reforming and reducing government finances, reducing subsidized and directed credits, and liberalizing interest and exchange rates.[22]

Costa Rica's tradition of governing by consensus made it difficult to implement those reforms. Nevertheless, the reforms thus far have been promising. Costa Rica has returned to a path of rapid economic growth, and the social indicators have continued to improve. Unemployment has fallen dramatically since 1982 and 1983, the height of the economic crisis. Nontraditional products to countries outside the CACM grew to 43 percent of exports between 1980 and 1990 (see Table 4). Equally important, foreign investment in Costa Rica, which had declined precipitously in the early 1980s, was reaching new highs in the 1990s (see Figure 2).[23]

ROLE OF FOREIGN ASSISTANCE IN COSTA RICA'S DEVELOPMENT

Foreign aid generally played a positive role in Costa Rica's development.[24] The major donors were the Agency for International Development, the World Bank, and the Inter-American Development Bank.

The balance between bilateral aid and assistance from multilateral organizations has shifted over time. Direct U.S. aid accounted for most of Costa Rica's foreign assistance in the 1950s. It was largely technical assistance. In the 1960s, the United States was still a major donor, but the multilateral organizations were expanding their programs, particularly infrastructure loans. In the 1970s, U.S. aid played a marginal role, and the multilateral institutions contributed the overwhelming majority of resources. That pattern reversed in the 1980s, when the United States was again the primary provider of assistance (see Figure 3).

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22. Juan J. Buttari, "Economic Policy Reform in Four Central American Countries: Patterns and Lessons Learned," *Journal of InterAmerican Studies and World Affairs*, vol. 34 (Spring 1992), pp. 183-184.

23. Ibid., pp. 203-204. For a discussion of poverty isues, see Samuel A. Morley, *Poverty and Inequality in Latin America: The Impact of Adjustment and Recovery in the 1980s* (Baltimore: Johns Hopkins University Press, 1995), pp. 134-150.

24. This section relies heavily on the papers being produced for AID's forthcoming 50-year retrospective study on the role of foreign aid in Costa Rica's development.

TABLE 4. COMPOSITION OF COSTA RICA'S EXPORTS, 1980-1994 (In percent)

Type and Destination	1980	1985	1990	1994
Traditional (To all countries)[a]	57	63	47	47
Nontraditional[b]				
To CACM countries	27	15	10	17
To all other countries	16	22	43	36

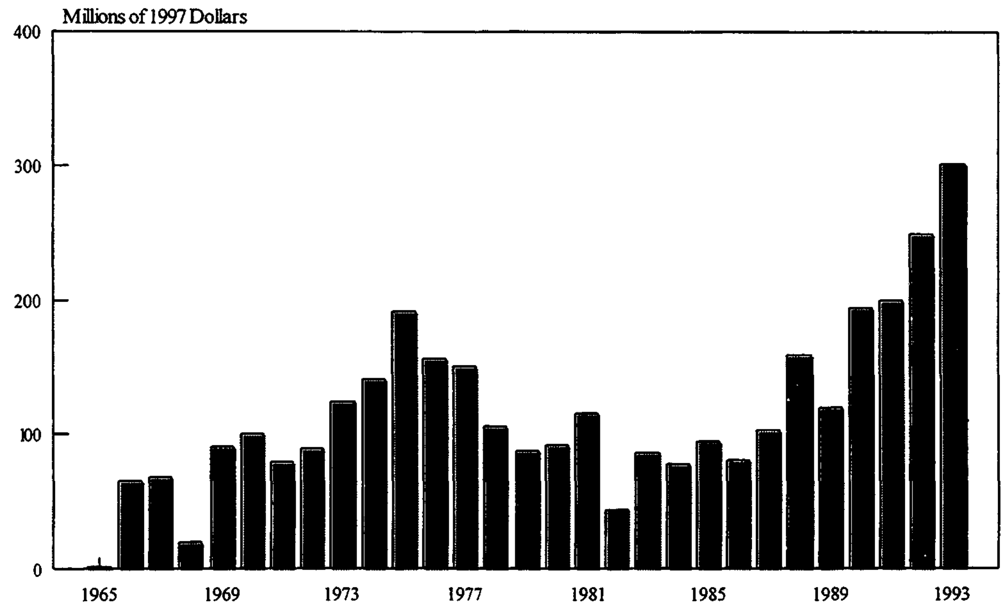
SOURCE: Congressional Budget Office based on data from the Agency for International Development.

NOTE: CACM = Central American Common Market.

a. Coffee, bananas, beef, and sugar.

b. Manufactured goods and different primary commodities such as watermelon.

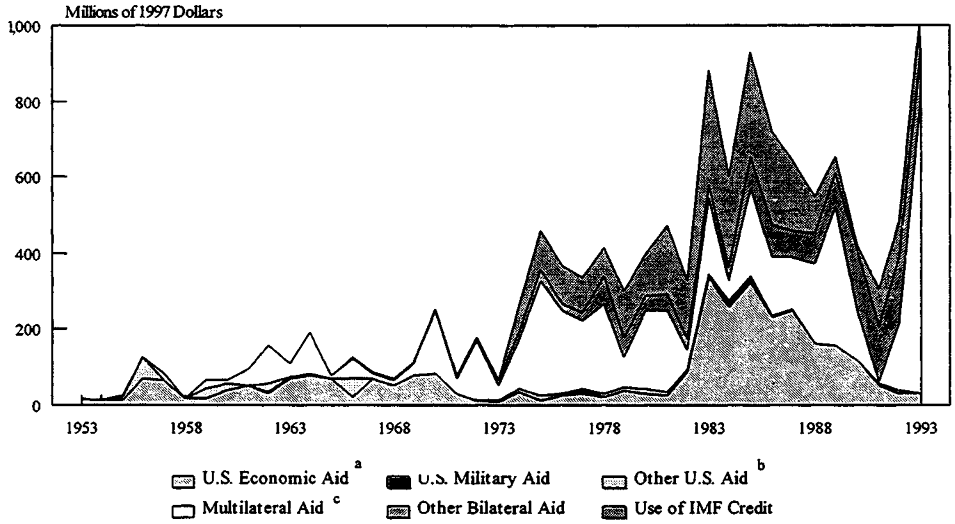
FIGURE 2. FOREIGN DIRECT INVESTMENT IN COSTA RICA, 1965-1993



SOURCE: Congressional Budget Office based on data from the World Bank.

NOTE: Data for foreign direct investment is in dollars deflated by the U.S. deflator for gross domestic product.

FIGURE 3. FOREIGN ASSISTANCE TO COSTA RICA, 1953-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development, the World Bank, and the Organization for Economic Cooperation and Development.

NOTE: IMF = International Monetary Fund.

a. Represents development assistance grants and loans, the Economic Support Fund, and P.L. 480 assistance.

b. Mostly loans from the Export-Import Bank.

c. Data for 1993 represent a major loan from the Inter-American Development Bank. The loan will be disbursed over succeeding years.

Health

The start of U.S. assistance to Costa Rica for health-related programs is difficult to date, but it began well before 1950. Assistance from some multilateral organizations, such as the Pan American Health Organization, the World Health Organization, and the United Nations Children's Fund also date to at least the 1940s. The involvement of the World Bank and the Inter-American Development Bank in the health sector occurred later. The United States has been a primary provider of assistance in this sector.

The Agency for International Development made 29 loans for health-related projects and 26 smaller loans with P.L. 480 food assistance funds between 1951 and 1987. The government of Costa Rica, despite occasional administrative and political stumbling blocks, invested substantially in the health sector and used foreign assistance to improve the health of its population. Health has improved markedly over the past 40 years along numerous indicators. Infant mortality decreased from 68 deaths per 1,000 live births in 1967 to 14 in 1992. Between 1973 and 1993, coverage of health care programs expanded from 11 percent to 59 percent of the population. The death rate per 100,000 people declined by over half from 1951 to 1981. Deaths from diarrheal diseases have declined from 1,411 in 1953 to 83 in 1993. Nutritional deficiencies have fallen according to a number of different measures. Access to water and sewers has been greatly expanded.

