

**Income Distribution and
High-Quality Growth**

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For those who are poor and able to work, the right strategy is surely to look for ways of finding them employment. Economic growth is central in this context. In some developing (and increasingly in developed) countries, cash for work (or "workfare") programs may be feasible. For those who cannot work, direct support is likely to be necessary, at least in the short and medium terms. In the longer term, private pensions or insurance may make important contributions.

While poverty involves a focus on the lower end of distributions, equity involves looking across the spectrum. Here we may ask about the sources of wealth in the transition economies. Central among these are housing, small businesses, and the natural resource endowments. There is little wealth in the ownership of an obsolete or bankrupt company. From this perspective, the transition has been inequitable in a number of respects. Housing has largely gone, or will go, to sitting tenants. These may be people who were well placed to manipulate the old regime. The rewards for such manipulation in housing may be large, but in many cases concerning natural resources, they have been astronomical. Such inequity can raise (understandable) resentments that damage the political acceptability of the new economic system.

There is no doubt that the political resentments against the inequities seen in the transition process so far are serious. These arise partly from those who find their economic position severely damaged for reasons they see as no fault of their own. There is no doubt that transition has moved the goalposts, and we might reflect on the fact that radical changes in the rules (e.g., concerning taxation) are sometimes seen as inequitable in capitalist societies. We might put this reflection to one side by recognizing that the rules of the game have been altered—because the earlier ones were repugnant and had disastrous consequences—and in the process inevitably there must be changed expectations and losers. We should acknowledge, however, that these feelings of inequity are strengthened by the perception that there are gainers who owe their positions to, putting it cautiously, haphazardness. At worst, the gains arise from recent manipulation, rewards for past manipulation, or criminality. Some action on poverty and inequity in transition economies is not only of importance in its own right but may be basic to the further progress of the transition itself.

Reference

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Monetary and Fiscal Policy for Equitable Economic Growth

Arnold C. Harberger

The key word in the chapter title is *equitable*, and the obvious question is, How do monetary and fiscal policies for *equitable* economic growth differ from monetary and fiscal policies for economic growth (with no qualifying adjective)?

My considered answer to this question is "not very much," for several reasons. In the first place, let us define as "good" economic policies those that promote the efficient operation of the economy and at the same time intelligently support the process of growth. I believe that good policies thus defined typically produce long-term benefits for all (or nearly all) segments of society. In particular, nothing in our experience suggests that the real level of welfare of, say, the bottom quintile in a society does not improve as economic growth takes place. More important, it is, on the whole, true that the poor as well as other segments of society fare worse under policies that work against the efficient operation of the economy and that put sand in the wheels of the growth process than they do under what I have called "good" policies. My conclusion is that adding the qualifying adjective *equitable* does not alter the general shape of the overall economic policy that is appropriate. In other words, equity considerations, at least up to a certain point, do not conflict with the growth objective.

Second, and quite in harmony with the first point, most of the policies that aim in the direction of making a society and polity more equitable can be equally well, if not better, pursued in a growing economy than in a stagnant one. I have in mind policies oriented toward helping the poorest segments of society fulfill their basic needs: nutrition, education, medical care, and perhaps housing. Some of these policies, particularly in the fields of public health and education, can be thought of as directly supporting the process of economic growth, but even those that are not directly supportive do nothing to get in the way of economic growth. The only point

of potential conflict that I see is the general competition among different types of government programs for the fiscal resources available at any given moment. I do not emphasize this, or even place much weight on it, because I believe that most countries (most developing countries, at least) can do a considerably better job than they are now doing with respect to helping the poor meet their basic needs, without seriously impinging on the growth rates or growth potential of their economies.

The optimism I have expressed concerning the compatibility between the objectives of equity and growth stems in considerable measure from a view of what it is possible for governments to do. A government that tried, for example, to squeeze a society's income distribution to the point where the richest had no more than five times the per capita command over resources of the poorest would end up dooming its economy to stagnation, if not extinction. On that definition of equity, there is enormous conflict between equity and growth.

For the efficient operation of an economy, its resources should be, in the main, allocated so as to maximize their contribution to meeting economic demand. This will lead to different types of labor having different rewards, depending on the capacities with which they are endowed and the demand for those capacities. The land resources of society will gravitate to their most productive uses, and the reproducible capital will seek the best return. All of these forces together will generate a distribution of before-tax income. At some point the government must decide what tasks it will attempt to do, and it must then extract, from the before-tax distribution of income, the resources necessary to finance its operations. In this view of the world, equity considerations enter in two ways: on the expenditure side and the tax side. In a well-functioning modern economy, the public sector budget will end up with the lower-income groups receiving in government services (or grants) more than they pay in taxes, and with the upper-income groups paying more in taxes than they receive in government services.

In such an economy, healthy political debate will focus on exactly what to include among the tasks of government and exactly how to raise the necessary funds. But healthy debate will not take it as the responsibility of government to determine the final after-tax distribution. The responsibility of government is to set its own tasks and raise the money for them. Issues of equity arise on both sides of the tax-expenditure equation, but I shall argue that the challenges and opportunities are considerably greater on the expenditure than on the tax side of the ledger. In particular, if we consider the income distribution of a typical developing country and

apply to it a tax system that is sensible in terms of its impact on efficiency and growth and reasonably progressive in the sense of concentrating relative sacrifice on the upper-income groups, we will find that the relative distribution of after-tax income is not greatly different from that of before-tax income. On the other hand, if we consider a plausible pattern of distribution of government services among income groups, we will find here a much greater potential impact on the relative economic status of rich and poor. For many countries, the tax system remains in urgent need of reform in order to make it more conducive to efficiency and growth. In the process, it is likely also to become more equitable, but it is unlikely to generate a big difference between the before-tax and the after-tax distribution of income. Expenditure systems are also in urgent need of reform. Here we find fertile ground for the intelligent pursuit of equity objectives. Good policies on the expenditure side can significantly improve the level of living of the poor, as well as the prospects for their children.

7.1 Macroeconomic Policy: Some Mistakes of the Past

Important mistakes have been made in three major areas in the past: inflation, the boom-and-bust syndrome, and populism.

Inflation

At this stage of history, little need be said about inflation as a useful instrument for bringing about good results in economic policy. The historical record shows that serious inflations have resulted basically from the "bankruptcy" of governments—that is, unable (or unwilling) to meet their expenditures from any more appropriate source—so they have turned to the printing presses, thus creating inflation.

In the major inflations of recent decades, almost invariably gross domestic product (GDP) per capita goes down as the inflation moves to its peak, and it recovers as the inflation is brought under control. Table 7.1 records a number of important recent episodes in Latin America, chosen for having had peak inflation rates of around 100 percent or more, followed by a substantial reduction of the inflation rate. Note that in spite of the known problems of effectuating a program of stabilization, all of these countries experienced significantly better growth of per capita GDP during the years of falling inflation than during the years of rising inflation.

One key factor that helps explain this result is that, on the whole, these countries had significantly better economic policies during their stabilization periods than during their periods of accelerating inflation. Here I

Table 7.1
Economic Growth Rates in Major Inflation Episodes

Country	Episode Years	Annual Inflation Rates (in percent)			Average Annual Growth Rate of per Capita GDP	
		Start	Peak	End	Rising Inflation	Falling Inflation
Argentina	1970, 1976, 1980	14	444	101	.004	.031
	1981, 1985, 1986	105	672	90	-.025	.011
	1986, 1989, 1993	90	3,080	11	-.013	.030
Bolivia	1981, 1985, 1989	32	11,750	15	-.055	-.013
	1971, 1974, 1979	20	505	33	-.035	.012
Chile	1981, 1987, 1992	25	132	16	-.022	.011
	1977, 1985, 1987	38	163	85	-.012	.065
Peru	1987, 1990, 1993	85	7,482	49	-.104	.016
	1964, 1968, 1970	42	125	16	.003	.050
Uruguay	1970, 1973, 1978	16	97	45	-.011	.030

Sources: International Monetary Fund, *International Financial Statistics*, various issues (Washington, D.C.).

would like to emphasize the ways in which inflation per se works to hamper economic efficiency and the process of growth.

The key to the most adverse effects of inflation lies in the way that it affects the signals emerging from an economy's price system. In a stable economy, rising prices are signals that a good or service has become scarcer or more desired, or both. Price rises should act to attract more resources to an activity, and price falls to deter them. With a stable price level, the bulk of price movements are signals of this nature. More generally, movements in relative prices provide these kinds of resource allocation signals. But when an inflation process is under way, particularly a major one, the different prices of the economy do not all move up in lockstep; some rise in steps, others in big jumps, still others in irregular patterns. The vision that people have of relative prices changes day by day. In this kaleidoscope of changing relative prices, it is much harder to discern the true signals of greater or lesser scarcity or desirability. Hence, economic agents are slower to respond, and the efficient operation of the economy is impaired.

Inflation affects the growth process in a similar way. For nearly fifty years we have known that an important part of economic growth stems from improvements in total factor productivity. Such improvements can also be called by another name: real cost reductions. I prefer this design-

nation because it reminds one immediately that this is a goal that every businessperson, every manager, every engineer is seeking, day by day, week by week, year by year. It reminds us that the nature of growth is multifarious, coming out of all the different ways that economic agents find for reducing real costs. The problem with inflation is that it blurs relative price signals, thus making it harder for businesspeople to recognize opportunities to reduce real costs. With a stable general price level, relative price signals can be seen as in bright sunlight; with moderate inflation, it is more like in a hazy mist; with rampant inflation, one gropes as in a dense fog to perceive relative prices. So when a significant inflation is under way, businesspeople become more tentative about testing new ideas, and when they do test them, they fail more often because price relationships are often misperceived. The end result is a smaller contribution of real cost reduction (total factor productivity improvement) to the growth process.

This is not the end of the story of the relation between inflation and growth. Another important contributor to growth is investment, and there are at least two ways in which inflation tends to crowd out productive investments. On the one hand, fiscally induced inflations usually reflect situations in which the government is seeking resources everywhere it can find them. This includes the capital market, whether it is primitive and rudimentary, or sophisticated and modern. More pressure from the side of the government crowds out productive investments and thus reduces the contribution of investment to growth.

There is a related connection between inflation and growth that operates through the monetary system. I like to work with the vision of the monetary system that *International Financial Statistics* initiated nearly fifty years ago. This focuses on the balance sheet of the consolidated banking system of a country (central bank plus deposit money banks). The liabilities of this consolidated system are mainly money plus quasi-money, and its assets are mainly net foreign assets plus credit to the public sector plus credit to the private sector. The important point is that inflation causes people to reduce their real balances of money plus quasi-money. This reduction in banking system liabilities squeezes the asset side of the consolidated balance sheet, tending to squeeze total bank credit in real terms. Moreover, if the inflation is being fueled by expanded government borrowing from the banking system, then the government's share in total bank credit is likely to increase, thus compressing private sector credit even more, and through it, of course, the rate of investment in productive capital assets.

