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PUBLIC P-ANCE FOR MARKET-ORIENTED DEVELOPING COUNTRIES

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Abstract

This paper discusses the role of fiscal policy in market-oriented, or liberalizing, developing countries in a broad perspective of the developing process. It is argued that in countries that choose a rather market-oriented development strategy, the "classical" role of public finance comes into the forefront, i.e., (i) to provide infrastructure and public goods, (ii) to help relative prices reflect opportunity costs, which is often more a question of avoiding and removing distortions previously introduced by the government itself than of fighting "spontaneous" market distortions, (iii) to contribute to the redistribution of income and wealth by methods that are as market conforming as possible, and (iv) to contribute to the development of market-oriented institutions that respond satisfactorily to market signals, for instance, in the field of finance, trade, labor markets, consulting, and the transfer of technology. The paper also emphasizes the crucial role of (v) macroeconomic stabilization policy, as failures in that field have often been extremely damaging to attempts to liberalize the economies of developing countries.

On the expenditure side of the government budget the paper emphasizes the importance of stimulating the build-up of human capital, including managerial skill and entrepreneurship, while on the revenue side the paper argues against highly differentiated tax structures, for instance based on some asserted "optimum" tax formulas. Instead, a case is made for the traditional view of basically uniform tariffs and commodity taxes as the basic norm, and of "comprehensiveness" in income taxation, with an ambition to rely on large tax bases combined with low tax rates.
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I. From planning paradigm to market paradigm: consequences for public finance

Opinions on the appropriate role of government policy, including budget policy, in developing countries have to be based on some vision of what the basic mechanisms of the development process are. The specification of such a vision is crucial also for the choice of analytical techniques when studying developing countries. This is why the present paper puts budget policy, or public finance, into a broad perspective of the development process. This also makes it natural to see budget policy as a complement and/or substitute for other types of policy.

The dominant vision of the development process during the nineteen-forties, fifties, and early sixties was that the market failures in less developed countries were so huge that the market mechanism could not be much relied on in such countries. This view was certainly characteristic of economists like Gunnar Myrdal, Ragnar Nurkse, Raúl Prebisch, Paul Rosenstein-Rodan, and Hans Singer—even though their emphases on specific aspects of asserted market failures differed strongly.

Various forms of "structuralism" were also popular. Developing countries were asserted to be characterized by pronounced "structural inflexibility" in the allocation of resources; in other words, low (or even zero) elasticities and long time-lags with respect to the economic
incentives of the supply and demand for goods, services, and factors of production, and, indeed, of productive effort and entrepreneurship in general were thought to exist. Based on such structuralist views of the economies of developing countries was also the idea of binding saving or balance-of-payments constraints on economic growth, due to asserted weaknesses in the response of saving and investment to changes in income and interest rates, as well as of exports, imports, and long-term capital movements to changes in exchange rates, the terms of trade, and the rates of return on assets. A special variant was the "two gap" theory of savings and balance-of-payments constraints, asserting strict limits of the national government to raise taxes, or difficulties in turning domestic saving into capital formation via the exchange of traditional export products for capital goods on international markets, due to inelastic world demand for the former (Chenery, 1965, 1979).

From views like these—which were far from uniform—followed both a strong distrust of the price mechanism, and as a mirror image, considerable enthusiasm for government regulation (such as licensing systems), and often also economy-wide central planning of inputs, outputs, exports, imports, and investment activity. Moreover, as the manufacturing sector, in contrast to agriculture, was often asserted to be characterized by constant or even increasing returns to scale, a high propensity to save and rapid technological progress, government-enforced industrialization, at the expense of agriculture and handicraft production, was usually strongly advocated. Without drastic government actions in these fields, developing countries were asserted
to be doomed to "underdevelopment equilibrium traps" or "vicious circles of poverty". Also popular was the notion that the entire manufacturing sector could be treated as an "infant industry," though this notion is difficult to distinguish from general political and ideological preferences for industrialization as the essence of economic and social "modernization."

The recommended, and indeed often also the actual, role of public finance during the first decades after World War II should be seen in this perspective: (i) as helping provide an industrial base by way of heavy public investment in both physical infrastructure and manufacturing, often in the form of large-scale government projects; (ii) as squeezing private consumption by increasing the aggregate saving ratio by way of taxes, in particular on traditional exports and on the large agricultural population (though in reality agriculture was perhaps squeezed more by overvalued exchange rates and regulated output prices than by explicit land or agriculture taxes); and (iii) as directing the allocation of economic resources in general by means of government enterprises, subsidies, government credits, taxes, and tariffs (import substitution policy)--as a complement to "command", which was to be implemented by physical regulations of various types. These ambitions made the government budget a main tool of aggregate and disaggregate "national economic planning" for the mobilization and allocation of resources (a point emphasized by, for instance, A. Waterston (1965)). While attempts to direct the economy by way of taxes, tariffs, and subsidies must have been based on the idea that private agents do react to economic incentives--though unguided markets were asserted to give the "wrong" incentives--the recommendations for
reliance on public enterprises and on command of private firms by way of physical regulations, were more consistent with a structuralist view of the world (in other words, weak responses of private agents to economic incentives).

It may be argued that the policy recommendation to raise the aggregate saving and investment ratio was the most valuable feature of the predominant development paradigm during the first few decades after the Second World War, and that the drastic increase in the saving and investment ratios to some 20-25 percent of GNP in most developing countries was the most important achievement of actual development policies. Developing countries have usually been much less successful in increasing economic efficiency, and hence in speeding up the rate of productivity growth. For instance, while output in manufacturing in developing market economies increased by 5.1 percent per year during 1960-83, the accompanying increase in labor input was as high as 3.5 percent, which implies that the increase in labor productivity was only about 1.6 percent (Calculations of time trends based on data in UN, Industrial Statistics Yearbook, 1983).

By itself, a strong increase in labor input is, of course, favorable from the point of view of mitigating unemployment, or "underemployment", but output growth, and hence labor productivity growth, has certainly been much weaker than would have been possible in reasonably efficiently functioning economic systems. Indeed, labor productivity should be able to grow by several percentage points per year even if very labor-intensive methods of production are used, "simply" by the introduction of better technologies and organization, as illustrated by the experience of developed countries, and indeed
also of some developing countries. Many developing countries have simply been getting too small an increase in labor productivity from their investment. We also notice extremely high marginal capital-output ratios in many developing countries, such as in Africa and Latin America.²

It has in fact become obvious that vastly different rates of growth of GNP, and perhaps in particular of consumption, can be achieved with about the same rates of capital accumulation depending inter alia on the allocative efficiency of investment and production. For instance, reference is often made to the success of a number of countries in Pacific Asia (Taiwan, South Korea, Singapore, Hong Kong, etc.), which have relied to a considerable extent on economic incentives and an outward-looking development strategy—though active and competent governments in these countries have certainly also stimulated growth and economic efficiency by way of institutional reforms, redistributions of assets and infrastructure investment. To some extent, these countries have also been engaged in growth forecasting ("indicative planning") and, in varying degrees, also state-owned firms, but it is difficult to have a firm opinion about the role of these features, which they share with many other, less successful nations. What has clearly differentiated these countries from many others is that governments have tried to support rather than restrict the activities and initiatives of the private sector.

It is for these various reasons natural that the emphasis in analytical discussions about economic policy in developing countries has gradually shifted to issues relating to the allocation, and not
just the total volume, of investment, and indeed to the allocative
efficiency in general of production activities. This is probably an
important explanation for the increased respect for decentralized
decision-making by way of markets, price signals, and economic
incentives, and, as a mirror image, an increased scepticism about the
usefulness of direct government regulation and central planning.

More generally, it has become increasingly understood during the
last one or two decades that, contrary to previous assertions, both the
aggregate and the "fine" (disaggregate) micro structure of the
economies of developing countries, respond quite strongly to economic
reward, including profitability prospects and relative prices and
wages—if governments allow such a response. This is perhaps what we
should expect, as poor people have no less reason to respond to the
opportunities for improving their economic situation than do more
affluent people, perhaps rather the reverse.

Moreover, after having brought about large infrastructure
investments, and in some cases a considerable mobilization of
resources, it is natural that problems of economic efficiency, and
hence resource allocation, become more interesting. It has also become
more clear over time that the potentialities of import substitution in
manufacturing were rapidly exhausted in most countries due to the
smallness of domestic markets. It would also seem that the
attractiveness of the Soviet planning model subsided when it became
more widely understood that this was more of a "mobilization model"
than a prescription for economic efficiency—indeed that the model
stimulated inefficiency.
When relying on markets, it is, of course, important for governments to help ensure that the market signals are "right", in the sense that prices reflect opportunity costs and preferences. However, it is also crucial that the price signals "work", in the sense that various institutional "filters" in society do not distort, or even "abort", the information and incentive content of market signals. Thus, there is a potentially important role for the government both as regards improvement of the information and incentive structure and helping strengthen (and perhaps, at an early stage of economic development, even helping create) market-oriented institutions.