The three largest donors to Costa Rica—the United States, the World Bank, and the Inter-American Development Bank—have devoted approximately 7 percent of their economic assistance to health programs. The overall purpose of those efforts was to improve the quality and access to health care for the population. Between 1950 and 1980, those efforts encompassed a wide range of activities devoted to improving community health, including health infrastructure, education and training of health professionals, improving water supplies and sewage, general sanitation, malaria control, expansion of primary health care, reproductive health, child nutrition, health research, preventive health, and medical services.

In addition, the construction of the Inter-American Highway, which began in the 1940s with U.S. funds, played an important role in helping unify the country and providing the means to get health services to rural areas. It also provided many jobs and, because of the large U.S. presence, introduced a wider and healthier diet to the various local regions during construction.

During the 1980s, however, most AID projects focused on medical issues that were more distant from the public health requirements of the country. Preventive and primary health care were de-emphasized. Projects for improving health services support, new drugs, skills for maintaining medical equipment, and technology transfer appeared to have yielded limited results. Most of the money seems to have been spent on consultants and travel, with few obvious benefits for Costa Rica. To be fair, however, Costa Rica is no longer confronting the health problems that usually plague developing countries. The health issues it now faces are more similar to those of a developed country.[25]

Education

Spending on education programs represented less than 4 percent of the assistance provided by the United States, the Inter-American Development Bank, and the World Bank. The Costa Rican government had already placed a high priority on education, and its education levels were higher than in most other developing countries. Nevertheless, those organizations played a mostly positive role in enhancing educational opportunities and quality for Costa Ricans. The record is occasionally marred by the inability of the receiving organizations in Costa Rica to use the funds effectively and by conflicts between the developmental and political priorities of AID and the Costa Rican government.

Through 1961, AID's funding focused on the training of Ministry of Education personnel and University of Costa Rica academicians. Other projects included supporting vocational education, bringing U.S. professors to Costa Rica to teach, and financing graduate degrees for Costa Ricans. In the 1960s, education assistance was limited to supporting mass primary education through a textbook project. That low level of funding continued into the 1970s. In the 1980s, AID placed greater emphasis on education, viewing it as a means of spreading the benefits of future economic growth.

Population Growth

The fertility rate had begun declining in Costa Rica as a result of the country's relatively good socioeconomic conditions even before any foreign assistance was provided to those programs. AID, in cooperation with such agencies as the United Nations Fund for Population Activities, carried out numerous activities in this area. The first significant project was initiated in 1970. Foreign assistance for population-related issues included such activities as training for medical personnel, introducing a wider variety of contraceptives to a larger proportion of the population, education in family planning, and public information campaigns.

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25. This is drawn from a draft paper for AID's retrospective study on the impact of foreign aid in Costa Rica.

It is impossible to allocate responsibility precisely for Costa Rica's improvement on population-related indicators. Nevertheless, the role of foreign assistance seems to have been a modest one. Foreign assistance was a catalyst at times for supporting projects and programs that the government or other elements of Costa Rican society wanted. But the trend of declining fertility was already in place before AID or multilateral donors entered the picture. Costa Ricans practiced contraception effectively before there were organized family planning activities. Even when some of those programs encountered political disinterest or administrative problems in the late 1970s and ceased being effective, the fertility rate continued to decline.

Agriculture

An important and valuable contribution of foreign assistance in Costa Rica, according to AID's evaluation, was in the realm of agricultural education and research. In the first decade covered by this study, foreign aid helped establish an agricultural extension service to transfer technology. AID supported research and extension projects for improving pasture lands, irrigation, and soil conservation. Foreign assistance, particularly from multilateral organizations such as the Inter-American Development Bank, supported the development of economic and social infrastructure. Increasingly, agriculture became part of a larger and broader food production and processing industry.

After the 1982-1983 economic crisis, aid played a role in developing and promoting nontraditional agricultural exports, which diversified Costa Rica's export base and improved its export earnings. In 1983, for example, nontraditional export products (those other than coffee, bananas, sugar, and beef) represented 38 percent of total exports. By 1990, that figure had increased to 53 percent. And because nontraditional agricultural exports are more labor intensive, they employed more people at better wages. The United States, the Inter-American Development Bank, and the World Bank devoted approximately 11 percent of their assistance to agriculture.

Economic Growth

The three big donors to Costa Rica allocated almost 75 percent of their assistance to activities associated with promoting economic growth. Most of the resources in the 1970s and especially the 1980s were devoted to that sector. In the 1980s, foreign assistance helped Costa Rica undertake necessary and costly adjustments to its financial, institutional, and trade policies. But the aid given to Costa Rica in the

1970s was arguably quite harmful in that it enabled the government to pursue the self-destructive policies that brought on the 1982-1983 economic crisis.

Until 1982, aid that was intended to promote economic growth seemed to reinforce the economic policies of the government regardless of how wise those policies were. In the 1950s under President Eisenhower, the United States was a determined advocate for free trade and liberalized economies. But the Cuban revolution of 1959 prompted a different course. During the 1960s, the United States, partly for political reasons, provided Costa Rica with foreign assistance to support its integration with the economies of Central America and thereby resist communist expansion. In addition, "economic planning" was also a requirement of the Alliance for Progress program. Multilateral institutions provided loans and grants to build infrastructure. The short-term result was that Costa Rica's economy continued to grow, and its industrialization process intensified.

During the 1970s, AID focused on basic human needs and reducing poverty. Overall, however, the United States played a very small role in Costa Rica as a whole, and only very small amounts of U.S. direct aid were given in the economic and trade sector. The multilateral institutions, especially the Inter-American Development Bank, contributed substantial sums to Costa Rica for various economic projects. Those financial inflows helped offset Costa Rica's trade deficits at a time when the Costa Rican economy was slowing and its financial situation was worsening. The government's spending and protectionist trade policies were beginning to catch up with it. In that sense, foreign aid enabled the Costa Rican government to postpone the necessary adjustments to its national finances and continue with counterproductive economic and fiscal policies.

In contrast, after the crisis hit, foreign aid helped Costa Rica undertake the reforms it had been postponing. Between 1982 and 1986—the most crucial years—the United States took the lead in supporting and encouraging those reforms, providing 57 percent of all foreign assistance given to Costa Rica. The major initiatives included liberalizing the financial sector, reducing the size and spending of the public sector, promoting exports, reducing trade barriers, and supporting general macroeconomic stabilization and adjustment.

Political and security concerns motivated the U.S. interest in Costa Rica at this time. The Sandinista revolution in Nicaragua and the civil war in El Salvador increased Costa Rica's symbolic value as a stable, market-oriented democracy. Preserving that democracy was a high priority during the economic crisis and, hence, the Reagan Administration provided large amounts of financial assistance to help Costa Rica weather the storm. The National Commission on Central America, chaired by former Secretary of State Henry Kissinger, provided an endorsement of that strategy for those reasons.[26]

Donors to Costa Rica, including AID, not only provided financing for many of these activities but also made that financing *conditional* on the implementation of reforms. The newly elected government of Luis Monge in 1982 was committed to making those changes. Without a government committed to making reforms, donors' efforts would probably have been fruitless. The relative agreement between the Monge government and the foreign aid donors over what needed to be done—and that the policies were the right ones—is what helped make Costa Rica a success story in the 1980s. In that case, the dual purpose of U.S. assistance did not materially impinge on its usefulness in promoting reforms so that Costa Rica could continue on its development path. Indeed, the flow of foreign aid to Costa Rica in the 1980s far exceeded foreign investment as a percentage of GNP (see Figure 4).