There is thus a whole host of ways in which inflationary policies impinge on economic growth. The lessons of history in this regard should not be forgotten.

Boom-and-Bust Syndrome

There are analogies between the problems that policymakers face in their task of guiding a nation through good times and bad and the problems that ordinary households face as they confront the vicissitudes of daily life. The perils of wishful thinking, the temptations that lure one, the moral dilemmas that never cease to arise, the difficulties of maintaining discipline in the face of adversity, one's terrible reluctance to cut back: All these fit as easily in the world of the policymaker as in the world of the householder.

Nowhere is the analogy more poignant than in what I call the boom-and-bust syndrome: the tendency to live beyond one's means when times and prospects are good and then to be forced to tighten one's belt when times turn bad. Consider two oil-exporting countries in the Western Hemisphere: Ecuador and Mexico. Between 1978 and 1980, the dollar value of Ecuador's merchandise exports rose by two-thirds, and that of Mexico's went up by 250 percent. One would think that such a bonanza would signal the wisdom of special efforts to build up their productive capital stock and perhaps to pay off some foreign debt. But such was not the case. Gross fixed capital formation was 14.8 percent of GDP in Ecuador in 1977 and 13.8 percent in 1978. With the oil bonanza, it went to 12.8 percent in 1979, 14.7 percent in 1980, and 14.3 percent in 1981. In spite of the oil boom, Ecuador ran a larger average current account deficit over 1979–1981 than it did in 1977–1978. In Mexico, fixed capital formation went up by some 5 percentage points of GDP, but the current account deficit went up by even more. The sad truth is that by 1983, Ecuador's GDP per capita was no higher in real terms than it had been in 1978 (in spite of the fact that real oil prices were well above their 1978 levels), while Mexico's was barely 7 percent higher (in spite of 1983's exports being more than triple 1978's in nominal dollar terms and more than double in real dollar terms).

The oil-exporting countries were the lucky ones, for they were in a position to benefit from the oil bonanza. But in a curious twist of fate, it seemed that some nonoil countries gained more from the oil boom than the oil countries themselves. The mechanism was the huge expansion of international lending, as the great international banks recycled their "petrodollars" (deposited predominantly by Saudi Arabia and the Persian

Gulf States). During the years 1979–1982, the current account of Brazil had deficits totaling more than \$50 billion (over \$400 per capita); Argentina's ran over \$12 billion (also over \$400 per capita). Chile's over \$10 billion (around \$900 per capita), Peru's over \$3 billion (around \$200 per capita), and Uruguay's over \$1.5 billion (around \$500 per capita).

Stimulated in part by the borrowing binge, GDP per capita peaked in Argentina and Brazil in 1980, in Chile and Uruguay in 1981, and in Peru in 1982. There ensued the great international debt crisis during which real GDP fell absolutely in every one of these countries. The balance of trade in goods and nonfinancial services turned positive in Argentina from 1982 through 1991; in Chile, from 1983 to 1993; in Peru, from 1983 to 1986; and in Brazil and Uruguay, from 1983 to the present. This meant that the large net resource transfer into these countries that occurred in their period of boom was reversed and turned into an outward net resource transfer in their period of bust. Real GDP per capita did not return to its early 1980s peak until 1989 in Chile and 1992 in Argentina and Uruguay. In Brazil and Peru, it was still below 1981 levels in 1992 and 1993.

This is not the place to try to analyze in detail how all these countries could quite plausibly have managed their affairs more prudently, keeping a closer rein on their borrowing and spending in the boom years and thus leaving themselves less saddled with debt, and in a better position to continue to resume healthy growth after the flow of petrodollars was cut off. Perhaps the key variable in this story is the country's real exchange rate, which, though not itself an instrument of policy, can certainly be considered a variable of legitimate (and sometimes serious) policy concern. All of the countries discussed underwent dramatic currency appreciations in the boom years and had to pay a huge price in terms of major real depreciations of their currencies later. Countries that have attempted to use the policy instruments at their disposal to keep real exchange rates within range of what are thought to be their medium-term equilibrium levels have had little reason to regret these policies. Particular instances of this type of policy include Brazil (1968–1979), Chile (1965–1970 and 1985 to the present), and Colombia, in a broad characterization of its policy (since the late 1960s).

Populism

It is not easy to define what I (let alone others) mean by the word *populism*, but its broad connotation is clear: politicians promising much more than they can deliver and then trying to carry through on their impossible

promises anyway. It includes having cheap bread and buses and rents when their true economic costs are much higher; imposing arbitrary sharp wage increases independent of movements of productivity and other conditions in the labor market; keeping failing enterprises alive in order to avoid laying off their workers; building huge government bureaucracies that have little or no (or even negative) economic yield or function; making credit cheap and easily available to preferred groups (and sometimes quite broadly); and failing to cover government expenditures by taxes, and when taxes are imposed, choosing them in terms of their political resonance rather than their economic impact. This list could easily be made longer.

Bouts of populism have been witnessed in Latin America (the area of the developing world with which I am most familiar) for a long time. In recent decades we have had Presidents Goulart and Sarney in Brazil, President Allende in Chile, President and Mrs. Perón in Argentina, and Presidents Echeverría and López Portillo in Mexico. In all these cases, the economy was left in critical condition, in urgent need of major surgery as far as economic policy was concerned. The important lesson to be learned from these and other experiences with populism is that it does not achieve the objectives that were proclaimed for it. Inflation is almost always its consort, as are widespread economic distortions, ill-functioning markets, and counterproductive foreign trade incentives. Except when populist regimes are very short-lived, they typically end up with real incomes and real wages lower than at their start.

No one should ever make the mistake of confusing populism and democracy. To my knowledge, the oldest extant democracy in the world is Switzerland, which has proved itself quite resistant to the populist virus over the centuries. Nor are so-called left-wing governments predestined to be populist. Some link of that kind may once have existed, but recent history has shown that parties of left, right and center can all embrace good economics and implement good economic policies.

7.2 Key Features of Good Economic Policy

Experience has taught us a great deal about the types of policies and policy packages that allow an economy to perform up to (or, better, close to) its potential. It is probably fair to say that a reasonably wide consensus has emerged concerning things a country definitely should try to do and other things it should definitely avoid doing. There is no single place where this emerging consensus is fully codified, so I shall content myself with drawing on two sources familiar to me

In April 1983, a conference was held in Mexico City under the auspices of the Institute for Contemporary Studies (ICS). The topic was world economic growth, and the bulk of the papers were country studies of developed and developing economies. The focus of the papers was to try to distinguish in each case what the country's policymakers had done that was right and also what had been their principal errors (both of commission and of omission) in economic policy.

It fell to me to summarize the results. I ventured to draw thirteen lessons of economic policy (Harberger 1984):

1. Avoid false technicism in economic policymaking.
 2. Keep budgets under adequate control.
 3. Keep inflationary pressures under reasonable control.
 4. Take advantage of international trade.
 5. Recognize that some types and patterns of trade restrictions are far worse than others, and work to liberalize and rationalize them.
 6. If import restrictions are excessive and reducing them is politically impossible, mount an indirect attack on the problem by increasing incentives to export.
 7. Make tax systems simple, easy to administer, and (as much as possible) neutral and nondistorting with respect to resource allocation.
 8. Avoid excessive income tax rates (50 percent was selected as representing a plausible marginal rate that should not be exceeded).
 9. Avoid excessive use of tax incentives to achieve particular objectives.
 10. Use price and wage controls sparingly, if at all.
 11. Rarely can a cogent economic justification be found for quotas, licenses, and similar quantitative restrictions on output, imports, exports, and so forth.
 12. Policy professionals tend to take a rather technical view of the problems associated with public sector enterprises, emphasizing the many extra constraints and demands that are typically placed on their operations.
 13. However it is determined, the borderline of public sector and private sector activity should be clear and well defined. When the two compete in a given area, the same rules should govern their operations.
- It would be easy to augment this list, but I prefer to leave it as a rough reflection of where a group of experienced policy professionals (the bulk of the conference participants) stood some dozen years ago.

Some six and a half years after the ICS Conference in Mexico City, another conference was held in Washington, D.C., this one under the auspices of the Institute for International Economics. The focus of this conference was what John Williamson, its organizer, initially labeled the "Washington consensus," but at the conference's end he felt that the term "universal convergence" might have been more accurate. Williamson's (1990) summary description of the content of the Washington consensus is "macroeconomic prudence, outward orientation, and domestic liberalization." The great compatibility between Williamson's "consensus" and my "lessons" should already be apparent. (Neither of us claims to be the author, only the scribe of what we set down.) Following is my attempt to put ten main points of the Washington consensus into a form similar to the thirteen lessons:

1. Countries should maintain fiscal discipline, though not necessarily strictly balanced budgets.
2. Education and health are high-priority expenditures; indiscriminate subsidies are to be condemned; many infrastructure investments will pass the cost-benefit test.
3. Taxes should ideally be levied on a very broad base, and with moderate marginal tax rates.
4. Interest rates should be market determined; negative real interest rates, which often tend to emerge in inflationary episodes, should particularly be avoided.
5. A competitive real exchange rate is the first essential element of an outward-oriented economic policy.
6. The second element of such a policy is import liberalization. Tariffs are far better than licenses and quotas, and distortions should be kept to a minimum by limiting tariff dispersion.
7. Foreign direct investment is viewed with considerable favor, while the consensus is more neutral with respect to controls on financial flows into developing countries.
8. Privatization of public enterprises has been viewed with favor by Washington institutions, but many experts prefer to view it on a case-by-case basis.
9. Deregulation is an important step in the modernization of economies that carry heavy burdens of detailed state control over economic activities. One should aim for simple rules of wide applicability: the rules of the game.

10. Advanced economies often take property rights for granted; many developing countries have yet to recognize their fundamental importance for the operation of a modern market economy.

Between the "lessons" and the "consensus" one can get a good sense of the directions in which thinking about economic policy has evolved over the past couple of decades. There is not even a wisp of approval for many elements of policy that were accepted by many almost as dogma during the 1950s and 1960s: the detailed planning of the economy through the use of planning models; the strategy of import substitution behind very strong barriers to trade; the use of subsidized interest rates and allocated credit as important policy measures guiding resource allocation; the widespread reliance on public sector enterprises, almost always including electricity, telecommunications, and transport; and typically going far beyond them; and the use of inflation in many countries as the standard device for covering fiscal deficits.

Although there are many areas of economic policy not explicitly mentioned in the twenty-three points listed, I believe that these points are extremely useful in setting the stage for the discussion that follows.

7.3 Tax Policy in Developing Countries

In this section, I summarize what I believe to be the contemporary (or at least the emerging) consensus on tax policy for developing countries.

Value-Added Tax

Perhaps the most important innovation in the tax field in the past half-century is the value-added tax. This tax first emerged in France in the early 1950s and has experienced a phenomenal spread to all parts of the globe. It has gained most ground in places where it has replaced an old-type sales tax, levied in cascade fashion on every successive stage of production. It has made least headway where (as in the United States) it would compete with a retail sales tax, which has a quite similar ultimate base. In some cases, it has succeeded in supplanting a whole host of tiny nuisance taxes, many of them initially levied in earmarked fashion, with their revenues reserved for financing particular classes of outlay.