In broad terms, the main contribution of public finance to the economic development of market-oriented developing countries would then probably be (i) to provide infrastructure and public goods; (ii) to help relative prices reflect opportunity costs and preferences, which is often more a question of avoiding and removing distortions previously introduced by the government itself than of fighting "spontaneous" market distortions; (iii) to contribute to the redistribution of income and wealth (according to certain values concerning equity) by methods that are as market conforming as possible; and (iv) to contribute to the development of market-oriented institutions that respond satisfactorily to market signals, for instance, in the fields of finance, trade, labor markets, consulting, and the transfer of technology. However, it is also important to emphasize the crucial role of (v) macroeconomic stabilization policy, as failures in that field have often been extremely damaging to attempts to liberalize the economies of developing countries.
If governments start to rely more on markets for the supply of ordinary goods, the public sector can increasingly concentrate on just those activities, mentioned above, which only the government can pursue, or where the government at least has a comparative advantage relative to private agents. The administrative resources that are then released in the public sector can instead be used to improve the quality of the public sector's remaining functions, to the extent that such resources are not simply transferred to the private sector. This is an important consequence of a shift of a developing country to a more market-oriented system, as the majority of these countries are characterized by a shortage of competent civil servants. Administrative "overload", which has recently been much discussed in developed countries, is an even more characteristic feature of most developing countries--a problem which could be mitigated by a shift to a more market-oriented system. Indeed, managers of firms would then also be able to devote more time to "ordinary" business, rather than bargaining with government officials ("rent seeking," Krueger 1974), while today the latter often yields higher returns than do attempts to improve efficiency within firms. A removal of regulations could change that.

More generally, in market-oriented economies, the role of government planning and public finance is largely to "plan" the physical and psychological environment of private agents rather than to plan what those agents are supposed to do.
II. Method of analysis

On the basis of the dominating view in the early post-World War II period that private agents in developing countries react (if at all!) completely differently to economic incentives than do agents in developed countries, and that markets in developing countries cannot function properly in the foreseeable future, there followed a profound skepticism towards traditional methods of economic analysis. Developing countries were often asserted to be "different kinds" of economies requiring both new tools of analysis and different behavior assumptions; indeed "development economics" was often asserted to represent a new and separate branch of economic analysis. By contrast, this paper is based on the assumption that there are great enough similarities between behavior patterns and economic mechanisms in general in developed and developing countries, as to make standard economic analysis relevant for the latter type of country as well.

It is indeed quite easy to illustrate the relevance of standard economic analysis for developing countries. For instance, in a similar way as in developed countries, "overvalued" currencies, by keeping down profitability, tend to reduce output and employment growth in the tradable sectors, which often also results in (increased) budget deficits due to the negative consequences for the tax base. Moreover, it is well established by now, not only for developed but also for developing countries, that high real wage rates, in particular when combined with low real interest rates, tend to favor capital-intensive methods of production. Regulated wage rates tend to accentuate unemployment for certain types of labor (for instance where minimum
wage rates are binding), while for other types of labor more or less permanent vacancies tend to prevail. Pegged interest rates create credit shortages, with "arbitrary" credit rationing and an inefficient allocation of credit and capital as a result. High tariffs and large subsidies to specific sectors tend to expand these sectors at the expense of others, in particular sectors for which government regulations have kept down prices, such as in agriculture. Rent control hits housebuilding, creates housing shortages, and results in a deterioration of the housing stock as well as a reduction in labor mobility.

We also note that, as in developed countries, regulations breed new regulations, as politicians and public administrators try to fight the unintended, and for them, often unexpected, side-effects of previous regulations. And, probably even more than in developed countries, regulation is "the mother of corruption" as corruption presupposes that politicians and administrators have "something to sell"--such as licenses, tax concessions, tariffs, or subsidies. Indeed, there is most likely also a "reverse causation": corrupt politicians and public administrators have a strong self-interest in promoting regulations.

Moreover, the possibilities of substitution between labor and capital, and indeed between inputs in general, have come to be regarded as much more promising than they were earlier thought to be--a development which in economic theory is symbolized by the replacement of the rigid Harrod-Domar growth equation with more flexible aggregate growth models à la Solow and (in more detailed and quantified form) Denison. Such possibilities to substitute labor for capital in
developing countries have proved to be particularly promising in multiple-shift operations and in ancillary services, such as maintenance, and handling of material and other transport services, like packing, etc. (Morawetz (1976); White (1978)).

My conclusion is that it is quite appropriate to regard "development economics" as an application of the standard tools of economic analysis (whether at micro- or macroeconomic levels) to long-term growth and development issues for all types of countries, in the same way as trade theory is the application of micro- and general equilibrium theories to issues of international trade, regardless of what types of countries are studied. In particular, the traditional microeconomic theories regarding prices, markets, and incentives are probably no less useful for the analysis of developing countries than for that of developed countries. This also means that the entire arsenal of tools and insights from applied fields of economic analysis like industrial organization, money and banking, labor economics, and, as illustrated by this paper, public finance, can be put into operation in the analyses of developing countries and not just developed ones.

Of course, it is important to take into account various institutional peculiarities in the analyses, though not by treating institutions as insurmountable obstacles to development, which was typical for early post-war development theories, but rather as the "filters" through which incentives, as well as commands, necessarily have to pass. However, that cannot be done by assuming some kind of "standard" developing country institutional set-up. Due to the wide variations in institutional conditions among developing countries—heuristically speaking, with stronger variations than among developed
countries—the institutional conditions have to be specified for each country separately.

The main contribution of the earlier evolution of economic analysis for less developed countries as a specific field of economics, is then mainly that it has increased awareness of the importance, when pursuing economic analysis (indeed of both developed and developing countries) of watching out for various institutional peculiarities, and the changes in these over time.

However, when discovering "institutional peculiarities", which sometimes make markets look unfamiliar, it is important to realize that what in the light of traditional models may (superficially) appear as a "market distortion", may in fact be a simple reflection of costs that are not apparent when examining only conventionally defined production costs. It is, for instance, well known that price differences between apparently similar goods, services, or factors may reflect differences in risk, information costs, or "interlocking" markets (Stiglitz 1985).

Concern for the interaction between incentives and institutional conditions is important also in the field of politics and public administration, and not just in markets. Indeed, if it is agreed that differences in government policies are responsible for much of the variations in economic performance among nations, it must be a research topic of the uppermost priority to try to establish which institutional circumstances are conducive to various types of policies. More specifically, policy recommendations that do not rely on a realistic assessment of the functioning of the political system, and the administrative capabilities of the countries concerned, often do more harm than good. In particular, policy advice that is based on the
assumptions that governments and public administrators behave like well-informed, competent, and highly "benevolent guardians of the public good", maximizing some asserted Social Welfare Function, are bound to lead to disappointing results. Indeed, it may be argued that a policy advisor should base his advice on a hypothesis about the effects of his advice on the actual policies (Lindbeck 1973).

Against this background it is important to include in the analysis not only traditional concepts of static efficiency and Pareto optimality, but also broader ideas about the functioning of the economic and political system, such as J.M. Clark's vision of competition as a dynamic process ("workable competition"); Joseph Schumpeter's idea of competition as "creative destruction" (when new kinds of competition, technologies and products threaten existing ones); Friedrich von Hayek's view of competition as decentralized search for ways of using existing knowledge more efficiently; Harvey Leibenstein's vision of X-efficiency, reflecting other types of economic efficiency than traditional allocative efficiency; and Herbert Simon's theory of "satisfying behavior", "bounded rationality", and endogenous changes in the aspiration levels of agents.

For instance, rather than taking the production function as given, it is important to analyze the process by which the production function is chosen or developed, not only via research and investment in physical and human capital, but also through organizational modification, innovation, and entrepreneurship. And when analyzing economic policy, it is necessary to regard political and administrative decision-making as an endogenous process with its own patterns of behavior, as suggested by the Public Choice School (Buchanan and
Tullock, 1962) and others. The latter point also emphasizes the importance of studying constitutional rules and political culture, including not only the distinction between democracies and authoritarian regimes, but also the rules of election, the degree of political centralization, the character of party-competition, and the use of referenda. (Lindbeck, 1985). Moreover, Amartya Sen (1981) has argued that the existence of a free press, and an active political opposition, has helped prevent crop failures from resulting in starvation for various population groups.

In other words, analyses of the development process, and appropriate government policies, including budget policies, have to include much broader, though often less rigorous, aspects than those on which formalized general equilibrium theory and optimization analysis are built. Institutional conditions and institutional change, the political and administrative processes, and the environment for human creativity and entrepreneurship are factors that seem to have played too small roles in economic analysis of both developed and developing countries.