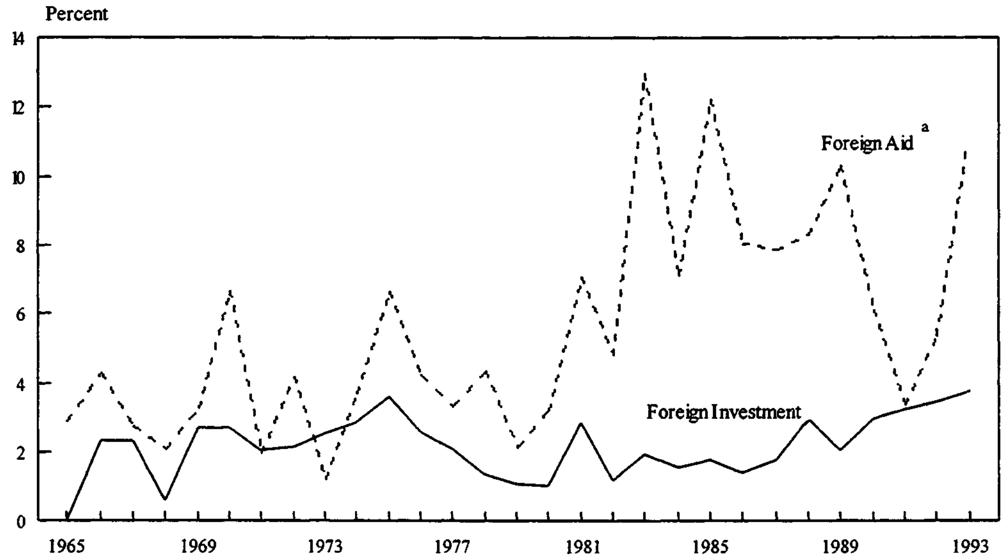
It is impossible, however, to disentangle the separate roles of bilateral and multilateral aid in the economic and trade sector. The United States worked closely with multilateral institutions—the International Monetary Fund (IMF), the World Bank, and the Inter-American Development Bank— in promoting the reform program in Costa Rica. All of those institutions conditioned their aid on the progress of reforms. AID and the multilaterals reinforced each other. The United States would sometimes make its aid conditional on progress that the World Bank or the Inter-American Development Bank wanted, and vice versa.

Stabilization. The first task was to stabilize Costa Rica's economy. That was accomplished with infusions of cash from AID and the IMF that allowed Costa Rica to pay for needed imports. That adjustment program can be judged a success. Unemployment in 1983 was 9 percent but had declined to 3.8 percent by 1989. After two years of negative growth, the economy began growing again in 1983. The average annual growth rate of GNP between 1983 and 1993 was 5.3 percent; per capita GNP grew by an average of 2.7 percent. Costa Rica's external debt, which had soared to over 160 percent of GNP in 1982, fell to little more than 50 percent by 1993 (see Figure 5).

Government Downsizing. The Agency for International Development promoted government downsizing by pushing the privatization of government-owned enterprises, notably the Costa Rican Development Corporation, in three phases. First, the United States pressed to end CODESA's unlimited line of credit with the

26. *Report of* the *National Bipartisan Commission on Central America* (January 1984). See also Marc Edelman and Rodolfo Monge Oviedo, "Costa Rica: The Non-Market Roots of Market Success," *NACLA Report on the Americas*, vol. 26 (February 1993), pp. 22-29.

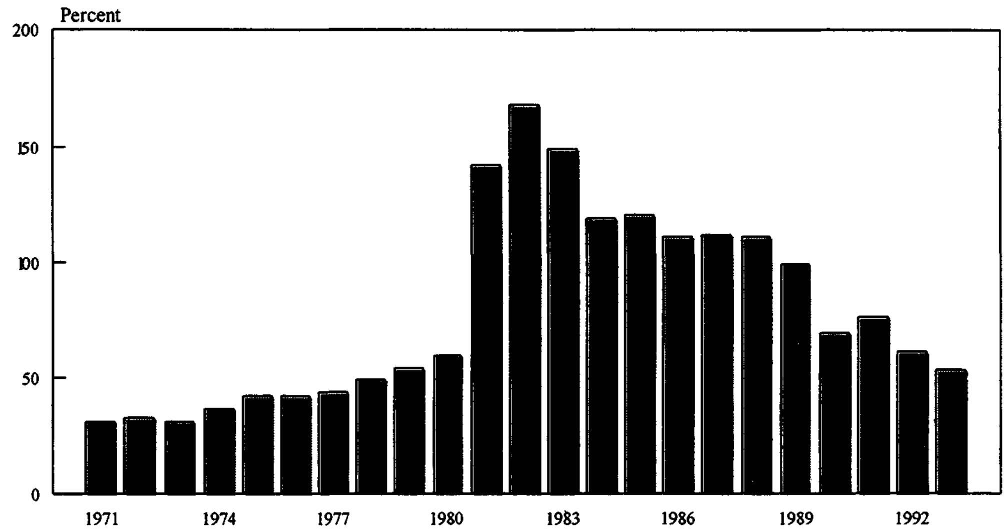
FIGURE 4. FOREIGN AID AND FOREIGN INVESTMENT AS A PERCENTAGE OF COSTA RICA'S GROSS NATIONAL PRODUCT, 1965-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development and the World Bank.

a. Excludes the use of credit from the International Monetary Fund.

FIGURE 5. EXTERNAL DEBT AS A PERCENTAGE OF COSTA RICA'S GROSS NATIONAL PRODUCT, 1971-1993



SOURCE: Congressional Budget Office based on data from the World Bank.

NOTE: No data are available for external debt before 1971.

Central Bank of Costa Rica. Second, AID pushed for the sale or closure of CODESA enterprises. Third, AID promoted reducing the size of the central government in part by financing "labor mobility" programs that enabled government workers to find employment in the private sector.

Financial Liberalization. Donor money was used conditionally to force various reforms in the financial sector. The reforms included freeing interest rates, eliminating sectoral allocation of credit by the central bank, and strengthening oversight of the banks. AID also directly promoted a private-sector banking industry that could compete with the state-owned banks. State banking has proved to be one of the most difficult sectors to reform in light of the long history of the nationalized bank. Still, without those reforms Costa Rica's recovery would probably have been much more difficult. The growth of private banking played an important role in fueling the export-oriented trade strategy. Yet the private banking sector is not fully developed. Intermediation margins in the banking system do not meet international standards. The five largest private banks control almost 60 percent of the loan portfolio of the private sector. They tend to behave oligopolistically and neglect rural consumers of credit.

Trade Liberalization and Export Promotion. AID financed the creation of CINDE, a trade organization that established investment promotion offices abroad to lure investors to Costa Rica and supported programs to promote nontraditional exports and industries. AID and other donors sought improvements in the export regime, realistic exchange rates, and reductions in tariffs. By 1990 the highest tariff had fallen to 40 percent and by 1993 to 20 percent. Nontraditional exports to countries outside the Central American Common Market more than tripled between 1983 and 1990. Nontraditional exports accounted for 54 percent of Costa Rica's exports in 1994.

INFLUENCE OF GOVERNANCE ON HONDURAS'S DEVELOPMENT

In contrast to Costa Rica, Honduras is one of the poorest countries in Latin America. Although Honduras's real per capita GNP grew by an average of 1.8 percent a year between 1965 and 1980, it declined by an average of 0.7 percent a year between 1981 and 1994.[27] It suffered from the same type of economic crisis in the early 1980s as Costa Rica, but it was much less successful in overcoming that crisis. Per capita

27. To compare economic growth in two countries, CBO adjusted GNP to reflect estimates of purchasing power parity provided by the Penn World Tables at the University of Pennsylvania. To calculate the change in GNP per capita within a country, CBO used a constant-dollar series converted by exchange rates. The numbers generated by those two series may appear quite different, even contradictory, but they are appropriate for the two different tasks.

growth has not managed to make any lasting progress since 1978. A great divide between rich and poor remains a particular problem. Most Hondurans live in rural areas and make their living through subsistence farming. A small elite of business executives, military officers, and bureaucrats benefit most from Honduras's economy.[28] The political and economic management of the country deserves much of the credit or blame for Honduras's halting progress. The role of foreign aid in this story is mixed. While it managed to improve the lives of thousands of Hondurans, it has made much less progress in facilitating sustained economic growth. Indeed, some critics believe that Honduras has become dependent on foreign aid.