Tax professionals recognize that in spite of its typically broad base, the value-added tax never comes very close to being a fully general tax. Educational and medical expenses are usually outside its net, as are expenditures for casual labor and household servants in most countries, plus the

imputed rent on owner-occupied housing. On the whole, these reductions of its base lead to a situation where, with very good administration, a uniform value-added tax of 10 percent, designed as a consumption-type tax, will have a yield of no more than 5 to 7 percent of aggregate consumption, as measured by the national income accounts. In spite of this, which some may consider a limitation, the value-added tax is the principal single source of revenue in a considerable number of developing and developed countries. Rates in such countries have ranged all the way from 5 to 6 percent at the bottom to 18 to 20 percent at the top.

In the context of this chapter, the issue arises of the potential progressivity of a value-added tax. It is relatively easy to implement a value-added tax with varying rates, particularly if it is administered using the credit method. With that method, every selling entity pays the full tax on the value of its sales but can then claim a credit for the tax embodied in its purchases (as evidenced by receipts or other documentation). Thus, if a maker of yachts buys wood, glass, paint, and other materials embodying a value-added tax paid at the rate of 20 percent, and if the yachts themselves carry a tax rate of 30 percent, the yacht maker simply pays at 30 percent on the full value of the yachts, then proceeds to receive a credit for the 20 percent tax paid on the embodied materials. In the end, 30 percent has been paid on the value-added at all stages, adding up to the final sales value of the yachts.

There is a considerable history of value-added taxation at different rates for different products, though more so in advanced than in developing countries. The consensus is that having different rates makes administration more difficult, mainly because of the tendency of taxpaying firms to try to falsify the composition of their output, exaggerating their sales of low-rate products and understating those to which higher rates apply. Perhaps for this reason, developing countries have tended to avoid multiple rates of value-added tax.

The most significant situation of multiple rates that one still finds in developing countries is the practice of zero-rating certain products. This says that a zero rate is applied to the sales of certain products of a firm, although the standard rate may still be applied to others of its products. Zero rating usually is applied to items viewed as basic necessities, such as bread, rice, and canned and powdered milk. Sometimes it is extended to all or most food items.

The difficulties of administration that emerge with different rates also carry through to cases of zero rating side by side with a single standard rate. Once again the problem is one of exaggerating the sales of zero-

rated items and understating those of taxed items. Tax professionals, on the whole, seem to favor eliminating zero rating, or at least keeping it to a minimum, concentrated on easily tracked items whose sales records cannot readily be inflated.

The one area where tax professionals look with some equanimity on differentiated treatment under a value-added tax is in leaving certain classes of sellers entirely out of the system. For example, in a country with thousands or millions of small farmers, many perhaps illiterate, and most unaccustomed to the twists and turns of double-entry accounting, it is probably wise for the authorities simply to leave agriculture out of the value-added tax net. When this is done, the government may even end up collecting more revenue than by including the farmers in the net-work. The reason is that when farmers sell to food processors, and the food processors then pay value-added tax on their sales, they in effect pay tax on the farmer's sales (to them) plus their own value-added. In this case, the government gets more revenue than it would by including the farmers in the network, because nobody gets to take a credit for the value-added tax embodied in the farmers' purchases of fertilizer, seeds, tools, and other inputs.

That is only one side of the story, however. In addition, there are the sales that farmers might make directly to consumers (as in the Sunday markets and fairs common in developing countries). In principle, these sales would be taxable if farmers were included in the network; the tax on them is unequivocally lost when the farmers are left out. Thus, by leaving the farmers out, the government receives additionally the value-added tax embodied in their inputs but loses the potential value-added tax on their direct sales to consumers. Many tax professionals believe that direct sales to consumers are very hard to tax successfully in any case, so the government actually gains revenue while saving significant administrative costs by leaving the farmers out.

Some tax professionals modify this story slightly. Instead of recommending that all farmers be left out of the value-added tax net, they urge that large, modern farms be included and farms below a certain size excluded.

The value-added tax is important as a revenue source, and although a certain degree of progression can be built into it, such progression comes at a significant cost in terms of greater administrative effort as well as of evasion itself. I am trying here to lay the groundwork for my later conclusion that, come what may, no developing country is likely to be able to have a tax system that is very powerfully progressive.

Taxation of Imports: The Uniform Tariff

In the past decade or so, there has been a huge movement, across many developing countries, toward lowering the rates of import tariffs that they impose and, equally important, bringing them much closer to uniformity. Chile was a leader in this area, imposing a 10 percent uniform tariff in 1979. The rate of that tariff has been modified several times since, but it has never ceased to be uniform. It stands today at 11 percent. Many other developing countries have moved in the direction of uniformity, without going all the way. Whereas twenty years ago tariffs commonly ranged up to 100 percent or more, with many exempt items, today in many countries the tariff rates all lie between, say, 10 and 20 percent or between 5 and 15 percent.

The merits of a uniform tariff are not that it is optimum from any technical point of view. It is better defended as a very big step in the right direction, compared with where one was before. Differentiated tariffs have the serious flaw of providing rates of effective protection that are typically some multiple of the rate of nominal protection—a multiple that varies arbitrarily with the world market prices of final products and imported inputs, and with productive techniques (how much of importable inputs is used, and to what tariff rates are they subject?)

With a uniform tariff rate of, say, 10 percent, all issues of effective protection are clarified. All import-substitute activities are given effective protection at the rate of 10 percent, and all export activities (so long as they are rebated the amount of import tariffs embodied in their cost structure, as permitted by the rules of the General Agreement on Tariffs and Trade) are given zero effective protection. This may not be a tax professional's nirvana, but it is a lot better than the world as we saw it not too long ago, with effective protection rates that reached as high as 500 percent or more and went for certain activities as low as -20 or -30 percent.

An important added advantage of a uniform tariff lies in the field of political economy. Once there exist high and low rates of tariffs, producers will make great efforts to obtain high rates for their products and low rates for their important inputs. That is, each producing entity will be striving to make its rate of effective protection as high as possible. Political life being what it is, it is very hard for a tax authority or a tariff commission to resist this type of pressure from every side, and once a concession is made to one or a few, the rest will predictably line up again to get their share.

How much easier it is for the authorities to resist such pressures when the plaintiffs simply have no high and low rates to point to. The authorities can then maintain quite correctly that "you are being treated just like everybody else," and this blunts, or even forestalls, most of the pressures that would otherwise emerge.

Taxation of Income from Capital

One of the important insights that has come to be widely accepted as the world capital market becomes ever more open is that the incidence of the corporation income tax, or its twin, the enterprise income tax, tends to fall mainly on labor. Indeed, it is easy to construct examples in which this tax is more than fully borne by labor.

The key to understanding this apparently counterintuitive result is the recognition that capital has always been relatively highly mobile, and it is becoming ever more so. It is not so much that foreign capital is ready to move into developing country capital markets with great ease. Rather, it is that the families and groups that own the bulk of the enterprises there can easily move their capital to London, New York, Zurich, Hong Kong, or anywhere else. In these centers, the families can earn the market rates of return of the world capital market. In many developing countries, even their own nationals require a significant risk premium in their own market, vis-à-vis London and New York, but that is something they would likely demand in the presence of a corporation income tax or in its absence. If such investors are willing to accept a 5 percent real return in New York, they may very well insist on the expectation of a 10 percent net-of-tax return on their industrial and similar investments at home. This means that if there is no tax, investment projects will face a likely cutoff rate of expected return of around 10 percent. If now a 33 percent corporation tax is imposed, this cutoff rate of return will be 15 percent, and many investments will now be rejected, though they would have been accepted at a 10 percent cutoff rate. The capital that would have gone into these investments will likely flow abroad (or fail to flow in from abroad). Less capital will thus be working with the labor force in the developing country in question, and the equilibrium real wage accordingly will be lower. This is the mechanism by which labor comes to bear part, or all, or more than all of the burden of the tax.

In the simplest models of corporation tax incidence in an open economy, the assumption is made that the product of the corporate tradable sector has its price determined in the world market, so the price cannot rise when the tax is imposed, nor can the equilibrium net-of-tax return to

capital fall, for the reason stated. So if neither product price nor capital's net return can move to absorb the tax, the burden has to fall on labor, which is assumed to be substantially immobile, internationally. It could happen that wages would not adjust at all, or would adjust but not enough to absorb, in the corporate tradable sector, the full burden of the tax. In either of these circumstances, the developing country that imposed the tax would abandon the production of the good in question. In order for it to continue to produce the good on a continuing equilibrium basis, the wage of labor has to fall by enough to absorb the tax. But if wages fall in the corporate tradable sector, they must also fall in the rest of the labor market. It is here that the burden on labor can become significantly greater than the total yield of the tax. The fall of wages in the rest of the economy can cause the prices of services to fall, benefiting their demanders. They can also cause land rents to rise as agriculture, producing a tradable product, sees its labor costs fall while its product price is maintained. Thus, labor's burden is reflected not only in tax revenue to the government but also in benefits to buyers of services and owners of land.

I have but barely sketched the line of analysis of corporation tax incidence in the open economy. The key features of the argument have been published in several places over the past decade or more. More recently, I have revisited this topic and attempted to loosen some of the more rigid assumptions, allowing the prices of developing country corporate sector products to have some flexibility rather than be fully fixed in world markets. I also allowed, more for the U.S. case than for that of a developing country, for the world rate of return to capital to fall as one of the consequences of the imposition of the tax (in this case in the United States). These various attempts to bring more flexibility and realism into the analysis leave basically untouched the principal conclusion that labor is very likely to bear all or more than all of the burden of the corporation income tax (except when the major countries of the world move their rates up and down together). For independent policy actions by developing countries, it is very hard to escape the conclusions that labor will bear the burden (Harberger 1995, chap. 2).

I have provided extensive technical detail because I felt it necessary to support rather than simply assert the likelihood that the corporation income tax falls largely on labor. This is another pillar of the final conclusion that it is extremely difficult to find sensible tax policies that have strong redistributive consequences.

Given this analysis, I believe that the trend among developing countries to integrate their corporation income taxes with their personal

income taxes should be welcomed. One can say, with numerous qualifications, that absolutely full integration of the corporation income tax with the personal income tax almost amounts to the abolition of the corporation tax. One reason for keeping the corporation income tax, at least as a shell, concerns multinational companies, whose income would likely be taxed by Washington or London if it were left free of tax in Brazil or Mexico. Another reason has to do with monopoly profits, more common in the small markets of developing countries than in the highly competitive arenas of the United States and perhaps the European Union. Monopoly profits are not, in an analytical sense, fully accounted for as part of the marginal product of capital, but they are commingled with the return for capital for tax purposes, and the corporation income tax thus helps the government take its bite out of them.