This methodological point also implies that it is important that the genuine complexity and diversity of the development process is taken into consideration, and that evaluations of the performance of both markets and governments are made against much less ambitious benchmarks than perfect competition, perfect information, Pareto efficiency, and the maximization of social welfare functions. That we shall do below.
III. Government expenditures

If a country starts to rely more heavily on markets, economic incentives and decentralized private initiatives, the "classical" roles of government spending for the allocation of resources come into the forefront: (i) infrastructure investment in physical and human capital, including the supply of goods that are produced with particularly high fixed costs relative to the variable costs, like harbors, bridges, and some other transportation systems; and (ii) the supply of public (collective) goods--including the legal system, education, basic research, and environment protection. Moreover, as poor people in developing countries cannot be much helped by tax reductions, government expenditure policies become crucial also in (iii) redistributional policies.

Infrastructure expenditures hardly need advertisement today. However, as the low productivity level in developing countries depends to a considerable extent on the lack of human capital, it may nevertheless be worth advertising infrastructure investment in the form of the accumulation of human resources in a wide sense of the term--including not only education, but also health, sanitation, and in many countries food supply to particularly poor sections of the population. As it has been increasingly recognized that the social rates of return in most developing countries are higher for primary education and vocational training than for most forms of higher theoretical education (Psachropoulous (1981)), a change in the composition of public spending on education in favor of the former seems to make sense for many developing countries. It is also important that public policies in the field of education and training recognize the need to
build up competence that is relevant at the microeconomic level in society (for example, and in particular, within individual firms). This would probably be greatly facilitated if firms, rather than government institutions, were in charge of a considerable part of the vocational training programs, so that the activities become practically applicable and strongly market-oriented—the latter being particularly important in economies which follow a market-oriented strategy of economic development. However, as firms have suboptimal incentives to provide general training, due to the mobility of labor between firms, it is natural to recommend combinations of general schooling provided by public institutions and specific training within firms, though the latter too could, at least partly, be tax-financed. The apprenticeship system in West Germany may be a model worth following—modified to fit the specific conditions in the countries concerned.

It is also conceivable that the import, and domestic dispersion, of technology could be stimulated by government initiatives, even if the actual import is certainly best done by individual firms. For instance, government initiatives to help establish private import and service firms in the field of technology may be worth pursuing for a while in the least developed countries.

In many fields of technology it would certainly be useful if research could take place in the countries of the Third World themselves—though in many cases in cooperation with institutions and individuals in developed countries. The rationale is to increase the probability that the research will be relevant for the developing countries. Such activities, too, could perhaps, at least for a while, be stimulated by government initiatives. Obvious examples of such
fields are parts of agriculture and health, such as tropical agriculture, soil analysis, integrated development in arid areas, aquaculture, tropical medicine, etc. As the results of research and development in these fields are characteristically public goods due to the smallness of the firms, and the externalities in the ecological systems, government spending programs have a particularly important role to play here. For instance, the experiences of agricultural extension services, financed by the government, often seem to have been rather good. Indeed, the atomistic structure of the agricultural sector makes it important that governments take initiatives to help establish such services in precisely this sector.

Beside basic general skills and technological competence, one of the most important bottlenecks in the area of human resources in developing countries is managerial skills—in the private as well as in the public sector. The role of managerial skill is not only an issue concerning the competence of managers at the top of the organizations. Particular attention must probably be focused on middle-level management, supervisory staff, and people providing specialist services at the middle level—for example, procurement and inventory management, production management, control research, and marketing; tool room service; raw material and product testing; machine assembly and equipment maintenance; staff recruitment; advertising, project development, etc. Government initiatives to stimulate training in such fields is clearly a promising type of government investment in developing countries.

While the various types of training mentioned above are relevant for all types of developing countries, the build-up of entrepreneurial
capabilities is particularly important in liberalizing developing countries. Experience from many countries over long historical periods illustrates the enormous role of entrepreneurship in the development process, not least in small and medium-sized firms and newly started firms. Because of the difficulties involved in formalizing and quantifying the role and importance of entrepreneurship, it easily "disappears" not only in economic theory, but also in domestic development plans and in the political and administrative discussion, which has often concentrated on existing firms and large firms. However, all developing countries that opt for industrialization and modernization along market-oriented lines are strongly urged to facilitate the emergence of vital entrepreneurship not only by way of formal education in business, but also, and in particular, by allowing and stimulating entrepreneurial initiative. Indeed, in addition to land, capital, and labor, it is reasonable to regard entrepreneurship as a fourth factor of production of crucial importance for economic development—a factor which the government may promote by stimulating the build-up of facilities for the training of entrepreneurs, as well as by deregulation, which tends to release entrepreneurial skills.

So much for the "creation" part of Schumpeter's vision of "creative destruction." It is, of course, also important that politicians allow the "destructive" part of the process to operate—by avoiding subsidizing contracting or even "dying" sectors, firms, and production processes, even though the "demand" for such protection is certainly one of the most powerful forces in the political process in most countries. An important "constitutional" issue is then what types of political decision-making rules are conducive to preventing more
subsidization than the electorate, and a majority of politicians, on reflection would like.

The stimulation of entrepreneurship is also an issue of the political and social attitudes in society towards entrepreneurial activities. Indeed, the attitudes in society towards entrepreneurship may be regarded as an important collective good in a private enterprise economy.

In the context of government expenditure policies, it is often also important to look over the rules, incentives, and practices of the management of public owned firms and agencies, which play an important role in many developing countries. Indeed, if governments of developing countries are serious about the shift to a more market-oriented system, it is important that this shift incorporates state-owned enterprises too, in the sense that these are either handed over to the private sector, or given the same incentives and freedom of action as those—and that they also feel the same necessity as private firms, by way of competitive pressure, to react to market signals. The withdrawal of "automatic" government financing of losses of government-owned firms is crucial from that point of view.

This paper is not designed to deal with issues related to specific production sectors. However, it is nowadays well understood that the modernization and industrialization process is easily damaged, or may even fail completely, if agriculture is neglected, which may also have serious consequences for the distribution of income. "Negative" illustrations of this thesis are provided by several South American and especially African countries, while positive examples are found in
several countries in Pacific Asia—countries that have also been strikingly successful in manufacturing.

Widespread experiences suggest, for instance, that government Marketing Boards in agriculture tend to destroy incentives. Such Boards usually do not have either the competence or the incentives to create a level and structure of producers' prices that is even remotely rational for economic efficiency. Moreover, they tend to direct the rents from agriculture to inefficient and highly protected manufacturing firms by way of import-substitution policies. Thus, as a way of improving the production incentives for farmers, it is, as a rule, useful to abolish Government Marketing Boards in agriculture. This would also contribute to the allocation of the rents and profits of agricultural production via market mechanisms rather than by bureaucratic fiat and government subsidies.

Favorable production opportunities in agriculture are important also for achieving a geographically dispersed income growth in society—both among regions and population groups. Obvious policies to promote this, besides a reasonably conducive price policy towards agriculture, are a decentralized public infrastructure and regionally dispersed public services in rural areas in general. Of course, this is something that is important regardless of whether the economy is liberalized or not. However, as decentralization of decision-making may in some cases accentuate regional income differences, at least for a while, there is a case for conscious government attempts to speed up the process by which higher income in the national economy as a whole raises incomes in regions which lag behind.
This raises the general problem of poverty and income distribution. Considering the enormous misery among a minority at the bottom of the income distribution, humanitarian values should certainly make us emphasize redistributive actions in favor of the very poorest members of society, in the same way as redistribution policy in the presently developed countries started with "poor laws" even before the industrial revolution. On the expenditure side of the budget, such programs could very well, to a considerable extent, consist of what has been called a "basic needs strategy", for the purpose of providing basic food, shelter, water, sanitation, health, and education to the very poor, which is perhaps to some extent most effectively done by way of transfers in kind. Indeed, experience suggests that it is possible for a country to achieve substantial improvements in a number of "social indicators" at relatively low levels of per capita income (Balassa 1983)--examples being life expectancy, infant mortality, and child death rates.

Thus, there is evidence of the usefulness of "direct" attempts to raise the satisfaction of some "basic needs" concerning nutrition and health, even at low levels of per capita income. A "basic needs approach" is therefore quite compatible with a growth-oriented approach based on economic incentives, provided that neither is pushed to the extreme. Indeed, a great number of studies indicate that increased spending on health, nutrition, and education--up to certain levels--may give considerable boosts to productivity growth (Balassa 1983).

So far, it has been typical for developing countries to provide income support via indirect subsidies of commodities rather than via
direct transfers. One reason has certainly been administrative feasibility. However, another reason has simply been that strong pressure groups in the urban centers have "demanded" low food and housing prices, which has not only reduced production incentives in agriculture and housing but has often also assisted people with income levels considerably above those of the rural poor.