Honduras has not enjoyed the political stability that Costa Rica experienced. Honduran politics have been highly contentious, and the military has not hesitated to intervene directly in the political process. Unlike Costa Rica, which dissolved its army in 1948, the Honduran military transformed itself into a modern professional organization in the 1950s. That transformation did not mean, however, a disinterest in the political development of the country. On the contrary, of the 12 changes in the executive between 1954 and 1994, five were coups (see Table 5). The military became an independent—and one of the most powerful—interest group within Honduran government and politics.[29]

Although reformist military governments sometimes took positive steps to promote Honduras's development, overall the pervasive influence of the military appears to have contributed to the country's underdevelopment. The military claimed a significant share of the government's resources that otherwise could have been used for development. Of course, that is true for most countries. A second problem was that the coups disrupted the political stability of the country and sometimes brought to an end reformist liberal governments. Finally, according to Kent Norsworthy and Tom Barry, Honduras suffers from a deep fear of its neighbors. The powerful influence of the military in Honduran society appears to have done little to alleviate that fear.[30]

Ostensibly, Honduras is governed by an executive, a legislature, and an independent judiciary. In practice, the chief executive, whether military or civilian, either dominates or ignores the other two branches of government. The president of the republic has been the center of political life and policy in Honduras. Thus, the political management of Honduras, whether good or bad, has been largely the

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28. James A. Morris, *Honduras: Caudillo Politics and Military Rulers* (Boulder, Colo.: Westview Press, 1984), pp. 29-31.

29. Ibid., pp. 35-37.

30. Kent Norsworthy with Tom Barry, *Inside Honduras* (Albuquerque, N.M.: Interhemispheric Education Resource Center, 1993), p. xvii.

TABLE 5. ADMINISTRATIONS OF HONDURAS, 1948-1994

Chief Executive	Method of Change	Date of Change[a]
Juan Manuel Gálvez (PNH)	Elections	October 1948
Julio Lozano Díaz (PNH)	Elections	October 1954
Military Triumvirate	Coup	October 1956
Ramón Villeda Morales (PLH)	Elections	September 1957
Col. Oswaldo López Arellano	Coup	October 1963
Gen. Oswaldo López Arellano	Elections	February 1965
Ramón Ernesto Cruz	Elections	March 1971
Gen. Oswaldo López Arellano	Coup	December 1972
Gen. Juan Alberto Melgar	Coup	April 1975
Gen. Policarpo Paz García	Coup	August 1978
Roberto Suazo Cordova (PLH)	Elections	November 1981
José Azcona Hoya (PLH)	Elections	November 1985
Rafael Leonardo Callejas (PNH)	Elections	November 1989

SOURCE: Congressional Budget Office, based on James A. Morris, *Honduras: Caudillo Politics and Military Rulers* (Boulder, Colo.: Westview Press 1984); and Tim Merrill, ed., *Honduras: A Country Study* (Washington, D.C.: Federal Research Division of the Library of Congress, 1995).

NOTE: PNH = National Party of Honduras; PLH = Liberal Party of Honduras.

a. Date of election or coup.

president's creation.[31] It is not clear, for example, how well the Honduran judicial system has protected property rights and ideas.

Two major parties have dominated Honduran politics: the National Party of Honduras and the Liberal Party of Honduras. Even when the country was governed by the military, it was often affiliated with the Nationalists. According to one study, political parties in Honduras have generally been narrowly based and unprincipled.[32]

In addition to this weak political structure, flagrant corruption—both government and private—has taken a heavy toll on Honduras's development. The military has readily used public funds and services to accumulate private fortunes, particularly during the massive infusions of U.S. military aid in the 1980s. In addition, private-sector business executives and political elites have often been indistinguishable from each other. Government resources have been diverted for the personal benefit of members of the business community. In 1992, for example, the Honduran congress launched a probe to investigate over 70 cases of alleged corruption within the executive branch, which at the senior levels was drawn largely from the business community.[33]

Finally, the way the Honduran government pursued development was sometimes helpful but at other times caused considerable harm. The administration of Juan Manual Gálvez in the early 1950s took a number of important steps to begin modernizing the Honduran government and, in particular, establish institutions that would further national development. Notably, Gálvez created the Central Bank of Honduras to control monetary policy and the Agricultural Development Bank. He also created the Ministry of Economy, the National Council on Economics, the Board of Budget Management, and the Income Tax Board—all of which were intended to create the means for modern development.[34]

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31. Morris, *Honduras*, pp. 62-63.

32. Norsworthy and Barry, *Inside Honduras*, p. xvii.

33. Ibid., pp. xviii-xix, 163. For a vivid illustration of this phenomenon, see Juan O. Tamayo and Gerardo Reyes, "Scandals Plague Honduran Ex-President," *Miami Herald*, March 16, 1997, p. 1A.

34. Mark B. Rosenberg and Philip L. Shepherd, eds., *Honduras Confronts Its Future* (Boulder, Colo.: Lynne Reinner, 1986), p. 99.

Employment in the Honduran economy in the 1950s was based almost entirely on agriculture. Most of the country's exports came from commercial agriculture and natural resources: bananas, coffee, wood, and meat. The manufacturing sector was small; it composed only 5 percent of the workforce in 1950, and by 1960 contributed only 9 percent of GDP.

The Honduran government's main development effort was to invest in infrastructure: roads, electricity, communications, and financial institutions. The government borrowed from abroad to finance the development of that infrastructure and needed expanded export earnings to finance that borrowing. That strategy caused some difficulty in the mid-1950s when floods, hurricanes, and labor strikes at banana plantations sharply cut exports. In 1957, short-term borrowings from the IMF helped Honduras weather a balance-of-payments crisis caused by diseased banana trees. In the late 1950s, the Central Bank of Honduras established a stabilization program that reserved foreign loans exclusively for long-term development.[35]

The CACM and Slow Progress

By 1960, industry had grown and was employing 11 percent of the workforce. The government's industrialization and development strategy in the 1960s focused on import substitution and diversification of the agricultural export base. Honduras joined the Central American Common Market (CACM), which lowered trade barriers among members but maintained stiff tariffs on outside producers. That strategy worked well for Costa Rica for a decade but was not quite as successful in Honduras.

The Honduran industrial sector and its exports grew during the CACM period but not nearly as much as those of its neighbors. The economy diversified somewhat, but Guatemala, El Salvador, and Costa Rica had better results. Guatemalan and El Salvadoran industries were more competitive and productive; Honduran businesses found it difficult to compete. For example, for the 40 years before 1963, Honduras had enjoyed trade surpluses with its CACM neighbors. Now Honduras began to import more from other Central American countries than it was selling. Limited infrastructure, an underskilled labor force, and an inexperienced entrepreneurial class all helped make Honduran business less competitive.[36] In

35. Ibid., p. 99.

36. Morris, *Honduras*, p. 88.

addition, the banking system was not strong enough to support business expansion. Despite some government efforts to widen the banking system and improve access to credit, entrepreneurs usually were forced to finance their own expansion and maintain levels of working capital. After a brief war with El Salvador in 1969, Honduras withdrew from the CACM in 1970.