Most efforts at integrating the corporation income tax with the personal income tax are only partial. If we have, per share, 300 of profits and 100 of corporation income tax, with 60 paid in dividends and 140 reinvested within the corporation, there are four ways in which integration can take place:

1. Full integration. Each domestic shareholder declares the full 300 of profits per share and claims the 100 of corporation income tax as "withholding."
2. Integration with gross-up of dividends. Since the corporation tax rate is one-third, 90 would be imputed as income to the shareholder and 30 of what had been paid at the corporate level would be considered as withholding.
3. Integration based on dividends but without gross-up. The shareholder declares 60 as dividend income and counts one-third of this amount as withholding.
4. Dividends free of tax at the personal level. This is equivalent to the second way if the shareholder has a marginal tax rate equal to the corporate rate. (Where this fourth way is employed, the top marginal rate of the personal income tax is often made equal to the corporate rate.)

The developing countries that have moved toward integration have, to the best of my knowledge, settled on either the third or fourth method. Thus, by design, they yield only partial integration, and the incidence analysis given above would still apply to the "unintegrated" portion of the corporation income tax.

Indexing the Tax System for Inflation

Inflation wreaks havoc with the implementation and administration of any tax system that has not been inoculated against it. Businesspeople suffer from having depreciation allowances, based on historic cost, that bear no relation to the true economic depreciation, at current prices, of the assets in question. Lenders complain about having to declare as income the full amount of interest they receive, even though a good part of it merely compensates for the loss in value of the loan through inflation, and thus might more appropriately be considered amortization. Investors complain that they are being taxed on capital gains, even when the asset they have sold has produced a loss in real terms. Tax administrators, budget directors, and finance ministers all complain of the so-called *Tanzi effect*, encompassing a variety of mechanisms by which an ongoing inflation erodes the real value of tax revenues.

It is possible to modify a tax system by a series of patches, each addressing one of the above problems or a similar one. One can permit the revaluation of assets for depreciation purposes; one can legislate that the cost basis of assets can be adjusted for inflation before computing capital gains that will be subject to tax; the tax authorities can apply an inflation factor, or even an interest rate somewhat above the inflation rate, to update tax liabilities between the time the taxes accrue and the time they are paid. All of these patches have been tried in one or another country, but in the end they remain just that—patches.

Anyone who looks closely at the problems that inflation creates for a tax system will quickly realize that each patch is designed to deal with a particular problem but calls attention to another, somewhat similar, problem that has not yet been dealt with.

The obvious answer is to index the entire tax system. This sounds like an enormous task, enmeshed with complications at every step. But closer examination reveals that it is actually easier to index the whole tax system than it is to implement a series of individual partial patches.

This is not the place to go into a full discussion of tax indexing. But readers should realize that a few simple rules are sufficient to cover the vast majority of cases. For the taxation of business income, all real or indexed assets are written up by the annual (or other periodic) inflation factor, and the amount of the write-up is added to taxable profits. Similarly, all real or indexed liabilities (including, in this case, capital and surplus) are written up by the inflation factor, with the amount of this write-up being subtracted from taxable profits. And finally, depreciation is taken

on the written-up value of depreciable assets. These three rules deal, almost as if by magic, with the whole panoply of the inequities induced by inflation. They do not cope, of course, with indirect taxation; here the inflation issue is met by sticking to *ad valorem* rates. And on the side of administration, tax liabilities should always be translated into fully indexed "tax units," thus dealing for all taxes with the burdensome issue of the *Tanzi effect*.

Unfortunately, a mythology has grown up among some tax authorities and many public figures, according to which the indexing of a tax system is thought to signal a weakening of the government's resolve to maintain price stability. This is sad, particularly in a world where general price levels rarely go down—where the issue is not whether there will be inflation but only how much. The time to index a tax system is when the rate of inflation is low, when taxpayers and administrators alike find the changes relatively modest and often welcome. They would quickly learn that the costs of compliance are no greater than under a nonindexed system and would easily accommodate themselves to the new procedures. Then, when trouble strikes and the inflation rate spurts up for whatever reason, the economy and the society will be in a far better position to deal with it. Moreover, because an indexed system can deal with the *Tanzi effect*, while a nonindexed system cannot, it is very likely that if an inflationary process starts, it will go less far under an indexed system, because real tax revenues will be better maintained, fiscal deficits will be smaller, with a consequently smaller gap to be financed through inflation.

I find it difficult to fathom why countries have not been willing to move to full indexation in a timely way. We do not say that fastening a seat belt means we intend to have an accident or that buying fire or health insurance means that we are courting disasters of these types. Why can our societies not view tax indexing in the same light?

On Taxes and Income Distribution

The bulk of this section has been devoted to discussing important aspects of the design and administration of tax systems. The underlying purpose was to convince readers that the tax system is unlikely to be a major determinant of the income distribution of a country. Rather than enter into a lengthy disquisition on this point, I shall content myself with presenting what I believe to be a decisive example.

In setting up column 2 of table 7.2a, I have tried to mirror the type of income distribution actually found in many developing countries. It is a highly unequal distribution, but that is what one actually finds.

Table 7.2
Income Distributions Before and After Tax

Quintile of families (1)	Income before tax (2)	Tax (3)	Income after tax (4)	After-tax distribution [(4) ÷ k ^a] (5)	Relative "transfer" [(5) - (2)] (6)
a. With sharply progressive taxation					
First	4	0	4	5.56	+1.56
Second	6	1	5	6.94	+0.94
Third	10	2	8	11.11	+1.11
Fourth	20	5	15	20.83	+0.83
Fifth	60	20	40	55.56	-4.44
Total	100	28	72	100.00	0.00
b. With moderately progressive taxation					
First	4	.3	3.7	4.47	+4.7
Second	6	.6	5.4	6.52	+5.2
Third	10	1.3	8.7	10.51	+5.1
Fourth	20	3.0	17.0	20.53	+5.3
Fifth	60	12.0	48.0	57.97	-2.03
Total	100	17.2	82.8	100.00	0.00

Source: Author's calculations.

a. The value of k is 0.72 for table 7.2a and 0.828 for table 7.2b.

The tax system I have assumed is highly progressive—much more progressive than one is likely to find in reality. This was made intentionally unrealistic in order to reinforce my main point: that it makes no sense to think of the tax system as a vehicle for making major changes in the income distribution. The total tax burden shown in table 7.2a is much higher than the tax burdens usually found in developing countries. Given that the assumed system is so progressive, this again has the effect of giving greater scope to the redistributive potential of the tax system. Yet when all is said and done, the relative after-tax distribution is not very different from the before-tax distribution.

Now we should ask, Given the constraints discussed in the earlier parts of this section, how could one expect to get a tax system as progressive as this one, in a typical developing country? Table 7.2b moves in the direction of greater realism while still maintaining a significant degree of progressivity in the tax system. It raises less revenue than the example of table 7.2a, and the tax system is moderately less progressive. Here the

conclusion comes through even more strongly: The relative income distribution is not greatly altered by this tax system.

It is extremely important, as we think seriously about tax systems, to internalize the lesson of this section. We are on the wrong track if we think that equity considerations should lead us to think of the tax system as a redistributing vehicle. We are on the right track if we apply equity considerations to find a distribution of the tax burden that accords reasonably well with a society's sense of what is fair, just, and appropriate.

7.4 Equity on the Expenditure Side

Expenditures and Income Distribution

The expenditure side of the budget offers greater scope than does the tax side for differential relative impact on different income groups. This is clearly illustrated in table 7.3. The two parts of the table are built to mirror the two parts of table 7.2, adding reasonable (i.e., not excessively extreme) assumptions about the expenditure side.

I do not believe it ever makes a great deal of sense to try to allocate the whole of government expenditures as benefits to particular income groups. When we undertake this kind of exercise, we are not trying to allocate the generalized benefit of "having a government" versus "living in anarchy." Rather, we are trying to allocate the benefits that people can reasonably be thought to recognize, to perceive. In real-world cases we should limit ourselves largely to items like education, medical care, nutrition, housing, plus, perhaps, the costs of the highway network. To these should be added other direct transfers plus the subsidies implicit in artificially low prices for such items as food, water, and electricity.

This is not the place to pursue in detail the issues of coverage and measurement of benefits. Suffice it to say that we explicitly do not want to try to allocate such items as general government administration, the defense budget, the costs of police, the courts, and the penal system. And since these costs have to be paid, our preferred method works out to yield a net tax burden. It is the remaining expenditures, which are more readily assigned to specific beneficiary groups, that we would deal with directly in an expenditure allocation. (My approach here is the best one to apply in any serious attempts to work with the notion of expenditure incidence. It does no good, and in fact clouds the basic issues, to impose arbitrary allocations for defense, justice, and administration, and thus because of the care of the expenditures, to end up imposing on the resulting estimated

Table 7.3
Income Distributions After Taxes and Expenditures

Quintile of families (1)	Income before taxes (2)	Minus tax plus benefits (3)	Dist. of perceived income [(2) + (3)] (4)	Absolute perceived income [(4) ÷ k ^a] (5)	Net tax (-) transfer (+) [= (3)] (6)	Relative "transfer" [(5) - (2)] (7)
a. With sharply progressive taxation						
First	4	-0 + 2.8	6.8	7.91	+2.8	+3.91
Second	6	-1 + 2.8	7.8	9.07	+1.8	+3.07
Third	10	-2 + 2.8	10.8	12.56	+0.8	+2.56
Fourth	20	-5 + 2.8	17.8	20.70	-2.2	+0.70
Fifth	60	-20 + 2.8	42.8	49.76	-17.2	-10.24
Total	100	-28 + 14	86.0	100.00	-14.0	
b. With moderately progressive taxation						
First	4	-3 + 1.7	5.4	5.91	+1.4	+1.91
Second	6	-6 + 1.7	7.1	7.78	+1.1	+1.78
Third	10	-1.3 + 1.7	10.4	11.39	+0.4	+1.39
Fourth	20	-3.0 + 1.7	18.7	20.48	-1.3	+0.78
Fifth	60	-12.0 + 1.7	49.7	54.44	-10.3	-5.56
Total	100	-17.2 + 8.5	91.3	100.	-8.7	0

Source: Author's calculations.

Note: Assumes that perceived benefits equal half of total taxes and perceived benefits are equally distributed among quintiles.

a. The value of k is 0.86 for table 7.3a and 0.913 for table 7.3b.

distribution of benefits a particular coloration that largely stems from the arbitrary allocations themselves).

In the exercises of table 7.3, half of the burden goes to general, unallocated purposes, and the remaining half produces perceived benefits that are equally distributed across the quintiles. Some may think this is not a generous assumption, but I believe it is when viewed in the light of the world's realities. More important, I want to show that with this assumption, expenditures exert a lot more influence on the relative distribution of income than we found for the taxes analyzed in table 7.2.