Sooner or later, when the "modern sector" starts to dominate the national economy, we would expect the same types of demands for social security systems for a broad section of the population as in developed countries. This is, again, not something which is confined to market-oriented systems. But market-oriented systems are certainly often blamed for creating inequalities and insecurities. Thus, in order to maintain their legitimacy among broad sections of the population, such systems need not only to pursue redistributions to the very poor, but also to provide social security systems for the population as a whole, though powerful urban pressure groups may benefit the most from such systems.

Indeed, while social security spending is only about 1.2 per cent of GNP in low-income developing countries (with per capita income below $400 in 1983 prices), the figure is as high as 6.6 per cent in upper-middle income countries (per capita incomes above $1,600); see Chart 1. (Other categories of public spending do not differ much between developing countries with different per capita incomes.5)

Eventually, of course, public spending programs may raise the same type of Welfare State incentive problems that are intensively discussed today in most developed countries. Indeed, there may be a risk of the
creation of "Premature Welfare States" in the sense that the economic foundations for an elaborate system of social security, transfer payments, and redistributions of income among large population groups does not yet exist; (Uruguay is often mentioned as an example).

"Early" attempts to create elaborate social security systems might not only create severe incentive problems in the private sector; they may also strain the taxation system so much that governments will not be able to provide what they have a comparative advantage for: collective goods and infrastructure facilities. These points lead directly to the problem of taxation.

IV. Taxation

The level and structure of taxes, subsidies, and tariffs differ so much between various developing countries that generalizations about their taxation problems are difficult. However, the general level of taxation in this group of countries is still usually much lower than that in developed countries--typically 10-25 percent of GDP, as compared to about 30-55 percent in Western Europe, 33 percent in the U.S. and 25 percent in Japan. Among 82 developing countries for which information is available, the average tax share of GNP seems to have been about 18 per cent in the early 1980s (Tanzi, 1983), with taxes on goods and services and foreign trade playing a much more important part than in developed countries. (Chart 2 provides statistics for "central government" revenues; figures for "general government" are probably, on average, one or two percentage points higher.) Thus disincentive problems for private agents, due to a generally high level of tax rates, cannot possibly be a serious problem in most developing
countries. However, these figures underestimate the "tax bite" for those sectors that actually pay the bulk of the taxes. (For instance, if we assume, as an extreme case, that agriculture pays no taxes at all, the average tax rate for the rest of the economy would be about 24 per cent as compared to 18 for the entire economy.)

One dilemma, though, is that a given level of taxes (as a percent of GDP) may "hurt" people more in a poor than in a rich country by depressing an already very low level of private consumption. However, this is not really a problem of economic disincentives for private agents, but rather an issue concerning the ability, or disability, of the political process to generate a reasonable allocation and distribution of resources between private consumption, public consumption, and investment. However, it is also an issue of the efficiency of the allocation of investment, as in a country where this allocation is more efficient than in other countries, it is not necessary to squeeze private consumption so much by way of taxes.

It is not clear whether a liberalization of the economic system requires, or can be expected to result in, a higher or lower total level of taxation. Reductions in the level of tariffs no doubt raise the need for new tax sources. Moreover, if increased reliance on markets results in a more uneven distribution of income, and indeed if it is already believed that this is the case, the political process may generate strong pressure for more redistributions via public budgets and hence a need for tax increases.

However, there are also factors that reduce the need for taxes in connection with economic liberalization, since some expenditure items would tend to disappear, or at least fall. In particular, a reduction
in the need for subsidies to enterprises—private as well as government—would be an important part of a shift to a more market-oriented economic system, provided profitability is kept up sufficiently, which requires that the real exchange rate is not overvalued. The need for taxes would also recede to some extent if public authorities shifted to a greater reliance on users' fees for various types of public services, a reform for which there are well known allocative and efficiency arguments. A reduction of the public bureaucracy, and increased competition for public service agencies from private agents would further reduce the need for taxes—partly because competition would most likely increase efficiency in the public sector, and partly because the size of the public service sector would be smaller due to the existence of private alternatives.

Another feature of economic liberalization is that increased incentive for private saving would reduce the need for public saving, though the recent fall in public saving in some developing countries is a reason for not advising the authorities to make substantial tax reductions on this ground.

However, even though the level of taxes in most developing countries cannot be regarded as excessive, or "harmful", the structure of taxes, subsidies, and tariffs is certainly already a serious problem. It is hardly necessary to say that high and strongly selective tariffs and taxes on foreign trade—export discrimination policies—often result in a suboptimal size of foreign trade, and hence in an under-utilization of the gains from the international division of labor. Indeed, it is today quite well established that such policies, often designed to promote "import substitution," when pursued for long
periods (such as several decades), have been highly detrimental to most developing countries which have pursued them.

It is also quite clear that highly selective commodity taxes, as in fact implemented, have often created inefficiencies in the allocation of resources in the private sector, both on the consumption and production side, without always providing advantages in terms of the distribution of income. And in cases where selective taxes and subsidies actually have improved the distribution of income (on the basis of certain values), the same improvements could perhaps in many cases have been achieved by a structure of taxes and subsidies with smaller efficiency costs.

Severe distortions may also come out of some other taxes. The provision of accelerated depreciation for investment and subsidies to some investment, in combination with payroll taxes on labor, may contribute to raising the wage/rental ratio—though recent increases in interest rates may have reversed this feature in several countries. Moreover, some developing countries do have quite high statutory marginal income tax rates for high-income groups, and sometimes also for middle-high income earners—such as households with two or three times the national average. For instance, according to a study by Sicat and Virmani (1986) referring to the situation in the early eighties for married couples with one earner and a "standard" number of children (three), about half out of fifty studied developing countries have marginal income tax rates above 30 per cent for incomes three times the average, and about a third of the countries have marginal income tax rates of at least 40 per cent for that (relative) income bracket. (The mean marginal rate was 34 per cent for that income
bracket, as compared to 19 per cent for the middle-income bracket.) If separate statistics had been available for the formal sector in urban areas we would certainly have found much higher figures. Of course, legal avoidance and illegal evasion mean that many taxpayers do not in fact pay those rates, even remotely. However, the statutory marginal rates are an indicator of the incentives to avoid and evade, which is part of the process by which marginal tax rates distort the allocation of resources and human effort.

Of course, an overhaul of the tax system makes perfectly good sense even without a shift to a more market-oriented system. However, a reform of the price and incentive system is clearly more crucial for a pronounced market-oriented system than for a highly regulated and centrally planned system, as the gains of shifting to a more market-oriented system cannot be fully achieved without reforming the price and incentive system in conformity with efficiency criteria. Indeed this truth has been well illustrated in recent decades by the attempts of socialist countries in Eastern Europe to rely more heavily on markets and economic incentives. Moreover, if capital movements, too, are liberalized, it is important to adjust capital taxation to levels that make domestic and foreign wealth owners and firms willing to invest enough in the country in question, rather than abroad—and to allow remittances of earnings, as well as providing guarantees of property rights in general. Stability of the domestic currency is, of course, also crucial in this context. Indeed, the problem of "capital flight" in developing countries is to a large extent a "confidence problem" concerning property rights and the value of the domestic money.
What are then the most important specific changes to be considered in the tax system, when an economy shifts over from regulations and central command to increased reliance on markets? Some economists may want to base their policy advice on sophisticated calculations of optimal tariffs, taxes, and subsidies. There is no doubt that the literature on optimum taxation has helped us understand the general problems of taxes and subsidies in cases where compromises have to be made between the requirements of tax revenues, on one hand, and the losses of economic efficiency due to the "excess burden" of positive marginal tax rates on the other. The literature on optimum income taxation has, for example, given precision to the old idea that marginal tax rates should be higher, the smaller the elasticity of effort with respect to rewards is, ceteris paribus. And the literature on optimum commodity taxation has formalized old views among economists about how to make a compromise between the allocative efficiency of consumption and concern for the distribution of income. While in the interest of economic efficiency tax rates should be relatively high on goods and services for which the demand and supply elasticities are small, the rates should, for distributional reasons, be high also on goods and services that play a relatively important part in the consumption pattern of groups of households that are supposed to be discriminated against in redistribution policy; these groups are often, of course, high income earners. Taxes should, ceteris paribus, also be high on goods and services which are close complements, for the consumers, of untaxed or indeed untaxable goods and services, like leisure. Quite complex formulas have in fact been derived to strike a balance between these different, often conflicting aspects, using a
Social Welfare Function as the criterion for the trade-off (Atkinson and Stiglitz (1980); Stern (1984)).