The structure of the agricultural sector remained largely unchanged through the 1960s. In 1961, agriculture employed 70 percent of the labor force but accounted for only 37 percent of GDP. Foreign corporations dominated Honduras's agricultural export sector, which may have limited the benefits of economic modernization—though in some ways Honduras might have modernized more slowly without them. The most important players, the banana corporations, led the diversification into new, nontraditional agricultural products such as citrus and African palm. They also invested in large food-processing and other industries.[37]

With respect to human capital, more than half the population was illiterate and population growth was nearly 3 percent a year in 1961. The liberal government of Ramón Villeda Morales, with domestic and international prodding, pushed through and signed the 1962 Agrarian Reform Law, which sought to address issues of land distribution. But a coup in 1963 put an end to those efforts.

State-Centered Development

By the 1970s, the Honduran economy was industrializing but at a slow rate. The industrial sector had continued to grow relative to agriculture as a percentage of GDP (see Table 6). The economy suffered a bout of stagnation in the early seventies but returned to robust growth late in the decade as a result of higher commodity prices, especially for coffee, between 1976 and 1979.

The government undertook a number of structural reforms to the economy. Perhaps the most important was a massive expansion of the state's role in the economy and large increases in public-sector investment. In 1972, the reformist military government of General Oswaldo López Arellano inaugurated the National Plan of Development. One of its positive features was an agrarian and land reform plan. Large amounts of resources were invested in the agrarian sector; the government sought to encourage co-ops to produce bananas and African palms. It also managed to take some modest steps toward land reform.

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37. Norsworthy and Barry, *Inside Honduras*, p. 52.

TABLE 6. COMPOSITION OF HONDURAS'S GROSS DOMESTIC PRODUCT BY SECTOR, 1950-1980 (In percent)

Sector	1950	1960	1970	1980
Agriculture[a]	44.8	32.8	34.6	25.1
Manufacturing[b]	9.0	15.3	14.0	15.0
Mining	2.3	1.9	2.3	2.0
General Government[b]	4.1	4.7	3.6	5.2
Other Sectors	39.8	45.3	45.5	52.7

SOURCE: Congressional Budget Office based on data from Victor Bulmer-Thomas, *The Political Economy of Central America Since 1920* (New York: Cambridge University Press, 1987).

a. Includes forestry and fishing.

b. The available data do not indicate how the state-owned enterprises are being accounted for—in government or in manufacturing. They are probably recorded in "Manufacturing."

But the government also paralleled Costa Rica's strategy of state-centered development. Honduras, with the support of the major aid donors, started a large number of autonomous, state-owned enterprises. Perhaps the most important was the National Investment Corporation (CONADI), which was charged with promoting public, private, or joint industrial projects, primarily in sugar, hotel, cement, food, and textile industries. It was inefficient and corrupt, however, and accumulated $300 million in debt by 1982. Other enterprises included the Honduran Corporation for Forest Development (COHDEFOR), which nationalized privately held forest resources, and the Honduran Banana Corporation (COHBANA), which was supposed to support banana growers. The National Bank of Economic Development (BANASUPRO) created stores to supply the people with basic goods, reinforcing measures intended to control the supply and prices of most essential consumer products.[38]

Other reforms and unforeseen external events also undermined economic growth. The government helped the labor movement, which had been relatively strong since the 1954 strike by workers on banana plantations, to set up new organizations and associations. That tended to discourage private investors. Hurricane Fifi in 1974 destroyed a large part of the banana plantations. Large government infrastructure projects, financed by loans from international banks and organizations, turned in mixed results. Some projects came in on budget and served the country well; others finished over-budget, behind schedule, and with their economic viability questionable. But the government was still obligated to repay those international loans.[39]

Economic Crisis

The worldwide recession in the early 1980s and the decline in commodity prices were severe blows to the Honduran economy. Export earnings dropped, making it difficult to finance the country's growing external debt, much less other development projects. Higher energy prices also hurt the trade balance. Businesses failed; unemployment and underemployment together exceeded 50 percent. Those conditions encouraged the flight of domestic and foreign capital from Honduras. More and more of the country's development projects were being financed by external borrowing. As a result, between 1973 and 1981 the ratio of debt-service payments increased from 3.7 percent to 12.7 percent of export income.

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38. Rosenberg and Shepherd, *Honduras Confronts Its Future*, pp. 101-102.

39. Ibid., p. 102.

To stimulate growth, the civilian government elected in 1981 responded with large foreign borrowing to finance an expansionary fiscal program centered on expensive high-tech infrastructure projects.[40] Between 1981 and 1984, public-sector investment as a percentage of GDP grew from 7.7 percent to 13 percent. Monetary policy supported that program. The public- sector deficit increased from 7.4 percent of GDP in 1980 to 11.4 percent in 1984. Rather than create private-sector employment, those projects increased the public-sector workforce and lined the pockets of a small elite. They apparently never sparked private investment or substantial private employment. Per capita income fell after 1988 even as the external debt grew considerably as a percentage of GNP (see Figure 6).

<u>The Absence of Recovery</u>

In the early 1990s, the Honduran economy deteriorated rapidly. The new government of President Rafael Leonardo Callejas, elected in 1989, did not manage to make much progress in addressing the economy's problems. The need to cut fiscal and trade deficits conflicted with his party's promise to improve social programs and employment and address the concerns of disgruntled and vocal public-sector employees. Real economic growth between 1989 and 1993 was absorbed by a fast-growing population. Per capita GNP fell from 1989 to 1991 and showed little recovery by 1994.

As part of his effort to move Honduras away from a state-centered development strategy, Callejas attempted to reform economic policy and reduce the influence of government. He sought to privatize government-owned enterprises, liberalize trade and tariff regulations, and encourage increased foreign investment. He focused on reducing the size of public-sector spending and employment. He sought to improve Honduras's terms of trade by devaluing the currency. The lempira, the Honduran currency, had been fixed to the U.S. dollar since 1918 and had become dramatically overvalued by 1990. Other reforms included reducing the average tariff rate from 90 percent to 40 percent and removing most surcharges and exemptions. He also aimed to increase government revenue and instituted a continuing program of trade and price liberalization and deregulation.

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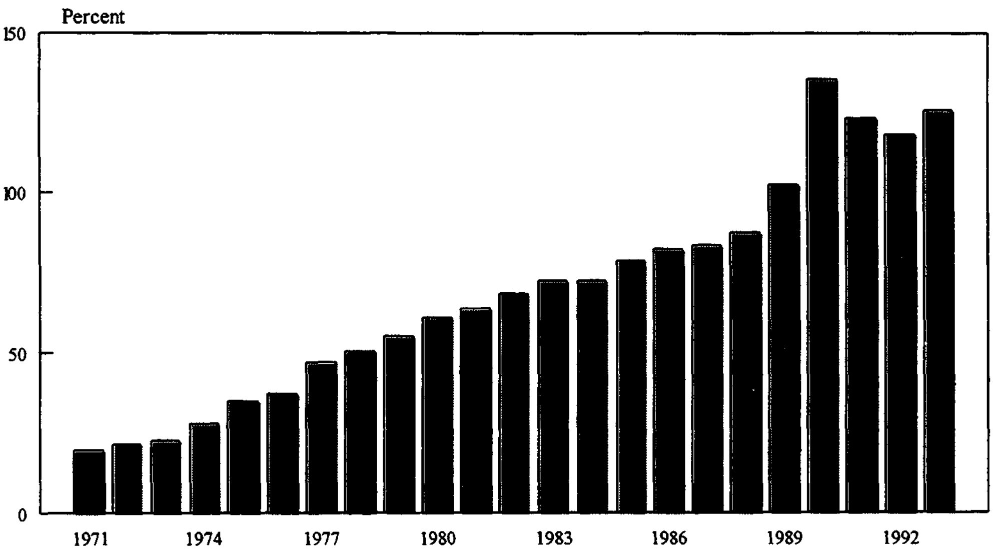
40. Tim Merrill, ed., *Honduras, A Country Study*, (Washington, D.C.: Federal Research Division of the Library of Congress, 1995), p. 113.