The tax scenario employed in table 7.3a is the same as that for table 7.2a, and the same is true for tables 7.3b and 7.2b. Thus, one can quickly pass to the final columns of both tables. With expenditures taken into account as I have described, the top quintile loses about two and a half

times as much in each panel of table 7.3 as in the corresponding panel of table 7.2 (compare -10.24 with -4.44, and -5.56 with -2.03). In a similar way, the gains of the bottom quintile are about two and a half times as large in the top panel (+3.91 versus +1.56) and about four times as large in the bottom panel (compare +1.91 with +0.47). This latter case is important because the tax assumptions of the top panel were intentionally biased toward progressivity, while those of the bottom panel are likely to be closer to the truth in most cases.

Political Economy of Public Expenditures

I believe that it makes sense to use an equal distribution of perceived benefits from government expenditures as something like a yardstick against which to judge real-world cases. Obviously it would not be a sensible yardstick if all or most countries routinely did better than that. But in fact, at least for the great bulk of developing countries, the assumption of a flat (per capita or per family) distribution of perceived benefits is quite optimistic. As a yardstick, it is simply a reference point, but I am betting that careful study will show that for many, if not most, developing countries, it could be turned into a sensible, intelligent, humane, yet plausibly realistic goal.

Let me start from some of the unpleasant facts. In many of the poorest countries, the children of the poorest quintile get virtually no education, their families receive virtually no medical care, and even the simplest public health amenities (like potable water and minimal sewerage facilities) are often lacking. Such countries are far below the standard implied by a flat distribution of perceived benefits.

Now consider the middle-income countries (like Argentina, Brazil, Chile, Colombia, and Mexico), with which I am more familiar. Even here, it is hard to argue that the poorest families receive their proportionate share of perceived benefits. Consider the quantity and quality of public schooling in poor urban neighborhoods versus those that are not so poor, or in poor rural villages versus the median rural village. Now proceed to ask similar questions about medical care, sanitation, and other public health benefits; I find it hard to believe that the bottom quintile receives 20 percent of the total perceived benefit for any of these major classes of public expenditures.

The reason for these unpleasant facts is not hard to find: Everywhere in the world, the poor lack not only economic but also political power. In many societies, these two types of power are concentrated in a numerically small elite. But even where this is not true, those who share

political power with the top economic group are more likely to be at the next rungs down the economic ladder, not at the very bottom. According to this view, reality would likely differ from table 7.3b by having more of the relative transfer go to the third and fourth quintiles, and perhaps less to the second, but certainly less to the bottom quintile.

In those places where the bottom quintile is not left so far behind, it is interesting to ask why this is so. Is it because in those (I believe relatively few) countries the poor wield a significant amount of political power? Or is it because of a sense of decency, altruism, and empathy for the poor, arising within those strata of society where the political power actually rests?

Perhaps it is better if it is the latter, because I think it is easier to reach people by moral suasion if they are in any event inclined to want to alleviate the suffering and to raise the sights and the opportunities of the poor than it is to reach the poorest people (from a vantage point elsewhere in the world like Washington, Tokyo, Paris, London, or Berlin) by persuading (or otherwise helping?) them to obtain a greater piece of that elusive quantity called political power.

Policies Targeting the Very Poor

By now there is a widespread recognition of the "scandalous" distributive outcome of some expenditure-side policies. For decades it has been noted that most Latin American countries allocate a huge portion of their education budgets to their universities, that attendance at these institutions is heavily subsidized, often almost free, and that those who enter these subsidized universities come disproportionately from well-to-do families; indeed, they are often the products of expensive private primary and secondary schools. (Something similar happens in many advanced countries, where, at the very least, the beneficiaries of subsidized university education come much more from the upper than from the lower half of the income distribution.)

This is a problem whose technical solution is readily at hand: Simply charge competitive tuition to cover the costs of higher education and deal with the special needs of the poor through scholarships and special loans. But this technical solution does not face up to the political economy problems of the interest groups that support the status quo. If university tuition is zero, the middle classes do not want to give that up; if it is merely subsidized, they want the subsidies to continue. Actually there has been some movement in several Latin American countries, and in most

state universities in the United States, in the direction of increased tuition and reduced subsidies for higher education, but this movement has on the whole been quite slow, and largely impelled by budgetary crises rather than any fundamental reappraisal of the problem.

Clearly an educational policy that concentrated its subsidies on students from lower-income families would be more egalitarian than the system described above, but it still might find few qualified clients, owing to the deficiencies of the primary and secondary education available to the poor. In short, it takes great effort to keep the educational system from being a regressive transfer mechanism.

The shantytowns of Latin America are famous under many different labels (*favelas*, *villas miserias*, *barriadas*, *poblaciones callampas*, etc.), and government after government has mounted programs to deal with them. In the past, many of these programs probably aimed too high, attempting to provide a quality of housing that was out of phase with the income and tastes of the people concerned. The consequences were overcrowding (compared with the plan) of the new, more spacious dwellings, as the recipients augmented their incomes by sharing the space with numerous "cousins" (genuine or not), and an incapacity of the programs to reach more than a small fraction of the subject population, in part because of their high cost per dwelling unit.

The current wisdom on this problem is inclined toward more modest contributions from the state, combined with substantial self-help from the recipients. One model is for the government to provide clear title to a small lot, plus a concrete slab with sanitary facilities attached, and let the recipients build around it. This combination has been found to produce self-built houses of surprisingly solid construction and good durability.

Medical services for the poor always pose problems. Medical doctors do not want to live in poor communities; indeed, it is often difficult to get them to locate their practices there, even when the population-to-physician ratio is five or ten times that found in the richer neighborhoods and towns. Again, this problem extends to advanced countries as well as developing ones. One line of solution is to put medical stations in poor neighborhoods, staffed perhaps by nurses and nurses' aides. These stations then serve to give quick treatment in emergencies and for minor ailments, while filtering patients up the ladder to group practice medical clinics or central hospitals, depending on the severity of the case.

On quite another plane, small farms and other very small enterprises in developing countries have often suffered from the sheer inaccessibility of

credit. Some recent programs have achieved significant success by targeting these tiny businesses. In contrast to earlier programs, most of which failed in their purpose, these recent programs do not try to give subsidized credit but rather make credit available at an interest rate high enough to cover all costs. Some of these programs have managed the issue of creditworthiness by extending credit to groups of mini-enterprise owners, who jointly cosign each loan and thus in effect internalize what would otherwise fall as a burden of default risk on the lender. The experience of programs of this type suggests that small enterprises can make very productive use of even quite modest amounts of credit. One summary version of their story says that they suffered in the past from the lack of availability of credit rather than too high a price for it. Thus, sensible programs providing such availability can succeed, without requiring a subsidy element.

Other Targeting Issues

There are no panaceas in the policy areas we are exploring, so we can be sure that targeting the very poor also has its problems and limitations. I shall mention two cases: where the poor are too numerous and where the very poor are a separate category, almost disjointed from the rest of society.

In very poor countries, it may make little sense to draw a line at the twentieth or thirtieth percentile of families arrayed according to their economic status. In such countries, the economic hardships suffered by even the fiftieth and sixtieth percentiles may be hard to distinguish from those facing the bottom two quintiles. In such countries, the importance of attacking poverty at its roots, helping to educate the children of the poor, improving public health and medical care, and so forth is likely to be even greater than in middle-income countries with an identifiable, hence targetable, lower stratum.

I see an issue here but feel it is mainly semantic. If one thinks of the primary motivation as arising from a concern for basic human needs, this concern leads naturally to targeting the lower deciles of the population in most countries, and it leads to policies of wider coverage in countries where the vast majority suffers from extreme poverty. The problem is more difficult in these latter countries, but the basic policy instruments for handling it are much the same.

Special cases arise in countries with poor minorities that are somehow separated or otherwise distinct from the rest of the population. It was only on my third extended stay in India that I finally learned that the

bottom stratum in that country was not occupied by landless laborers (as I had always thought) but by millions of "forest people" living in primitive tribal conditions in forests and jungles all over India. In a similar vein, the whole Amazon basin is dotted with tribes of natives, many of whose lifestyles differ little from what they were five centuries ago. Whatever one can say about these cases, one surely does not want simply to amalgamate these groups with, say, the bottom quintile of bulk of the population of the country. At the very least they deserve to be thought of, and very likely treated, in different ways that recognize their unique characteristics.

7.5 Aiding the Escape from Poverty

I am particularly grateful for the opportunity to write this chapter, for it gives me a chance to express in an important forum some ideas that have been brewing in my mind for several years. These ideas were sparked, in part, by my experience in 1987–1989 as a member of the International Commission on Central American Reconstruction and Recovery. At one point in the deliberations of that commission, we were examining a very pessimistic document, which lamented that in spite of the experience of eighteen years (1960–1978) of almost uninterrupted growth and prosperity throughout the region, the absolute number of people living in poverty had remained about constant from 1960 to 1985.

Escape from Poverty

I was troubled by this document because it seemed to overlook the fact that the population of the region had doubled in the interim. What then had happened, I asked, to the children of the families who were living in poverty in 1960? Obviously, they could not all have still been in poverty in the early to mid-1980s. A simple demographic projection would suggest that over a quarter-century, something like half the children of the poor had managed to raise themselves out of poverty status. This important "fact" has stuck in my mind ever since, for we are not talking simply about a few lucky individuals who made their way up the economic ladder, but literally millions of people who somehow crossed that invisible line dividing the truly poverty stricken from the rest of society.

Here we have an important phenomenon that we do not fully understand: vast numbers of people who have in fact escaped from poverty. We need to know more. Who are they? What are the main routes they took to effectuate their escape? What policies and institutions aided, and what others may have tended to frustrate, the process?

On a somewhat different plane, I was quite convinced, on the basis of what I already knew about Central America, that, except possibly for Costa Rica, there had not been any substantial policy support for this observed massive "escape from poverty." Hence, I wanted to learn more about how it had been accomplished, with a view to possible new policies that might be designed to grease the wheels of the escape mechanisms and thus make them still more effective.

On the Central American Commission, we were not in a position to initiate a major (and necessarily expensive) study of the phenomenon. But I was able later to engage in a brief experiment, whose whimsical title was "Ask Any Grandmother." The idea was to try to start assembling oral histories of poor families. One would ask a grandmother when and where she was born, the occupations of her parents, the type of house she lived in as a girl (What kind of roof, floor, windows, plumbing? How many people in how many rooms?). One would also ask how many siblings she had, how many died in infancy or childhood, and other similar questions. One would inquire, too, about schooling levels—of her parents, her siblings, herself. Then one would turn to her own marriage, her own children, the house she and her family lived in as the children were growing up. And finally one would ask questions about her children's marriages, their children (her grandchildren), and all their conditions of life.

The idea was to build up a family saga, covering three, or maybe even four, generations, with information that could help us piece together a vision of what life was like at each stage. How much progress had there been overall? How many siblings and how many children had made their way out of poverty? How had this been accomplished?