However, there are strong objections to the strategy of using such calculations as a basis for actual policy advice—in developing as well as developed countries:

(1) Firstly, formulas of optimum taxation catch only one, or possibly a few, types of mechanisms for adjustment by the individual agents, such as a shift between leisure and work, and/or between the consumption of different commodities. In reality there are, of course, myriads of other adjustment mechanisms for taxes, such as variations in the amount of do-it-yourself work and the intensity of work; adjustment of the level of saving and the composition of portfolios; changes in the level and type of investment in physical and human capital; changes of profession, workplace, or location of residence; emigration across national borders; the use of more time to search for tax loopholes, or even for cheating with taxes; etc. Formulas that would simultaneously reflect all such major adjustment mechanisms, or most of them, are quite simply beyond the range of useful analysis.

(2) Secondly, even to derive an optimum tax formula that takes into account just one single type of adjustment mechanism, such as the choice between leisure and income, or between different consumer goods on the demand side, it is in fact necessary to rely on extremely special assumptions, such as identical preferences of all individuals, and special forms of the production function, such as Cobb-Douglas functions.

(3) Thirdly, all optimum tax formulas, even rather modest ones, require statistical information that is not very reliable. Not only do
we need an "arbitrarily" chosen Social Welfare Function, but also information about individual capabilities and preferences, specific enough to quantify the sensitivity of the response to contemplated tax rate changes of the various types of adjustments that are supposed to be covered in the study. On most of this we will never get sufficiently reliable information. This is serious, as the tax rates that are derived from optimum tax formulas are very sensitive to alternative specifications of the various functions and the statistical parametrization.

Indeed, if all the necessary information on individual capabilities and preferences that is required for empirical application of the theory of optimum taxation were available, we would not be too far from the type of knowledge that is necessary to design lump-sum taxes and transfers, and hence avoid the economic distortions which is the reason for choosing an optimum tax approach in the first place! More specifically, in order to design optimum tax systems we would need information about both individual abilities and preferences at the same time as it is the difficulty in obtaining information about matters like these which is the basic reason why we are not able to use lump-sum taxes, and hence why there is a case for a second-best solution by way of "optimum taxation."

(4) Applications of the theory of optimum taxation are also confronted with a severe aggregation problem. More specifically, the tax rate that is assigned to a specific product in the context of an optimum tax formula depends crucially on the degree and type of aggregation of commodities. For instance, if furniture is put into the group of durable consumer goods, it gets one tax rate, but if it is put
into some other group of goods it would get a different rate— or even a zero rate or a subsidy. In other words, the tax rate of an individual good will be highly arbitrary depending on which other goods and services it is lumped together with. This means that optimum taxation will to a large extent be "arbitrary taxation." It is in reality also difficult to group the goods in such a way that only consumers' goods are included in the tax base. Many inputs in the production process will in fact also be taxed, which means that distortions of the allocation of resources will arise from the production side as well, without these distortions being considered in the calculation of the optimum tax structure. Attempts to differentiate the tax rates of one and the same type of good when used for direct consumption and when used as an input in the production process is bound to raise severe problems of administration and evasion.

Several of these difficulties with optimum taxation are, of course, well known by the adherents of optimum taxation. But it seems to me that they have not taken these problems seriously enough when ruling out "traditional" principles of uniformity of commodity taxes and tariffs, as well as "comprehensive" income taxation with similar tax rates for all sources of income (for instance the so-called Haig-Simons principle). However, there is an even more fundamental objection to using optimum taxation as a basis for policy advice:

(5) There is no reason to assume that politicians and public administrators would follow advice that is based on calculations of optimum taxation by the help of some (assumed) Social Welfare Function. Politicians have their own targets and ambitions, which may not bear
much relation to the ideas which lie behind calculations by economists of optimum tax or tariff structures. Indeed this is exactly the background for various attempts in recent years to endogenize the behavior of politicians and public administrators, as well as for suggestions tying the behavior of politicians to various types of "rules". More generally, there is no reason to assume that tax rates that are the outcome of political processes--with conflicts and compromises between various political parties and interest group organizations--would be much correlated to the tax structure that some economists may derive from optimization calculations.

This point about political behavior is important regardless of whether the main ambition of politicians is to satisfy some strong interest group, to increase the probability of being elected, or to adhere to some personal or ideological idiosyncracy. Politicians and public administrators, with the help of their economic advisors, can always present some reasonable-sounding argument for their particular choice of a differentiated structure of taxes and subsidies--for instance by referring to aspects that have not been considered in the calculations of the optimum tax specialist, or by exploiting the wide choice of "reasonable" elasticities of the demand and supply responses to taxes. The fact that calculated "optimum rates" for individual goods depend crucially on how goods are aggregated also opens the possibility for various interest groups to argue about the "proper" way of aggregating goods in official statistics.

If optimum tax theory then is not the most appropriate basis for tax policy advice in developing (or in developed countries for that matter), what types of considerations should be used instead? The
general answer, in my judgment, is that it is better to rely on
approaches that are less ambitious and less demanding concerning
knowledge about private behavior patterns, statistical information, and
administrative competence, but instead more ambitious with respect to
basic insights about the functioning of the political process. In
other words, it is important to focus on more "pedestrian," practical,
and "common sense" oriented aspects than those emphasized in the
optimum tax literature. For instance, the following types of tax
reforms are worth considering in a great number of developing
countries:

(A) As several developing countries, in particular those in Latin
America, often have high and highly variable rates of inflation, an
adjustment of tax assessment and tax collection to inflation is often
crucial. Though inflation functions as an implicit "inflation-tax" on
the stock of money and government bonds (with less than fully adjusted
interest to inflation), inflation often also implies that the
government loses "explicit" tax revenues in real terms due to the time-
lags in tax collection (the so-called Oliveira-Tanzi effect).
Inflation often also erodes the tax base, because of the deductability
of nominal interest rates, which in an inflationary situation means
that part of the amortization of the debt, in real terms, can be
deducted from the tax base. If the latter two effects dominate the
former, inflation will generate (or accentuate) higher budget deficits
(in real terms), which then often feed back into even higher inflation
rates. Obvious reforms to solve these problems are to shorten the time
lags in tax collection; make inflation-adjustments to the tax rates (or
tax brackets); and redefine the tax base in order to make a distinction
in real terms between (deductable) interest payments and (non-deductable) amortization.

(B) As the tax base is often very narrow in developing countries, the tax rates are often relatively high for certain sectors and groups of tax payers. For instance, in many developing countries today income taxation is, in fact, mainly a tax on public servants and employees of large corporations, rather than on capital owners, or on employers and employees in agriculture or in the "informal" urban sectors. The tax system is also plagued with other types of "asymmetries" with respect to the effective tax rates for different agents and sources of income, and these asymmetries are often accentuated by inflation. These asymmetries could, of course, be mitigated by moving in the direction of a Haig-Simons type "comprehensive" income tax, with uniformity between different sources of incomes, different assets, and different types of income earners. Basically that would mean a broadening of the base and a lowering of the rates--as has recently been tried in some developed countries. The tax system would then, most likely, be improved both in terms of efficiency and equity (and perhaps even equality), while attempts to make differentiations based on optimum tax formulas are likely to be exploited by various interest groups in their own self-interest. In other words, uniformity, as the basic rule of taxation, is probably less vulnerable to manipulation by powerful interest groups than is the principle of "differentiation" according to optimum tax principles.

(C) As the small degree of household saving that exists in most developing countries largely takes place among the very top income earners, attempts to redistribute income from these groups on a large
scale are likely to conflict with ambitions to stimulate private saving and to increase the supply of risk-capital. This is a reason for being careful about heavy increases in income and wealth taxes for upper-middle and high income groups. Moreover, as corporate saving plays an important part in aggregate saving in some developing countries, and could play an even more important part in the future, there is a strong case also against raising taxes drastically on corporations.

Superficially, it may be argued that tax increases that reduce private saving are not really a problem, as it does not matter if saving is done by private agents or public authorities. However, this argument is seriously flawed for two reasons. First, it neglects imperfections in the political process in the sense that tax increases that are originally designed to increase public saving often, in fact, will release increased public consumption or subsidies of private consumption. Second, public saving is not a perfect substitute for private saving in market-oriented economies, as private saving contributes to a decentralization of decisions regarding investment, the entry of new firms, and innovation. To keep down private consumption is not the only purpose of saving; another important role, which it plays in market-oriented economies, is to allow and stimulate the emergence of a system of decentralized decision-making, and hence to help channel resources to alternative types of assets in an efficient way.

Indeed, it may be argued that one of the most important prerequisites for a successful shift to a more market-oriented economic system is just this, namely the stimulation of private saving--a
conclusion that follows from informal (Hayek- and Schumpeter-type) common-sense views on the functioning of markets, rather than from formalized general equilibrium theories.