FIGURE 6. EXTERNAL DEBT AS A PERCENTAGE OF HONDURAS'S GROSS NATIONAL PRODUCT, 1971-1993



SOURCE: Congressional Budget Office based on data from the World Bank.

NOTE: No data are available for external debt before 1971.

The president had difficulty in cutting public-sector employment and reducing the fiscal deficit because of resistance among many different segments of the government. Honduras still depends on a few traditional commodities for most of its export revenue, although the percentage of nontraditional exports has been rising in recent years (see Table 7). In 1993, an election year, the government spent heavily to boost economic growth. That spending was unsustainable, however, as a severe drought and rising energy costs caused a steep decline in economic growth in 1994, leaving the government near bankruptcy.[41] As a recent study on Honduras put it, "the economy had operated so long on an ad hoc basis that it lacked the tools to implement coherent economic objectives. Solving the most immediate crisis frequently took precedence over long-term goals."[42]

ROLE OF FOREIGN ASSISTANCE IN HONDURAS'S DEVELOPMENT

Like Costa Rica, Honduras has received most of its foreign assistance in the 1980s and 1990s.[43] The United States made its largest contributions during that time (see Figure 7). The Reagan Administration had identified an important U.S. security interest in supporting the Honduran government during a time of considerable political turmoil in the rest of Central America. Thus, in the 1980s, U.S. aid was given for two reasons: to promote development and to support U.S. foreign policy interests.

If one were to judge the efficacy of aid in supporting U.S. national interests, one would probably conclude that it was a clear success. Honduras reliably supported U.S. political and military initiatives in the area, especially the U.S. Administration's effort to topple the Sandinista Nicaraguan government through support of the contra rebels. Honduras remained firmly allied with the United States and generally avoided the civil conflict experienced by El Salvador and Guatemala. Finally, Honduras provided bases for U.S. military training and exercises during the 1980s.

The role of foreign assistance in promoting development, however, shows mixed results, in part because of the political objectives of the U.S. aid. Foreign assistance—U.S. money in particular—probably did the most good for health,

41. Agency for International Development, *Congressional Presentation: Fiscal Year 1996* (February 24, 1995), p. 608.

42. Merrill, *Honduras: A Country Study*, p. 114.

43. This section is based largely on background papers that were prepared for CBO by AID's mission in Honduras.

TABLE 7. COMPOSITION OF HONDURAS'S EXPORTS, 1980-1994 (In percent)

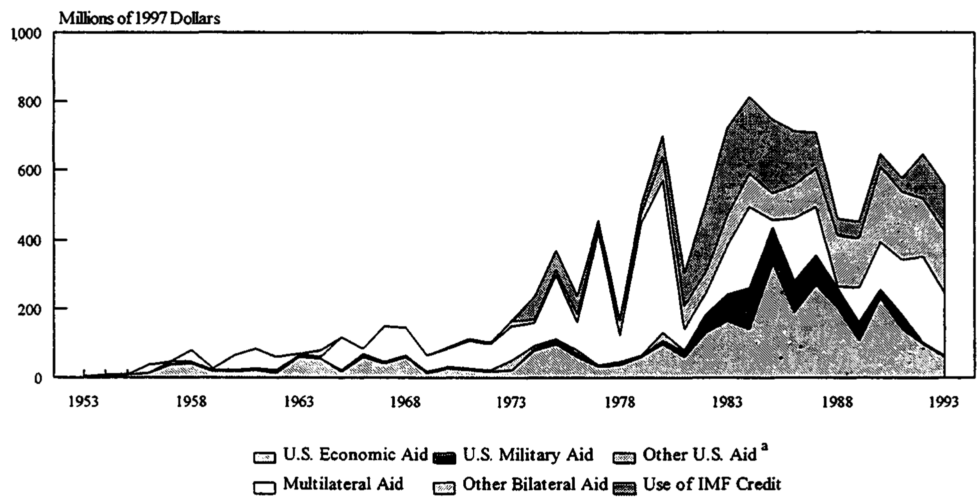
Type and Destination	1980	1985	1990	1994
Traditional (To all countries)[a]	75	80	86	67
Nontraditional				
To CACM countries	10	3	0.3	5
To all other countries	15	17	11	28

SOURCE: Congressional Budget Office based on data from the Agency for International Development.

NOTE: CACM = Central American Common Market.

a. Mostly bananas and coffee but also wood, beef, lead, zinc, silver, shrimp, lobster, sugar, and tobacco.

FIGURE 7. FOREIGN ASSISTANCE TO HONDURAS, 1953-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development, the World Bank, and the Organization for Economic Cooperation and Development.

a. Mostly loans from the Export-Import Bank.

education, and population. Assistance used to promote economic growth performed less well.

Health

Honduras has seen dramatic improvement in its infant mortality rates over the past 20 years.[44] In 1967, there were 119 deaths per thousand; by 1992, that figure had declined to 43. Other indicators are equally suggestive. Low weight-for-age malnutrition in children under two years of age declined from 30 percent in 1987 to 24 percent in 1994. Polio has been eradicated. Diarrhea is now the third leading cause of death in children under five years, whereas in 1987 it was the leading cause.

Foreign aid donors have played an important part in the health sector. The United States, the Inter-American Development Bank, and the World Bank devoted about 10 percent of their aid to the health sector. The number of donors in that sector has been high, especially since Honduras's return to democratic government in 1982. Those donors have included the United States, Switzerland, France, Japan, the Pan American Health Organization, the United Nations Children's Fund, and the Inter-American Development Bank.

Foreign aid donors have undertaken a variety of activities to improve health conditions in Honduras and expanded health access, especially among the rural poor. For example, AID sponsored the construction of rural water and sanitation systems, immunization programs, oral rehydration therapy to prevent death from diarrhea, and programs to strengthen the institutional capacity of the government of Honduras to sustain and expand health programs.

According to AID, the results of those activities are clear and measurable. AID's water and sanitation programs have served approximately 30 percent of the rural population. They have built 1,213 water systems, 2,942 wells with hand pumps, and 179,854 latrines serving 746,000 people. Although it is one of the hemisphere's poorest nations, Honduras has one of the highest immunization rates in Latin America.

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44. This section relies heavily on Thomas Bossert and others, *The Sustainability of U.S.-Supported Health, Population, and Nutrition Programs in Honduras: 1942-1986*, AID Evaluation Special Study No. 58 (Washington, D.C.: Agency for International Development, December 1988).

Education

According to AID, the role of foreign assistance in improving literacy rates and expanding access to education in Honduras is an almost unqualified success. Literacy jumped from 57 percent in 1967 to 73 percent in 1992. Most of that improvement reflected better education in the earliest grades, where AID has concentrated its resources. AID was the largest donor in the education sector. Thus, to the extent that foreign assistance is responsible for those dramatic changes, U.S. assistance deserves the lion's share of the credit for those accomplishments.

In the 1970s and early 1980s, the highest priority of AID's program was to expand access to education. Since 1986, the agency has also focused on improving the efficiency and quality of education. Honduras had a national curriculum, but AID helped to develop clearly defined learning objectives, a standardized testing system, and educational materials.

U.S. spending on education emphasized a variety of activities to achieve those goals. AID helped build and reconstruct 5,800 primary school classrooms. The agency's Primary Education Efficiency Project established learning standards and tests to measure student achievement in each subject area and grade level. It also developed student-centered textbooks, workbooks, and other materials for each subject and grade level. AID then printed over 17 million copies of those materials for the six grades of primary school and trained over 25,000 teachers annually on how to use them.

The Honduran government was especially committed to working with AID and improving education levels. In 1982, Honduras spent 3.8 percent of its GDP on education; by 1987, that figure had increased to 4.9 percent—a high figure among Central American countries. In 1995, education spending accounted for 25 percent of government expenditures.