I still feel that one or more major studies of this type should receive high priority from some source of funding, so as to help us break the cycle of our own lack of knowledge. The brief experiment to which I referred took place in El Salvador around 1990. It was far too hasty, far too rough, and far too small a sample to support any strong conclusions. But the basic facts that came through were as follows. First, the poor, even those who stayed poor, had experienced significant advances with respect to housing, life expectancy, infant mortality, and other areas, moving from one generation to the next. Second, there were many cases of family members (brothers, sisters, children and grandchildren of the interviewees) who had indeed effectuated the escape from poverty. The two most common routes were through building up a small business and receiving an education sufficient to surmount poverty, usually by becoming nurses,

accountants, secretaries, engineers, and similar other occupations, and rarely through becoming medical doctors or lawyers.

Another tantalizing tidbit of information that came out of the survey had to do with emigration. There were two effects, both easily verifiable through macroeconomic data. First, some of the children and grandchildren of the interviewees had emigrated, mainly to the United States. That simple fact automatically lifted them out of poverty status, as far as the Salvadoran grandmothers were concerned, regardless of what kind of job they had in the United States. Second, remittances from these emigrants turned out, in several cases, to be important supplements to family income. This is not an isolated phenomenon, for even when U.S. foreign aid to El Salvador was at its peak of around \$400 million, it was rivaled in size by emigrant remittances. Since then, U.S. aid has plummeted while the remittances have grown (even doubled, by some estimates).

Socioeconomic Mobility

Closely related to the escape from poverty is the general question of socioeconomic mobility, which deserves much closer study than it has received. It has important implications for the way in which a society might appropriately deal with poverty. Countries clearly differ from one another with respect to such mobility. At the one extreme, we have the ancient (perhaps not-so-ancient) Indian caste system, whereby economic status was simply inherited, generation after generation. At the other extreme, we have the vision we call the "American dream," which may be more reality than dream, given the high incidence of our professions, executive boards, and governments of people whose origins were below or near the median of our population. Obviously, the underlying reality with respect to socioeconomic mobility should have an important bearing, for example, on educational policy: People should be trained for the jobs they are likely to get. That reality also has a bearing on the ease with which the poverty problem can be "solved."

Just as in the case of the escape from poverty, we need much more information than we have about socioeconomic mobility in general. What are the backgrounds of a country's nurses, accountants, engineers, lawyers, and doctors? How many of them came from the same social stratum? How many rose from below? How receptive are the society's organizations (professional societies, clubs, other social groupings) to penetration from below? All of these phenomena are natural objects of study by social scientists. And such study, in some depth, will help us talk more sensibly about matters such as income distribution.

My own fear is that the process of upward social mobility is much slower in most developing countries than it is in the United States, or even in Western Europe (post-World War II). One gets the sense that the elites in developing countries, apart from being on the whole modern and well educated, tend to be highly prolific and are also pretty good parents. This means that their children are likely to be given the best of preparation for life in the upper stratum. This preparation, together with the sheer numbers in the upper stratum, poses a significant barrier to new entrants trying to break into that upper stratum from below.

In the end, it is relatively easy for me to envision the children of the poor in developing countries making a rather impressive escape from poverty. But I see them mainly becoming the secretaries, the draftsmen, the nurses and nurses' aides, rather than the leaders of business, finance, and government. It is easier for me to see, in Latin America, children of European grandparents (who may have arrived penniless a generation ago) rising to the very top than the children of the native poor.

For these things I have no clear answers, no obvious solutions. I think I see progress in most contemporary societies, in terms of socioeconomic mobility as well as in terms of more mundane measures like GDP per capita. But this progress is limited and often painfully slow. Outsiders can do virtually nothing, and even insiders relatively little, to speed it up. But perhaps with greater understanding of the phenomenon and its mechanisms, and with the general opening of economies around the world, old sources of resistance will begin to crumble, and societies will experience opening in contexts that go beyond just financial markets and international trade.

7.6 World Market Forces Affecting National Income Distributions

The fundamental proposition of this chapter is that, within any modern market economy, the distribution of before-tax income is substantially determined by the relative scarcity and abundance of different factors of production, in relation to the demand for their services. One of its main themes has been that at any given moment in time, policymakers can adjust this distribution, but they cannot change its basic shape. On the expenditure side, government can act to make society more humane and civilized; on the tax side, it can distribute the burden of its expenditure according to reasonable canons of fairness. But when all is said and done, the distribution of income will still be fundamentally determined by the powerful forces of supply and demand.

This story can apply equally well in a relatively closed or a relatively open economy, but the latter can introduce special features, which I explore in this section. Economics has long lived with the so-called factor-price-equalization theorem. This theorem points out that under certain quite plausible circumstances, the mere fact of international trade in final products can lead to the equalization of the prices of productive factors across countries—something that one might expect to happen if the productive factors were able to migrate freely, but perhaps not otherwise.

Volumes have been written first pointing out and then trying to explain the fact that the tendency pointed out by the factor-price-equalization theorem did not seem to be revealed in the real world. In my judgment, the deepest answer to the riddle is that, historically, backward countries have used backward productive processes, and advanced countries have used advanced productive processes. Because of this, it may have taken twenty workers combining with \$20,000 of capital to produce in Bangladesh or Haiti the same output produced by one worker combining with \$20,000 of capital in Canada or Japan. Once this fact is recognized, it is easy to see how Canadian and Japanese workers can earn twenty times the wages of their Haitian or Bangladeshi counterparts. This sort of differentiation, based on differential efficiency of productive processes, has been one of the most profound explanations of international differences in the real wage rates of equivalently skilled (or unskilled) workers.

The problem—if we want to call it a problem—is that times are changing, and there are very strong tendencies for the productive processes of backward countries to be upgraded. When today we see Manhattan shirts from Thailand, Florsheim shoes from Brazil, and Hamilton-Beach mixers from Mexico, we can be quite sure that they were made under the close supervision of those companies' managers, using the most efficient techniques at their disposal. That is, the productive processes of many once-backward nations have been modernized. They have moved closer to the efficiency levels of the advanced countries.

I believe this is the main reason that real wages have been so stagnant in many of the advanced economies over the past ten to twenty-five years. Table 7.4 records some outstanding instances. The table data are certainly compatible with the idea of intensified competition from new sources of supply like Taiwan, Korea, Malaysia, Thailand, and now China and India, plus the modern assembly plants in Mexico and Central America.

It is important to note that the stagnation of real wages in the countries shown in table 7.4 did not mean at all that GDP was stagnating. In the

Table 7.4
Recent Cases of Real Wage Stagnation

Country	Beginning	Ending	Beginning ^a	Ending ^a	Length of period (in years)
Australia	1975	1990	99	100	25
Canada	1977	1993	100	101	16
Denmark	1976	1992	94	102	16
Netherlands	1976	1992	97	100	16
New Zealand	1964	1992	98	100	28
Sweden	1975	1993	100	97	18
United Kingdom	1975	1990	95	100	15
United States	1965	1993	100	98	28

Source: International Monetary Fund, *International Finance Statistics Yearbook, 1994* (Washington, D.C.). For each country, the real wage datum is the IFS wage series divided by the IFS consumer price series for the given year.

^a 1990 = 100.

United States, for example, GDP more than doubled between 1965 and 1993, and population rose by about a third. Real income per capita rose at nearly 1.5 percent per annum. So it was not the U.S. economy that was stagnating, just the real wages of factory workers. Those with newly prized skills of computer programming and financial analysis fared much better over the same period. This situation helps to support my main point: that competition through international trade has narrowed real wage differentials in routine manufacturing-type jobs and is likely to continue to do so, thus affecting the income distributions we will see.

This heightened international competition will, I predict, keep real manufacturing wages from rising much in countries like the United States and Canada over the coming decades. It will also make it much harder for this type of real wage to rise in countries like Japan, Taiwan, and Korea and also in countries like Argentina, Chile, and Mexico.

These forces will inevitably have an impact on income distributions. I believe the most likely outcome is a further trend away from equality. If the capital factor becomes relatively scarce worldwide, so that real rates of return rise further, this trend toward increasing inequality will be strengthened. If real interest rates stay constant or fall, the trend will be somewhat weakened. But I believe the trend will continue to be present virtually worldwide, as an open world economy plus vastly increased mobility of capital-cum-technology give us a further demonstration of factor price equalization in action.

This pressure toward factor price equalization will clearly benefit people in countries like China, India, Indonesia, and Bangladesh, as modern factory methods vastly improve their productivity. These forces will also benefit consumers worldwide, who will continue to be able to find good shirts for ten to fifteen dollars, good shoes for less than forty dollars, good dresses for less than thirty dollars, and so forth (all at today's real value of the dollar). The same forces will also make it harder for the equilibrium real wage to rise in middle-income countries. I do not believe we will see many repeat performances of the type of happy miracle we saw in Taiwan or Spain or Brazil, where huge spurts of GDP growth led to notable rises in the wages of ordinary workers. Life in the early twenty-first century is going to be much tougher. It is not going to be easy for average Argentine or Chilean or Mexican factory workers to increase the relative advantage they now hold over, say, Thai, Chinese, and Indian workers. A lot of their benefit will come instead from their role as consumers of all the products whose real international prices are kept low, thanks to the efforts of those Thai, Chinese, and Indian laborers.

7.7 Summing Up

This is the place to try to put in perspective the various themes that I have treated. In my view, there is vast scope for policy improvement in most countries regardless of whether one's principal goal is economic growth or greater equity. Plenty can be done in both directions. Moreover, there is no substantial conflict between the two objectives, so long as one maintains a certain degree of realism about what are plausible, potentially feasible policy alternatives.

I have not emphasized—but only because I thought it so obvious—the degree to which improvements in education, public health, and medical care in general play genuinely positive roles in the process of economic growth. In most developing countries at least, there is great scope for policy actions in these fields, which will end up simultaneously promoting the causes of economic growth and social equity.

It is possible to consider improvement in education and health policies taking place and, in my view, improving equity, even if the overall Lorenz curve showing the income distribution of society remains substantially unchanged. It is also possible to consider expenditures that are focused on the very poor and have an impact on the overall distribution of benefits in the society. Such policies of targeting the lowest-income groups are one of the main vehicles for promoting greater equity and should be high

on the list of intelligent, feasible ways of moving toward a more just and humane society.

But what does (or can) it mean to implement policies that focus on the very poor? It is easy to define and describe individual policies like medical clinics in poor neighborhoods or self-help housing programs to replace existing slums, but will that change the overall distributional picture in a society? The answer I have already suggested is that the expenditure side has a potentially greater impact on a society's distribution of income or benefits or measured welfare, but even this impact may be regarded by some as scant.

In the discussion of the expenditure side, I bring into consideration issues of political economy. In every society with which I am familiar, the poor lack political as well as economic power. For better or worse, I believe that policies that improve the status of the poor are more likely to come out of the decisions of those who have more political power than out of the poor themselves "taking command." Thinking along these basically evolutionary lines, I set up examples in which the perceived benefits of government outlays are equally distributed across the five quintiles of the income distribution. Some may respond "And you call this *targeting*?" To this, my retort is, quite definitely, yes, compared with where things stand today in just about every developing country in the world. The fact is that in most countries, the poor now receive much less than their per capita share of government outlays. It would be a major step to move even half the distance from where most countries are to a simple level of parity for the very poor. This is a sensible way for us, trying to look at realistic alternatives, to frame the problem.