In fact the history of economic development in the western world during the last one or two hundred years illustrates vividly the importance of private saving and private supply of capital for the entry and growth of new firms, for "entrepreneurship", and hence also for innovation. In other words, it is difficult to keep an important role for the entrepreneur if the private capitalist is "destroyed"—partly because these are often the same persons. Thus, while both centrally regulated economies and market-oriented economies have to be careful not to destroy incentives to work, it is in market-oriented economies also important to watch out for disincentive effects on private saving and entrepreneurship. This means, of course, that certain "sacrifices" have to be made in the ambitions to redistribute incomes from high to low income groups—though less so in the case of redistributions from economically "passive" groups, such as "traditional" wealth holders keeping their assets in idle land and various types of collectors' items.

What then are the conclusions for indirect (commodity) taxation? My basic assertion is that if we opt for a reasonably nondistorting structure of taxes, tariffs, and subsidies, it is advisable to choose, at least as a starting point, a uniform structure (same tax rate on every commodity and the same tariff rate on every importable)—rather than attempting to find some optimum tax structure. The rationale simply being to avoid a situation where something even further away from an optimum structure will in fact be implemented by way of party
competition and the influence of strong interest groups. It is difficult for voters to judge if a highly differentiated tax structure reflects an attempt to implement "optimum tax rates" or if it is simply designed to assist some politically strong pressure groups. It is probably easier for voters to judge on this matter if the norm is a proportional structure of indirect taxes, rather than some asserted optimum structure.

Moreover, it is likely that highly selective taxes and subsidies, like direct regulations, breed both "rent seeking," via political lobbying, and corruption (Myrdal (1968)). This means that while a liberalization of the economic system in developing countries is most likely a necessary requirement for a drastic removal of rent seeking and corruption, this outcome could partly be jeopardized if a system of highly selective taxes and subsidies are introduced, as suggested by proponents of optimum tax theory.

An obvious objection to this reasoning is that it may, in fact, be difficult to induce politicians to follow a norm about uniform indirect taxes and tariffs. However, it is well known that politicians sometimes may find it in their own interest to "straight-jacket" themselves by accepting various types of norms--obvious examples being international GATT-rules on tariffs. Indeed, commitment by way of binding rules has been discussed frequently in game theory in recent years, emphasizing that this may be a method of preventing various groups in society from exploiting the difficulties of the government, without such rules, to commit itself in advance to a policy which it would like to pursue.
A braver strategy would be to use a uniform tax structure as the basis for the tax system, but to allow some additional, selective taxes on goods for which there are really strong and uncontroversial reasons to believe (i) that the supply and demand elasticities are very low, and (ii) that the goods are consumed proportionally much less among groups of citizens with low incomes than among high-income groups (assuming that an improvement in incomes of low-income groups relative to high-income groups is desired). Of course, there is then an equivalent case for deviating from the basically proportional tax structure by low tax rates (or even selective indirect subsidies) on goods and services for which there is overwhelming reason to assume have the opposite characteristics.

Such a modification of a strategy of uniform indirect taxes would be a modest attempt to accommodate some of the basic ideas of the optimum tax theory, without using that theory as the basic foundation for tax policy recommendations. It would differ from the idea of optimum taxation in the sense that (a) attempts to adjust tax rates to differences in demand and supply elasticities would be the exception rather than the rule, and (b) that considerations to the functioning of the political process would be paramount.

However, in a short- and medium-term perspective, the most important aspect of tax reform in developing countries is probably to improve tax collection and tax compliance. Not only is the administrative capacity of the tax authorities often weak, but in addition, firms are often small and difficult to control, and the loyalty to the national state is rather limited in some developing countries--often due to historical experience. Greater uniformity and
less differentiation in the treatment of different tax payers, products and sources of incomes may often facilitate both tax administration and tax compliance. Moreover, it may be advisable to use a sales tax on wholesale trade rather than a comprehensive value added tax or a sales tax in retailing. Reductions in the element of "arbitrary discretion" by local tax collectors may also help to increase voluntary tax compliance, as would the earlier suggestion about a broader base and lower rates.

To summarize my general points on tax policies: policy advice that relies on (i) sophisticated analytical techniques, combined with (ii) extreme oversimplifications of the functioning of the economic system, (iii) enormous requirements of sophisticated statistical information, and (iv) total neglect of the functioning of the political and administrative system, is likely to create more distortions than would recommendation of simple rules of thumb, using uniform and broadly based taxes and tariffs—possibly modified by some selective taxes or subsidies where the case for such a modification is particularly strong. Thus, there is a strong case for the "traditional" recommendation in public finance of a "comprehensive" income tax a la Haig-Simons, with uniform rates between different sources of income assets and types of income earners, and a similar case for uniformity of the tax rates for commodity taxation as the basic starting point, though exceptions may be made where strong cases can be put forward.
V. Growth, distribution, and poverty

Allocative efficiency and economic growth should, of course, not be regarded as "ends in themselves", but rather as means of raising the material well-being of "the ordinary man", and in particular of the poorest fraction of the population. This observation raises the classical question of the relation between the distribution of income, on the one hand, and allocative efficiency and economic growth on the other, hence highlighting the celebrated conflict between equity and efficiency--"the Big Trade-off" in Arthur Okun's terminology; Okun (1974). However, it is also obvious that equity and efficiency considerations in many cases are complementary rather than conflicting objectives. Indeed, it is important to try to find strategies and instruments of growth and redistribution policy for which such complementarities exist.

The most solid empirical observation on the relation between growth and distribution is perhaps that the fruits of economic growth, at least after a while, tend to become dispersed enough to result in an increase in the standard of living of both the great majority of the population and of the bulk of low-income groups (Kuznets (1955, 1963)). Thus, "immerserizing growth" (Bhagwati 1985) seems to be quite unlikely in a long-term perspective.

However, there is also rather strong evidence from time-series analysis that the relative overall distribution of income (as measured by, for instance, the Gini coefficient) often becomes more uneven during the very first decades of economic growth, with a reversal of this tendency later on. This is, of course, the empirical background to the celebrated "Kuznets' Law" about an inverted U-shape of the
relation between per capita income and the inequality of the overall distribution of income. Indeed, cross-country studies, too, (at a given point of time) support the hypothesis of such an inverted U-shape relation (Ahluwalia, 1976 and references in Bigsten, 1986).

The usual theoretical explanation for this asserted empirical regularity is that economic growth, to begin with, tends to be concentrated in the initially very small "modern" sector of the economy where per capita income is higher and more uneven, and often also tends to rise more rapidly than in the traditional (usually rural) sectors. When, later on during the growth process, the modern sector becomes a larger share of the total, and the intrasector distribution of skills tends to become more even, the overall distribution of national income, too, tends to become more even—possibly also more even than in the "initial" situation before the "take-off" of modern economic growth (Bigsten, 1986).

A similar pattern seems to hold if we look at the relative position of low-income groups (such as the very lowest income deciles) rather than at measures of the overall distribution of income: though low-income groups often seem to gain absolutely also during the very first few decades of economic growth, they usually seem to lose ground relative to other groups during that phase of economic development.6

Thus, though there is hardly any reason to be pessimistic about the possibilities of raising the standard of living of low-income groups, by way of economic growth, both concern for the relative positions of people during early phases of economic growth, and an eagerness to help the utmost poor certainly make a case for deliberate
policy actions to help the fruits of economic growth spread to the poorest fraction of the population. Thus Kuznets' Law should be regarded as a "tendency" at given economic and social policies, rather than some "Iron Law of Distribution" which cannot be repealed by appropriate economic and social reforms.

When discussing such reforms, it may be useful to distinguish between four (closely related) aspects: (i) attempts to redistribute the ownership of human, financial, and physical assets in favor of low and low-middle income groups; (ii) removals of institutional obstacles keeping these groups from participating in the process of income growth; (iii) redistributional considerations when designing general economic policies; and (iv) fiscal policy actions specifically designed to improve the living standards of people in the above-mentioned groups.

(i) It is (practically tautologically) true that a relatively even initial distribution of human and physical capital, in particular land, helps to spread the fruits of growth widely. However, it would seem that successful land reforms have to fulfil two requirements: they should opt for private ownership, largely in the form of family farms, and they have to be once-and-for-all actions, so that the owners of land can be sure about their property rights. Otherwise a serious conflict between equity and efficiency considerations easily arises in agriculture. We would also expect education reforms during a process of growth to even out the overall distribution of income, in particular if there is a strong emphasis on literacy and vocational training for broad population groups.
(ii) Obvious examples of methods to remove institutional obstacles to a dispersed distribution of the fruits of economic growth is the stimulation of the build-up of credit market institutions that reach low and low-middle income groups, in particular in rural areas. In the case of farm families, characterized by ample availability of labor and scarcity of land, it is also important to remove legal and institutional obstacles for additional land tenure (such as the leasing of land). It is also obvious that the possibilities for poor farmers to participate in the process of income growth may be drastically improved by government infrastructure investment, both to increase the productivity on the farms (irrigation systems, etc.) and by creating a favorable infrastructure for non-farm activities in the country-side, where family labor may get additional earnings.