In addition to the improvement in literacy, related indicators have strengthened. Between 1986 and 1994, dropout rates declined by 55 percent and repetition rates fell by 20 percent. Aggregate test scores for grades 1 through 6 increased by 229 percent between 1990 and 1995.

Population Growth

A consistent, recurring problem for Honduras has been its growing population, especially among the rural poor.[45] Although Honduras's aggregate GNP has continued to grow—even through the 1980s and 1990s—GNP per capita in 1993 was no higher than it had been in 1978. Over the past 35 years, GNP per capita barely grew as aggregate population nearly tripled. AID began supporting family planning activities in Honduras in 1965.

Family planning and population control programs did not always receive high-level support from the government or other prominent segments of Honduran society. Thus, the record of foreign assistance for population-related activities is understandably mixed. AID's major effort has been to expand the use of contraceptives—a program that has had some success. The percentage of women of reproductive age using contraceptive methods rose from 12 percent in 1976 to 47 percent in 1993. An AID evaluation team reports that roughly 60 percent to 70 percent of that improvement is attributable to AID's assistance. The fertility rate has declined from 7.4 births per woman in 1967 to 4.9 in 1992. But given the rate of contraceptive use, AID believes that the fertility rate should be lower.

Agriculture

Some critics have charged that U.S. food assistance to Honduras, particularly the P.L. 480 Title I program, has done more harm than good to the country's ability to produce its own food. As of the early 1980s, Honduras was no longer self-sufficient and had to import basic foodstuffs each year.

Basic grain production has not kept pace with population growth for some time. The P.L. 480 loans gave the Honduran government surplus grains that it then sold in the home market. That influx of relatively cheap foodstuffs over a long period of time created disincentives for local farmers to produce basic grains, including corn, which has been a traditional staple of the Honduran diet. That dependency on foodstuffs grown outside Honduras might not be an issue if the economy was not also facing other problems. For example, rural subsistence farmers who used to produce basic grains have few other employment opportunities.

That view of Honduran agriculture and the role of foreign aid, however, does not tell the entire story. In the view of some experts, including AID, the unfavorable policy environment was causing more damage to small farmers and agricultural

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45. Richard Martin and others, *AID's Family Planning Program in Honduras*, AID Technical Report No. 9 (Washington, D.C.: Agency for International Development, June 1993).

prices than P.L. 480 aid. Throughout the 1980s, as was mentioned above, the exchange rate in Honduras was overvalued, making imports (including food) cheaper than domestic products. Indeed, the overvalued exchange rate made P.L. 480 wheat seem particularly cheap. When the government began reforming the economy in earnest in the 1990s, including devaluing the exchange rate, the slide in agricultural production stopped and began to reverse. Those reforms were undertaken in part with U.S. assistance.

In addition, "self-sufficiency" may be less important than "self-reliance"; that is, providing adequate food for Honduras's population may depend more on generating economic growth and producing high-value products to enable Honduras to pay for any food imports it may need. Consequently, AID has focused on increasing exports of nontraditional products, such as melons and Chinese vegetables, and has had some success in recent years. Exports of nontraditional products to non-CACM countries more than doubled between 1990 and 1994 (see Table 7). In 1994, Honduras exported $180 million in nontraditional agricultural products and imported only $81 million in basic foodstuffs such as corn, rice, wheat, and beans. And Honduras is currently running a large surplus in agricultural trade. AID hopes that by helping small, poor farmers produce nontraditional agricultural products and bring them to market, they will increase their income and, consequently, their calorie consumption and overall welfare. Other AID efforts have included helping reform land rental laws so that small farmers may rent out their land or rent additional land and perhaps move beyond subsistence agriculture.

Economic Growth

Before 1980, the major bilateral and multilateral donors to Honduras did not focus much of their aid on reforming economic and trade policies. Multilateral donors, such as the World Bank and the Inter-American Development Bank, extended loans and credit for building infrastructure and reforming economic policies. The role and impact of multilateral aid for infrastructure on Honduras's economic and social development has not been systematically evaluated. More information is available on the role of U.S. assistance during the 1980s and 1990s. Overall, since 1953 the United States, the Inter-American Development Bank, and the World Bank have devoted over 58 percent of their assistance to promoting general economic growth and development, but the major portion of that amount has been given since 1980.

Paralleling the programs in Costa Rica, the United States provided only technical assistance to Honduras in the 1950s and supported the CACM strategy in the 1960s. In the 1970s, AID shifted its focus to poverty and basic needs programs. Some of the multilateral organizations and AID encouraged the Honduran government's efforts at state-centered development. Those organizations promoted the creation of the various state and semiautonomous institutions to manage the economy. Later, many of those state-run enterprises—suffering from corruption, inefficiency, and high debt—were closed, and the central government was forced to assume their debt burdens. There is little evidence to suggest that Honduras gained any material benefit from those experiments.[46]

With the onset of Honduras's economic crisis in the early 1980s, the United States and the multilateral organizations focused more of their efforts on supporting the economy and promoting policy reform. AID, along with the International Monetary Fund, initially thought that Honduras merely needed some short-term balance-of-payments support for stabilization in an economic downturn. In 1982 and 1983, the IMF and AID sought to impose fiscal and monetary discipline—a structural adjustment program—as a condition of assistance that took the form of cash transfers. But Honduras proved reluctant to carry through with the required austerity program, and the IMF and AID suspended their program in late 1983.[47]

Despite the unwillingness of the Honduran government and society to undertake the required reforms and austerity measures, AID resumed cash disbursements shortly after suspending them. The United States apparently placed a higher priority than other donors on maintaining the cooperation of the Honduran government in the broader East-West conflict that was taking place in Central America.[48]

The political importance of Honduras to the U.S. administration reduced the leverage AID had in forcing policy reforms. Thus, aid money in 1983 and 1984, from a developmental perspective, was largely unproductive. Still, AID argues that it managed to persuade the Honduran government to make some changes through quiet policy dialogue rather than overt conditionality. In 1985, the agency attempted to withhold some funding pending changes to tariff law, but aid was resumed in 1986 to signal political support of a newly elected government.

The economy did not improve very much in the late 1980s. Government deficits at that time were financed by large infusions of foreign aid, which was far more important to the economy than foreign investment (see Figure 8). AID continued its cash transfers to Honduras through 1989 but then suspended that aid to signal its displeasure with the outgoing government for failing to carry out reforms.

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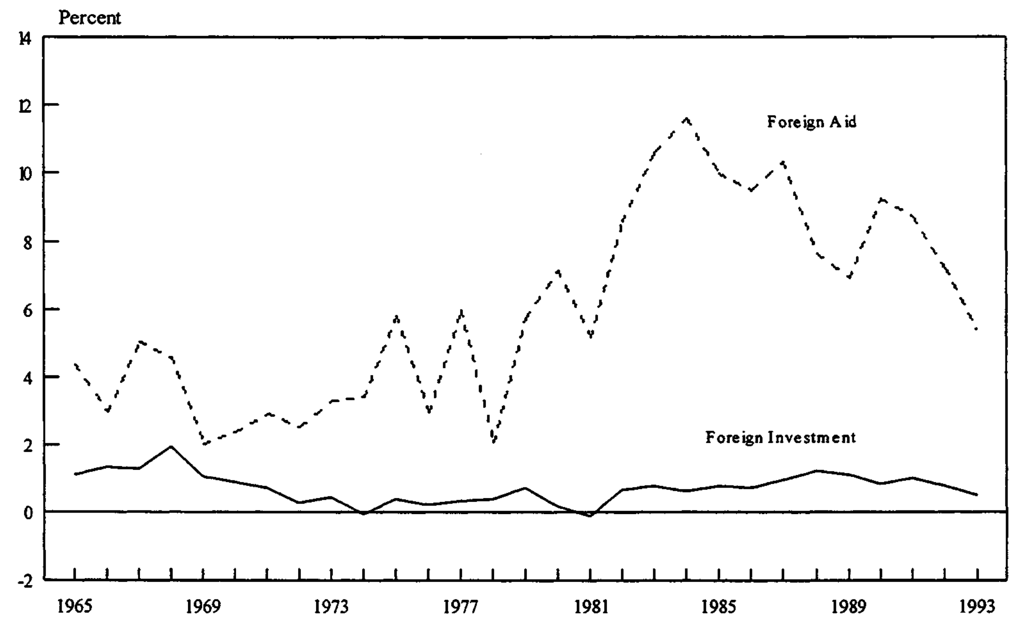
46. Norsworthy and Barry, *Inside Honduras*, p. 53.