I have emphasized that the tax system is not an appropriate vehicle for effectuating major shifts in the Lorenz curve. I show in table 7.2a that even a tax system that takes more than two-thirds of all taxes from the top quintile, with this amounting to 20 percent of total national income before tax, creates a distribution of after-tax income that is only moderately different from that of before-tax income. In my view, and thinking of relatively poor countries, we cannot classify the tax systems of table 7.2 as inequitable, even though their impact on the distribution of income is relatively modest.

This brings us to another important point. It does not make sense to think of the income distribution of a country as something the government can determine. Nor, what is much the same thing, should it be viewed as something for which the government should be held responsible. The income distribution at any moment is the product of the distribution of

resource endowments at that moment (together with the existing pattern of demand) and is thus largely the product of history. A policy that today gives good educational opportunities to the children of the poor, aids them in their "escape from poverty," and fosters upward socioeconomic mobility in general may very well have a significant impact on the distribution of income twenty-five years hence, but not on the distribution of income today.

Once one manages to set aside the idea of government's "determining" the income distribution, one can look to other ways of conceptualizing its role. I like to think of society's deciding what tasks it assigns to government. These tasks may be larger or smaller; they may be more or less oriented to growth or equity. But in the end, there will be a series of tasks that society through its government takes on. The good society, in today's world, would include in these tasks the sort of targeted policies I have mentioned, as well as policies to improve mobility and aid in the escape from poverty. They would also include policies that directly promote economic growth, preserve ancient cultures, and safeguard the environment, among others.

When, through its decision-making processes, a society settles on a range of governmental tasks, there inevitably arises the question of paying the bill. In my view, the right way to think about taxes is to ask, How can this bill be fairly divided among us? It is in these terms that distributions of taxes like those of table 7.2a, and even of table 7.2b, can quite readily be thought of as meeting sensible standards of equity.

An incredible force has been already exerted by the spread of modern technology and management to countries with very low levels of real wages. This tendency has kept the real prices of manufactured products low, but it has had many other consequences, chief among them putting a powerful brake on the advance of real wages of typical factory workers, particularly in advanced countries. Table 7.4 gives eight significant cases of the outcome of this process (together with other forces that may have been at work). I see this wage pressure as continuing into the foreseeable future, with new factories in China, India, and Indonesia bringing unrelenting new competition into the markets for tradable goods. I believe that this will hold back the advance of real wages in the advanced countries, though not at all (necessarily) their growth processes. This represents an important exogenous force leading toward less equal income distributions in the advanced countries. The same pressures out of, say, China, India, and Indonesia will make it less easy for middle-income countries to gain market share in the world markets for tradable goods

and, perhaps even more so, to enjoy rapid advances in real wages while doing so. Among the many exogenous forces operating to determine income distributions worldwide, the prospect of ever greater new supplies, coming from now-poor countries, is a relatively new and very important one.

Out of all of this there emerges a sort of existential view that governments cannot determine the fate of their societies, or their rate of growth, or their income distribution. But this does not mean that governments are powerless, nor does it free them from heavy moral responsibilities.

We know that governments possess almost unlimited potential to do harm. The great Latin American inflations are case studies in which bad monetary and fiscal policies brought misery to their countries. Table 7.1 records a little-known fact concerning these (and many other) great inflations: The economy grew more while disinflating than while inflating. I do not attribute this to any simplistic, mechanical connection, because I recognize that in all those cases the countries in question had bad economic policies "on the way up" (as the rate of inflation was rising), and significantly better policies "on the way down." Still, inflation by itself tends to inhibit economic efficiency and growth, predominantly through blurring people's perception of relative prices. When inflation is induced by government deficits financed at the banking system, it also crowds out productive investment, thus further deterring growth.

Other instances in which nations suffered disasters brought about in whole or in part by ill-conceived policies include numerous cases of what I have called the boom-and-bust syndrome. This is represented by major export booms on the one hand, or huge international borrowing sprees on the other, followed by vast suffering when adjustment eventually had to take place. Prudence in managing and containing the boom or the spree could have greatly reduced the degree of suffering that followed.

Finally, I mention populism as a portmanteau term for much of what is bad in economic policy. Populism is not to be equated with democracy, or with serving the people, or, at least now, with left-wing governments. Rather, it should be seen as thinking only of the present—of today's or tomorrow's benefits and not of next week's or next year's costs. It should be seen as doing what comes easily and avoiding hard decisions and choices. It should be seen as caving in to the demands of pressure groups rather than trying to mold and channel them productively, when not outright resisting them. One can find many real-world examples of populism thus defined, and to my knowledge, all of them have led to economic disaster.

If it avoids the temptations of populism, boom-and-bust, and inflation, what should a government do to carry out its responsibility? I reviewed two attempts (by John Williamson and myself) to summarize the converging views of policy professionals as to certain key norms appropriate for economic policy in developing countries. In this summary I can do no better than use Williamson's (1990) terse distillation: "macroeconomic prudence, outward orientation, and domestic liberalization" (p. 1).

I brought up four important innovations of tax policy of the past forty years or so: the value-added tax, the notion of a uniform (or more nearly uniform) structure of import tariffs, the idea of integrating corporation and personal income taxes, and the indexation of tax systems for inflation. My motive in introducing these topics was partly to bring my readers down to ground level in thinking about what are sensible and relevant options on the tax side of the fiscal policy equation. But this also provided the opportunity to comment on a number of specific matters that have special import for income distribution:

- It is possible to introduce a degree of progression in a value-added tax system, but its benefits have to be weighed against significant extra vulnerability to evasion, even if one fights back with higher-cost administrative efforts.
 - Significant differentiation among rates of import tariffs can lead to huge economic inefficiencies by giving vastly different degrees of effective protection to different activities.
 - Personal income tax rates above 50 percent are very hard to justify in the light of their efficiency and incentive costs.
 - Labor is likely to bear the burden of any unilateral rise in the rate of tax on the income of corporations (or businesses in general) once an open economy setting is posited (this means that moves toward integration of the corporate and personal income taxes are likely to benefit labor).
 - It is much easier to index a tax system than people think. By its nature, full indexation promotes both equity and efficiency; far from "inviting" more inflation, indexing—by reducing or eliminating the so-called *Tanzi effect*, by which inflation erodes real tax revenues and thus brings about even larger real deficits—actually helps to keep incipient inflations from exploding.
- But when all is said and done, and even with what one might call quite heroic efforts to create an equitable tax system, one does not greatly modify the shape of the income distribution as one moves from before-tax

to after-tax concepts. This is the point of table 7.2 and is a key pillar supporting the main line of thinking in this chapter.

Once one comes down to earth in a discussion of these topics, there are a great many things that governments can do to make their societies more just and equitable. Great challenges exist all through the developing world, to overcome the handicaps against which the poor must struggle. The great priorities for our time are these:

- Bringing to the poor the benefits of simple preventive public health programs, such as potable water, sewerage, insect control, and basic immunizations.
- Bringing the level of outlays per child on education for the poorest segments of the population much closer to the standard for the rest of society.
- In most countries, raising the level of educational effort in general and paying lots of attention to its quality as well as its quantity.
- Bringing at least elementary medical care to within close reach in poor towns and neighborhoods and providing ready access to more sophisticated medical treatment for the cases that warrant it.
- Dealing with problems of inadequate housing by offering programs with a substantial self-help component, thus providing modest housing to a broad client population—in contrast to many past programs that gave highly subsidized housing to a lucky few.
- Seeking ways to reinforce the mechanisms of an escape from poverty that have worked in the past. In each country this would start with efforts to ascertain what those mechanisms have been.
- Seeking ways to promote the opening of the upper strata of society to freer entry from below. Few modern visions of the good society will stand up if the doors to upward socioeconomic mobility are closed (or open only a crack).

This agenda is important, because it entails vast efforts, huge challenges, and overcoming enormous obstacles. Yet its budgetary costs are not so great that they could not readily be financed in many countries by diverting money from lower-priority uses. Where this is not likely to be the source of enough funds to do the job, it will probably be in countries like Guatemala and El Salvador, where taxes now take up less than 10 percent of GDP. In these cases, the tax take could be significantly raised without impinging seriously on economic growth or other objectives.

This is the basis on which I assert that if we stick with what is realistic and plausible, and if we attack sensibly and intelligently the problems of achieving greater equity while promoting economic growth, we will find no serious conflict between these objectives.

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Comments

Christian Morrisson

Economies, Fluctuations, Growth, and Equity

I agree with Harberger's analysis of the negative impact of inflation on growth and add a comment: Inflation also has a negative impact on income distribution or, more precisely, wealth distribution. The majority of urban poor have only cash assets; rich households possess mainly real assets and often invest part of their liquidity in foreign currency or abroad. As a result, poor households are proportionally much more affected by the erosion of the value of currencies through inflation. In this respect, a restrictive monetary policy reduces tax inflation and has a positive impact on wealth distribution. This process was demonstrated by the studies made by the OECD Development Centre's Adjustment and Equity project, which was completed in 1992.

On the other hand, even if "equity considerations do not conflict with the growth objective," we must qualify the assertion. Everybody knows examples of equitable growth, such as Taiwan in the 1960s and the 1970s. But contrary examples exist too. In some countries, growth performance coincided with high inequality or increasing inequality in the past (e.g., France or the United Kingdom from 1800 to 1870) and more recently (Brazil in the 1960s and the 1970s; Chile in the 1970s and the 1980s). So to ask if fiscal policy can have an impact on equity is a pertinent question. For example, enrollment rates in primary and secondary schools and education expenditures (as a percentage of GDP) were lower in Brazil and Thailand than in Taiwan (comparing these countries not for the same year but for the same per capita GDP).

Concerning the boom-and-bust syndrome, the nontradable sector benefits during a boom period from an improvement of the terms of trade between the tradable and nontradable sectors. The evolution of the internal terms of trade may increase inequality to the extent that average income

in the nontradable sector is usually higher than income in the tradable sector. For example, in six of the seven countries in this sample (Cameroon, Hong Kong, Iran, Madagascar, Malaysia, Mexico, and Zambia), the average income is higher in the nontradable sector than in the tradable sector. We can also assume that part of the bonus that was not invested, as Harberger showed, was spent on public sector salaries or lavish public expenditure, benefiting the top quintile.

I agree with the picture of populism but propose to differentiate two stages in the process. During the first stage, politicians give subsidies (for bread or buses) and the wage increases they have promised. We can then observe a popular decrease in inequality between households. In the second stage, however, all the negative consequences of the populist strategy emerge. Finally, real incomes and real wages fall to a lower level than at the beginning, which explains the ensuing unpopularity of this policy package. Depending on whether priority is given to subsidies for poor households or to advantages for large bureaucracies, levels of inequality may rise or fall during this second stage.

An additional argument in favor of lower taxation of imports is that the trade protection worsens income distribution in developing countries. According to regression on a sample of twenty countries (Bourguignon and Morrisson 1989), the income share of the bottom 40 percent of the population is on average three points lower in a highly protected economy, while the top 20 percent gains by the same amount. Because our objective is equitable economic growth, this income effect is an important advantage of trade liberalization, which must be taken into account.