(iii) The distributional consequences of alternative general policy strategies is a more difficult and controversial matter. However, both casual observations and systematic research indicate that a shift to an outward-oriented growth strategy tends to favor not only overall economic efficiency, but also employment and redistribution of income to unskilled labor (Krueger, 1978, Bhagwati, 1978). One of the explanations is that import protection in manufacturing turns the terms of trade against agriculture where the majority of poor people are to be found in most developing countries. Another explanation is that such policies tend to increase competition and hence reduce monopoly profits. However, even more fundamentally: an outward-looking growth strategy in labor-abundant countries favors labor-intensive sectors and labor-intensive production techniques, simply because free trade tends to allocate factors of production in
confomity with comparative advantages, which tends to turn the composition of national income in favor of labor income, in particular for low-skilled workers. Poverty will then tend to be reduced, as there is overwhelming evidence that increased employment is of utmost importance for the removal of poverty (Fields, 1984). Indeed, as pointed out by Ranis (1978, p. 407), "The only sure method of achieving a sustained improvement in equity lies in hastening the advance of commercialization, i.e. the end of the labor surplus conditions."

The importance of high demand for labor for an even distribution of income, and for the mitigation of poverty, also creates a strong case for fighting various regulations in the labor market that keep low-skilled labor unemployed. Obvious examples are minimum wage legislation and wage policies by unions with similar characteristics, though such legislation and policies do help some low and middle income employees—if they do not lose their jobs by way of such actions. Here then is another illustration that efficiency and equality do not always conflict.

However, when stimulating employment it is, from the point of view of distributional considerations, important to avoid using methods, such as aggressive demand expansion, that generate high and fluctuating inflation, which easily hurts low-income groups. This is particularly important as inequalities generated by inflation are usually "non-functional inequalities" in the sense that they do not contribute to efficient economic incentives (probably the reverse), in contrast to inequalities that are caused by differences in productive effort. As high-inflation economies tend to get large distortions of relative
prices, including the real exchange rate, here is another example where allocative and distributional aspects are complementary.

The upshot of all this is that those who, for efficiency reasons, are in favor of outward-oriented development strategies have certainly no reason to be shy about their position from the point of view of the distribution of income—rather the opposite. Recent experiences in countries like South Korea and Taiwan illustrate this point. These countries have demonstrated the possibility of reconciling efficiency and distributional considerations both by choosing an outward-looking development strategy and by making early redistributions of the ownership of land and human capital. Thus, even if examples are easy to find where specific tools of egalitarian policies, such as high marginal tax rates, do harm economic growth, there is no presumption of an unavoidable negative reverse causation, according to which increased economic growth would necessarily be unfavorable for income equality even in a short- and medium-term perspective.

The situation is more complex for countries with abundant natural resource rather than labor, as a growth process based on comparative advantage in this case tends to result in high rents. It is then often important to achieve institutional conditions, including a well functioning capital market, dynamic entrepreneurship, and tax and expenditure policies that help these rents to flow to other sectors where the country has a comparative advantage, rather than using these rents for subsidies to import-substitution production.

(iv) Of course, various arguments for institutional reforms in favor of low-income groups, redistribution of assets, and an outward-looking development strategy, do not rule out the possibility of more
direct policy actions, specifically designed to improve the consumption of poor people. One obvious example is the provision for these people of water, sanitation, health, and food— as pointed out in the section on expenditure policies. It is, however, important to warn countries against choosing methods of redistribution policies that harm growth, as after a while economic growth usually tends to be accompanied by an equalization of the overall distribution of income.

VI. Problems of transition and macroeconomic instability

So far our discussion has been confined to various aspects of the allocation of resources and the distribution of income. However, when analyzing public finance, or economic policy in general for liberalizing developing countries, there is a strong case for emphasizing stabilization policy aspects as well. For instance, greater reliance on foreign trade, which is an expected consequence of more market-oriented economic policies, would be expected to accentuate the size of "imported" disturbances from world markets, though at the same time domestically generated disturbances will have smaller effects on the domestic economy, as part of the effects "leaks out" through the balance of payments.

However, it is conceivable that a market-oriented and outward-looking country will be so much more flexible than a highly regulated one (with the emphasis on import substitution) that the effects on the domestic economy of foreign shocks will not be greater in the former than in the latter type of country. Indeed, Bela Balassa (1985) asserts that a number of highly "outward-oriented" economies, in particular in Pacific Asia, though being exposed to greater
international shocks than most other developing countries, have recently been able to "absorb" the shocks better than more regulated, "inward-looking" developing countries. However, it is equally striking to note that attempts to liberalize the economies of some developing countries, in particular in South America, have "backfired" because of their inability to deal with problems of macroeconomic instability during the period of transition to a more market-oriented economic system. These important issues will be dealt with below.

One obvious problem during a period of transition to a more market-oriented economic system is that the redistribution of income and wealth, which is induced by the accompanying shifts in relative prices, profitabilities, and the composition of demand, will be resisted by various interest groups in society. New market uncertainties will often also be created during the transition period. One reason is that when an economy is originally in a situation characterized by pronounced disequilibria, which is a characteristic feature of a regulated economy, it becomes difficult to predict what will happen to various relative prices, demands, and supplies when the economy is liberalized. It is therefore important that there is confidence among private agents that the shift of system is permanent, as otherwise economic agents may not be willing to fully adjust their activities, in particular their investment, to the new information and the new incentives that are transmitted via the market system. An important explanation as to why the economic liberalization in West Germany in 1947-50, and in Pacific Asia in the 1960s and 1970s, was so successful is probably just that there was considerable confidence that the shift to new rules of the game was permanent. More efficient
market-oriented institutions in product and factor markets would also help smooth the transition, obvious examples being highly flexible credit institutes and labor exchange agents. It would also be useful if the government could adjust the public infrastructure rapidly, if possible even in advance of the liberalization of product and factor markets.

Another obvious transition problem is the emergence of severe risks of large increases in frictional and structural unemployment, as the requirements of reallocations of labor may outstrip the ability of the labor market to achieve this smoothly. Thus, it may be hazardous to liberalize product markets without at the same time removing important obstacles to the flexibility of the factor markets. From that point of view it would be wise if, for instance, minimum wage regulations and interest rate ceilings were removed before, or simultaneously with, a liberalization of the product market. Recent studies indicate however, that severe unemployment problems have not been caused by the liberalization attempts during the seventies--except in a few countries that pursued stabilization policies that severely damaged the employment situation (Michaeli, 1986).

Indeed, experience suggests that the most important transition problem concerns macroeconomic instability--the difficulties of avoiding fluctuations in capacity utilization, inflation, and the balance of payments. For instance, inflation and balance of payments problems will most likely be accentuated when price controls and other types of regulations are removed. Indeed, this is exactly what has happened when socialist countries have experimented with a freer system of price and wage formation. The obvious, and generally accepted,
conclusion is that a liberalization of the economic system has to be combined with increased concern for the management of stabilization policy—with fiscal, monetary, and exchange rate policies as the main tools.

However, many years of experience in developed countries certainly show that even rather well designed macro policies may not be enough to prevent high, and perhaps even rising inflation. A main reason for this is that the mechanisms of wage formation are characterized by a pronounced inflation bias in most, perhaps all, of the world’s market economies. Thus, some adjustment of these mechanisms is therefore worth considering when developing countries plan to liberalize their economic system (in the same way as such modifications are today discussed in various developed countries). This argument may carry particular weight in countries with fairly strong labor unions, as in some Latin American countries.

Obvious candidates for such reforms are: removals of price index clauses in wage contracts, and the introduction of new contract forms with bonus systems that tie wage increases to productivity increases or profits. When developing countries introduce unemployment insurance systems, a strong case can also be made for letting unions and firms, in each separate sector, bear the bulk of the insurance costs, rather than shifting these costs onto the taxpayers. The idea is, of course, to internalize the negative consequences on the employment level of aggressive wage increases. Clearly, government budget policy has a direct responsibility for the rate of wage increase in the public sector, which in some developing countries has an important bearing on wages in the entire labor market. However, in some developing
countries, where labor unions are weak, general macroeconomic policy—with a concentration on getting the budget surplus, the monetary aggregates, and the exchange rate right—may not only be a necessary, but also a sufficient condition for reasonable macroeconomic stability, if international disturbances are not too large.

In countries with large fluctuations in the terms of trade, for instance due to heavy exports of raw materials, there is also a strong case for pursuing monetary and fiscal policies that avoid large swings in the real exchange rate for nontraditional exports—to prevent a "dutch disease" in that sector in connection to export booms. The "sterilization" of extreme export earnings (for example, by taxation) or their consequences for domestic financial markets (by monetary policy actions), is a crucial aspect of a successful stabilization policy for such countries—to reduce instability in the real exchange rate.