47. Agency for International Development, *The Effectiveness and Economic Development Impact of Policy-Based Cash Transfer Programs: The Case of Honduras*, AID Evaluation Highlights No. 3 (May 1989), p. 2.

48. Ibid., pp. 2-3.

FIGURE 8. FOREIGN AID AND FOREIGN INVESTMENT AS A PERCENTAGE OF HONDURAS'S GROSS NATIONAL PRODUCT, 1965-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development and the World Bank.

The dire economic situation in Honduras and the end of the Cold War—and, hence, the end of Honduras's political leverage—seemed to convince the incoming government of President Callejas to make some reforms. AID resumed support of the Honduran government. In particular, the United States helped the government clear its arrearage with the multilateral financial institutions, and aid flows from those organizations resumed in 1990. But when Callejas allowed the fiscal deficit to grow in an effort to secure reelection for his party, many of his gains were undone. The United States held up disbursement of economic support funds in 1993 until the newly elected administration came to grips with the fiscal problems it inherited. Although the problems have been dealt with and the Honduran economy shows some encouraging signs of growth, that progress could once again unravel.

Some critics of foreign aid to Honduras have charged that it has left the country worse off. AID and the multilateral institutions have not used their resources to address the structural problems of the Honduran economy, such as the wide divide between rich and poor caused mainly by the concentration of land among a small percentage of the population. The gap between rich and poor has grown in the 1990s. Furthermore, waste and corruption of aid dollars is widespread. Jaime Rosenthal, former vice president under President Azcona, charged that up to 30 percent of U.S. aid may have been lost to corruption and up to 50 percent went to business elites rather than into programs that would have improved the living standards of the poor. Nor has AID used its leverage to persuade the government to adopt development strategies and programs to meet the basic health, educational, and income needs of the country's rural, poor majority.[49]

Furthermore, those critics argue, the Honduran economy and society have become largely dependent on aid money. Most important organizations and officials appear to receive U.S. money. Recipients include political parties, judges, military/civic-action teams, business associations and business executives themselves, journalists, unions, development groups, charitable organizations, churches, cattle ranchers, and government ministries and ministers. Structurally, the economy does not appear to be able to break the dependency on foreign aid for continued economic growth. In addition, critics charge that because of its wide involvement in Honduran society and economy, AID has created a "shadow" government, setting up or funding institutions that carry out functions that properly belong to the Honduran government, thereby weakening the effectiveness of that government.[50]

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49. Norsworthy and Barry, *Inside Honduras*, p. 164. Susan C. Stonich discusses some of the negative consequences of promoting nontraditional exports in Honduras in "The Promotion of Non-traditional Agricultural Exports in Honduras: Issues of Equity, Environment and Natural Resource Management," *Development and Change*, vol. 22 (1991), pp. 725-755.

50. Norsworthy and Barry, *Inside Honduras*, p. 165.

CONCLUSION

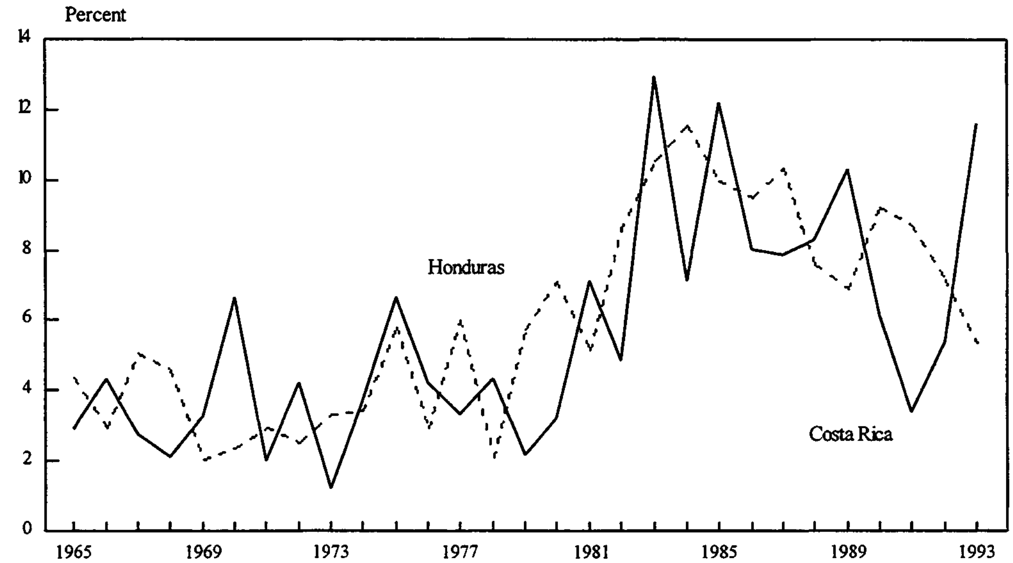
In comparing the development histories of Costa Rica and Honduras, several factors stand out. First, investment in human capital was particularly important in Costa Rica's progress, and the relative lack of investment in Honduras probably inhibited its progress. Costa Rica's better-educated and healthier population seemed more willing and certainly more capable of starting new businesses and making them work in an international economic environment that was constantly changing. Honduras's mostly poor and rural population simply do not have the means to improve their plight. The government of Costa Rica, reflecting its long democratic tradition, made the commitment to growth with equity. That did not happen in Honduras.

Second, the stability of Costa Rica's political system stands in contrast to the instability in Honduras. Power was transferred every four years by election in Costa Rica, whereas Honduras endured a number of unelected military governments. Rights and property were protected in Costa Rica by its well-developed judicial system. And having abolished its army, Costa Rica was certainly able to devote more resources to activities that had a beneficial impact on development than did Honduras, whose military demanded a significant percentage of national resources.

Third, foreign aid most often seemed to reinforce the prevailing political and economic policies pursued by the respective governments. In the 1970s, foreign aid was given to both Costa Rica and Honduras while they pursued the counterproductive macroeconomic policies that contributed to the severity of the economic crisis in the early 1980s. In contrast, Costa Rica's commitment to change those and other policies in the 1980s made the application of foreign aid useful in its reform program. Costa Rica may very well have reformed in any event, but foreign aid played a mostly positive role in minimizing the hardships that come with structural adjustment. In Honduras, however, the political commitment to reform was not as high. Aid money stimulated some temporary consumption-driven growth, but no permanent development followed—even though Honduras has received assistance comparable with that of Costa Rica as a percentage of their respective economies (see Figure 9).

Finally, there is little basis to distinguish between bilateral aid and multilateral aid. Both bilateral institutions, such as AID, and the multilateral World Bank and Inter-American Development Bank provided aid during the massive and counterproductive expansion of the state in the economies of Costa Rica and Honduras in the 1970s. Both types of organizations provided aid for structural adjustment programs and policy reform in the 1980s.

FIGURE 9. FOREIGN ASSISTANCE TO COSTA RICA AND HONDURAS AS A PERCENTAGE OF GROSS NATIONAL PRODUCT, 1965-1993



SOURCE: Congressional Budget Office based on data from the Agency for International Development and the World Bank.

NOTE: Excludes the use of credit from the International Monetary Fund.

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