Taxes, Public Expenditure, and Equitable Growth

Harberger's analysis of taxation is careful but nonetheless arouses comment. The conclusions on the relative impact of public expenditure and taxation are correct. My analysis of a sample of forty-three developing countries some time ago leads to the same conclusions. But two points require clarification. First, since government cannot tax income from capital (and as income tax in developing countries concerns only the top decile), value-added tax must be progressive. Two rates are needed: very low or zero for necessities and a standard rate for other items. Naturally, two rates involve additional costs, but these must be balanced against the disadvantage of regressive taxation, as the consumption-income ratio decreases with income. Second, a figure higher than twelve for taxes supported by the top quintile (table 7.2) is consistent with reality. For exam-

ple, with a value-added tax of 20 percent on consumption equal to 50 and a 10 percent income tax, we can reach sixteen instead of only twelve.

Perhaps we could be less pessimistic concerning the targeting of public expenditures. One example will suffice as a demonstration. In Tunisia, the enrollment rate in primary schools is nearly 90 percent in both urban and rural zones, and grants to university students are given only to poor households; consultations for poor people in medical stations or public hospitals are free, whereas private physicians and clinics are for people who are less poor. Such a policy ensures benefits to the lowest quintiles equal to or higher than benefits to the top one.

Finally, two expenditure items seem decisive to obtain growth with equity. The first is expenditure on primary and secondary education. Enrollment rates in these schools always have a significant and positive coefficient for the income share of the poorest 40 or 60 percent. The second expenditure item is public expenditures in rural zones (mainly on infrastructure, technical assistance, and credits), to increase the labor productivity of agriculture. In regressions explaining the income share of the poorest 40 or 60 percent, the ratio of labor productivity in agriculture to labor productivity in the rest of the economy has a positive and significant coefficient.

Promoting Socioeconomic Mobility

The considerations Harberger expressed on socioeconomic mobility are very important. Nearly all controversies on inequality concern income distribution in one year, whereas there are very few studies on socioeconomic mobility in developing countries. I agree that this mobility can solve poverty problems in some respects. For this reason, it is necessary to scrutinize fiscal policy carefully in order to distinguish measures that promote mobility. Of course, primary and secondary education are an efficient factor of mobility, but there are other expenditures, like technical assistance and credits to craftsmen or infrastructure and assistance in rural zones. This means that if a government's fiscal policy is directed toward equity, it must be designed not in a yearly range but in a long-run perspective. Also, we must aim at equity (equal opportunities for everyone) more than equality.

Implications of Openness

Finally, I think that Harberger's conclusions on the world market affecting internal income distribution are correct. As the factor price equalization

benefits factory workers, developing countries might be able to combine growth with decreasing inequality. Advanced countries, however, are likely to face more and more difficulties as the same process results in increasing inequality. In the future, this increase in inequality could be a real threat for the political and social stability in those countries.

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Comments

Lawrence Summers

Arnold Harberger's chapter is filled with insight and wisdom. The most important insight concerns maintaining an appropriate degree of humility regarding what governments and international organizations can and cannot accomplish with respect to the natural forces that shape economic life. Now that the cold war is over, it is worth noting just how many lives have been lost in efforts that had as their fundamental raison d'être the idea that governments can shape or ignore the power of natural economic forces. Such efforts have cost tens, if not hundreds, of millions of lives in this century. As people in international organizations mention "our countries" and as academic advisers use the term "we" to describe policies that are undertaken in places where they have spent only a week or two, it is well worth maintaining that sort of humility as we go forward.

Conceptions of Equity and the Equity Implications of Rent Seeking, Trade, and Targeting

My first observation is about conceptions of equity, a complicated notion to which traditional economists' conceptions do not always do full justice. Economists tend to view equity in terms of ultimate outcome. That sometimes contrasts with most other people's perceptions of equity, which have much more to do with notions of just and unjust acquisition. For example, most people feel very differently about billionaires who have built businesses by selling products successfully than they do about corporate raiders who buy privatized companies, only to flip them for enormous gains two years later. Similarly, a 1995 *New York Times* article that refers to Mexico's privatization efforts as a Mexican "garage sale" reminds us how important it is to keep most people's conception of equity considerations in mind as we design economic development programs. I am unsure how, as economists, we can address these issues more

satisfactorily. Nonetheless, it is essential for such equity concerns to become a more central part of our thinking.

I also argue that this goal supports the worldview Harberger urged, one favoring less extensive government involvement in distributional issues. That is the case because it is fair to presume that explicit distributional choices made by government can often be perceived as unfair.

My second observation involves the question of rent seeking, latent in Harberger's chapter and stressed in all of Anne Krueger's work, as well as in chapter 9, by Alberto Alesina. In the classic model, one had the triangle and the rectangle, and the rectangle was dissipated seeking itself. If that were really true, rent seeking would have no inequitable consequences. The result would be simply resource dissipation.

The real world is more complicated. Large parts of rents are not in fact dissipated. They are transferred, and then they become the source of substantial inequity. We must therefore constantly consider this process of rent creation and the inequities that it engenders.

We must also bear in mind the difficulty of implementing reforms once rents have been created. My favorite example involves the proposals in the United States to repeal tax deductions for the three-martini lunch. The people who consume the three-martini lunch are not the chief lobbyists against such provisions; rather, the chief lobbyists are the restaurateurs who provide these lunches. In a sense, they have a point. Restaurants are not an especially profitable industry. Once the rent is introduced, it is then necessarily inequitable to remove that rent. That is why we must be extremely cautious about creating such entitlements.

My third observation involves trade, and the link between trade and wages. I used to marvel over the willingness of policymakers with no knowledge of the relevant analytical models to speak about complicated subjects. I am about to do so, so my remarks on this subject are prejudices rather than analysis. I believe that Harberger is right when he asserts that the important point about the changing trade relations between developing and industrialized countries is neither that there has been a reduction in trade barriers, nor that there is all that much physical capital going from the industrialized countries to the developing countries. The significant change, rather, is that the production function in developing countries is evolving and catching up with the production function in developed countries.

On the other hand, I suspect that Harberger is wrong in asserting that this is a major factor shaping income distributions in industrialized countries, despite the a priori appeal of that argument. I disagree because I

think that such a change in the developing world is just too small a tail to wag too big a dog. If one looks at the fraction of imports into the United States that come from developing countries, it is not that large—on the order of 3 percent of GDP, depending on how one measures it. True, a certain amount of economic activity competes very directly with that. Nonetheless, the proportion is small. Moreover, the fraction of U.S. imports that come from countries in which wages are less than 50 percent of U.S. wages has increased remarkably little over the past twenty-five years. In 1970, Japan was such a country. For all of these reasons, I find it difficult to see how so small a move could account for the kinds of seismic changes in income distribution that we have seen.

One of Harberger's points may have verged on error. In his discussion of what has happened to factory workers as distinct from the rest of the population, he may have ignored the point he made with respect to the corporate income tax: that wages in one sector must equalize with wages in another, because people are not born as factory workers. If there are some natural processes of wage equalization, then the tremendous improvements in service sector productivity should benefit workers in all sectors.

Harberger's idea regarding factory workers is very tricky. It is exceedingly politically incorrect for economists to think what he is asserting because the next question is, If trade really is shaping the income distribution the way Harberger suggests, then why not have protection?

I suspect that more intellectual energy goes into debunking these arguments than may be warranted. There is almost certainly an effect that works in the direction that Harberger talks about. However, I suspect it is not nearly as important as the changing technology of production, which is difficult to measure, and the fact that we have an increasingly competitive, efficient world that probably means that a whole set of mechanisms now exist to drive wages equal to widely dispersed marginal productivities. I think, for example, about the fact that the wages of academic economists are now much more dispersed than they were a generation ago. That is almost certainly due to the fact that academic economists are more willing to move and that more entrepreneurial universities are more prepared to pay for the professors they want. I suspect that kind of mechanism is more pervasive as an explanation for widening inequality than the change in international trade.

My fourth observation concerns targeting. Any discussion of targeting must take into account the need to maintain political support. I have heard it said that programs for poor people are poor programs. I am all for

targeting, but I am humbled by the knowledge that one of the United States's most successful social achievements has been the elimination of poverty among the aged. That task has been accomplished through our principal nontargeted program. One must therefore question how successfully programs that are too well targeted can be maintained and whether there is not some case to be made for adopting principles of universality. That may be the most politically viable way to benefit the poor. Perhaps Harberger's emphasis on universal primary education and setting a goal of getting the bottom fifth—a fifth of the resources—is actually consistent with that notion.

Possible Fragility of a Consensus View

In reading this book, I am struck by the degree of consensus: We all seem to agree on what the right model is for going forward. I hope that we are right, and believe that we are, but there have been similar consensuses in the past, all based on careful evaluation of evidence. And yet just at the moment when everybody thought the consensus model correct, events typically proved the consensus view wrong. So I do have some nagging doubts. Recall that there was a time when there was an equal degree of agreement on the wisdom of import substitution strategies or the importance of national industrial development banks. It is worth remembering these former consensus views as we proceed confidently forth. Nonetheless, I cannot think of anything else that I have read that offers as much insight, and as much wisdom for further progress, as Harberger's chapter.

8

External Sector and Income Distribution

Jagdish Bhagwati

The question of income distribution has never been distant from the concerns of economists preoccupied by the problems of development from the earliest postwar years. Indeed, there is nothing to the fashionable assertion that poverty and income distribution are novel concerns.

I had personal experience of this ignorance and the moral arrogance based thereon when I was the keynote speaker at the twenty-fifth anniversary of the Institute for Development Economics in Antwerp. When I had finished, a Dutch Social Democrat economist-cum-politician sarcastically remarked from the floor that it was "good to see Professor Bhagwati, long the champion of growth, finally talking about poverty." I could not help shooting back, "As it happens, I was looking at my 1966 paperback, *The Economics of Underdeveloped Countries* (London: Weidenfeld and Nicolson) last week, in view of my speech today, thinking back on how Professor John Chipman had written to me that an economist colleague of his at Minnesota had remarked with astonishment to him that I had just published a book with the photograph of a starving child in it. Having heard the complaints of people like you, I feared nonetheless that my chapter I would be entitled 'Growth.' Imagine my surprise when I found the title to be: 'Poverty and Income Distribution!'"

I retell this story not merely to show the lack of connectedness to facts that some economists on the left exhibit in this policy area, but also because of the sweeping charge made that anyone who talks about efficiency and growth must somehow be soulless in his or her disregard for poverty.¹ In fact, our thinking in the policy circles in India during the early 1960s was precisely focused on the amelioration of poverty and built after much reflection on the view that (given the enormity of the problem and the inability of redistribution to solve it, even on a one-shot basis) growth, by providing gainful employment to the rural poor, was the only way to make a sustained long-run attack on poverty. Indeed, we felt that