There are also a number of specific transition problems connected to the liberalization of foreign transactions—trade as well as capital movements. For instance, as a tariff reduction initially reduces the prices of import goods ("importables") relative to both export goods ("exportables") and non-traded goods ("nontradables"), both domestic absorption of importables and the production of nontradables are stimulated. In other words, there is an appreciation in the "real exchange rate". In combination with the reduced competitiveness of domestic production of importables, we would, in a short-term perspective, expect temporary unemployment problems in that sector, and most likely also an (increased) current account deficit. This is, of course, the rationale for the traditional policy advice to devalue the
currency in connection with a general tariff reduction--implying a slowing down (or reversal) of the appreciation of the real exchange rate. An additional complication is that the inflationary effects of the devaluation may dominate the deflationary effects of the tariff reduction, which is, of course, a reason to suggest that the devaluation is combined with restrictive demand management policies.

As direct regulations regarding imports are often more disruptive to the efficiency of the economy than tariffs, it is worthwhile starting a process of import liberalization with not only an "evening out" of the structure of tariffs between different groups of commodities, but also with liberalizations of direct import controls. Attempts to reduce the average level of tariffs could then be delayed somewhat if rapid devaluations prove to be difficult.

With sufficiently restrictive management of domestic aggregate demand, the combination of tariff reduction and devaluation could then, in principle, bring about the desired shift of resources not only from less to more efficient parts within the tradable sector, but also from the nontradable to the tradable sector, with an expansion of foreign trade without a deterioration of the current account and without increased inflation.

However, if nominal wage increases, for instance due to explicit or implicit indexation of wage rates, follow price increases closely, the result may be both stagflation and (with fixed exchange rates) a gradual disappearance of the gains in competitiveness which the devaluation was designed to provide. What would then remain of the entire operation would be a more efficient level and structure of tariffs, and hence, a more efficient allocation of resources, though at
the cost of more inflation and possibly also a deterioration in the current account of the balance of payments. Both the higher rate of inflation and the increase in the current account deficit then easily release political forces that result either in the reintroduction of a protectionist stance or in strongly restrictive unemployment-creating policy actions. All this highlights the importance of an appropriate combination of trade liberalization and macroeconomic policy during a transition period.

Of course, an increased current account deficit could, in principle, be financed by capital inflows, which is facilitated by the liberalization of capital movements, in particular if domestic interest rates were initially higher than the rates on world markets. However, such a development requires both high confidence in the permanency of the liberalization of capital movements and a sufficiently high real rate of return on domestically held assets, implying an appropriate and stable real exchange rate. As such conditions cannot always be taken for granted, a country that is about to liberalize foreign exchange reserve and/or lines of credit in advance, for instance by way of foreign borrowing by the government.

It would seem that the unsuccessful liberalization attempts in some countries in South America—in particular the so-called "Southern Cone Countries" of Chile, Argentina, and Uruguay—in the late seventies and early eighties were closely connected with serious deficiencies just in short- and medium-term macro-policies. These policies were simply not "consistent" enough with the liberalization attempts (Khan and Zahler 1984). An over-expansion of domestic aggregate demand, often via a large budget deficit and a rapid increase of the money
stock (partly to finance the budget deficit, partly due to large
capital inflows), during the process of liberalization contributed both
to inflation and to rising current account deficits, which then
resulted in severe liquidity and confidence problems for the national
economy.

In both countries, expansion of domestic aggregate demand pulled
up prices in the nontradable sectors, and wages in the entire economy,
which with fixed exchange rates severely harmed production and
employment in the tradable sectors. This also illustrates the dangers
of trying to fight inflation with a fixed exchange rate if domestic
aggregate demand policies are not kept under control—in particular if
wages are indexed to the domestic price level for consumer goods (with
a strong component of non-tradables). The experiences in Argentina and
Chile during the late seventies illustrate this point.

Thus, the most important aspect of the transition problem is
probably to avoid combining a liberalization of trade and capital
movements with (i) an expansion of domestic aggregate demand by way of
big budget deficits and a large expansion of the monetary aggregates,
and (ii) unstable real exchange rates, in particular heavy
appreciations, for instance due to rapid wage increases with fixed (or
lagging) exchange rates. Such policies have, of course, particularly
serious consequences in an international environment that is
characterized by drastically increased interest rates, a deterioration
of the terms of trade, and a cyclical weakening of foreign markets as
in the early eighties.

However, it is also difficult to introduce trade liberalization in
a situation in which the government tries to bring down inflation by
restrictive demand policies, as then the unavoidable disturbances in the labor market from the trade liberalization programs would be accentuated by restrictive demand policies. This dilemma has induced some observers to suggest that a trade liberalization program has to be postponed until inflation has been brought down substantially (Sachs 1985). It is also obvious that the order of trade liberalization is important. For instance, the experience from Argentina illustrates the danger of liberalizing imports before exports, and the experience from Chile illustrates the risk of liberalizing capital movements at an early stage of the liberalization process if effective actions are not undertaken to prevent inflationary effects from capital inflows.

Finally, it is also important to avoid destabilizing macro policies after a period of transition to a more market-oriented economic system, as both allocation and growth policies are likely to fail if the macroeconomic policy is not pursued with reasonable skill. An open economy, in particular a small one with large foreign trade, will be disrupted if aggregate demand is much too high, or much too low for that matter, and if the most important relative price of all—the real exchange rate—is excessive. Experience shows that this simple point cannot be stressed too much.
Chart 1

CENTRAL GOVERNMENT EXPENDITURE

FOR LOW, LOWER-MIDDLE, UPPER-MIDDLE, & INDUSTRIAL ECONOMIES

% OF GNP

Low Low-Mid 1983 Up-Mid Indus

DE = Defence
ED = Education
HE = Health
SS = Social Security and Welfare
ES = Economic Services
AF = Agriculture, Forestry, Fishing, and Hunting
TC = Transportation and Communication
OP = Other Purposes
TE = Total Expenditure
SD = Overall Surplus/Deficit

Source: See text.
CENTRAL GOVERNMENT CURRENT REVENUE
FOR LOW, LOWER-MIDDLE, UPPER-MIDDLE, & INDUSTRIAL ECONOMIES

IPC = Taxes on income, profit, and capital gains
SSC = Social security contributions
DGS = Domestic taxes on goods and services
ITT = Taxes on international trade and transactions
OT = Other taxes
CNR = Current nontax revenue
CTR = Current tax revenue
TCR = Total current revenue

Source: See text.
NOTES

1. Thus, "structuralism", as the term is used here, is something quite different from the idea that the initial structures of these countries, such as the proportions between various sectors and the existence of various disequilibria of factor rewards in different sectors, are important factors to recognize in a realistic analysis of both the existing state and the development prospects of such countries.

2. These observations do not, of course, mean that when countries strive for better allocation of investment this would have to occur at the expense of the aggregate volume of saving and investment. There is not necessarily a conflict between high, and efficiently allocated saving as witnessed by, for instance, Japan. Indeed, several countries that have experienced particularly poor economic performance have been unsuccessful with both the volume and the allocative efficiency of saving—obvious examples being countries like Bangladesh, Chad, Ghana, Mali, Sudan, and Upper Volta, with gross saving rates in the neighborhood of zero or even with negative rates; see World Development Report, 1985.

3. Jacob Viner (1952), Gottfrid Haberler (1959), Theodore Schultz, (1964), and Peter Bauer (1971) were pioneers in making these points, and early support for outward-looking strategies was provided by Hla Myint; (1967). Bhagwati (1966) was also early in noting the potential importance for economic development of a relative price structure that is conducive to allocative efficiency. Similar views have more recently been reflected in, for instance, Ian Little (1982) and Deepak Lal (1983), where liberal references are provided to research into the
role of relative prices and economic incentives. However, the "watershed" book, symbolizing a shift among economists, in general, away from a regulation-and-planning paradigm to a market-paradigm, emphasizing outward-looking strategies, is probably Little, Scitovsky, and Scott (1970).

4. There may, of course, also be causation in the other direction—from budget deficits to cost increases that result in overvalued currencies (in fixed exchange rate regimes).

5. These statistics, covering "central government," are compiled from World Bank: World Development Report, 1986, Table 22, and IMF: Government Finance Statistics Yearbook, 1985. A study by Tanzi (1983) indicates that total tax revenues of all levels of government, i.e. "general government", in developing countries are only slightly (one or two percentage points) higher than the figures for tax revenues of central government that are reported in Chart 2 in this paper. (The countries are not exactly the same in the two samples, however.) Perhaps we could assume that the difference between general and central government is also on the expenditures side.

6. It would seem that only a very modest part of the variations of the distribution of income among developed countries may be statistically "explained" by the level of per capita income. According to Bigsten, about 80 percent of the inequalities would remain to be explained by other factors (Bigsten 1986).
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