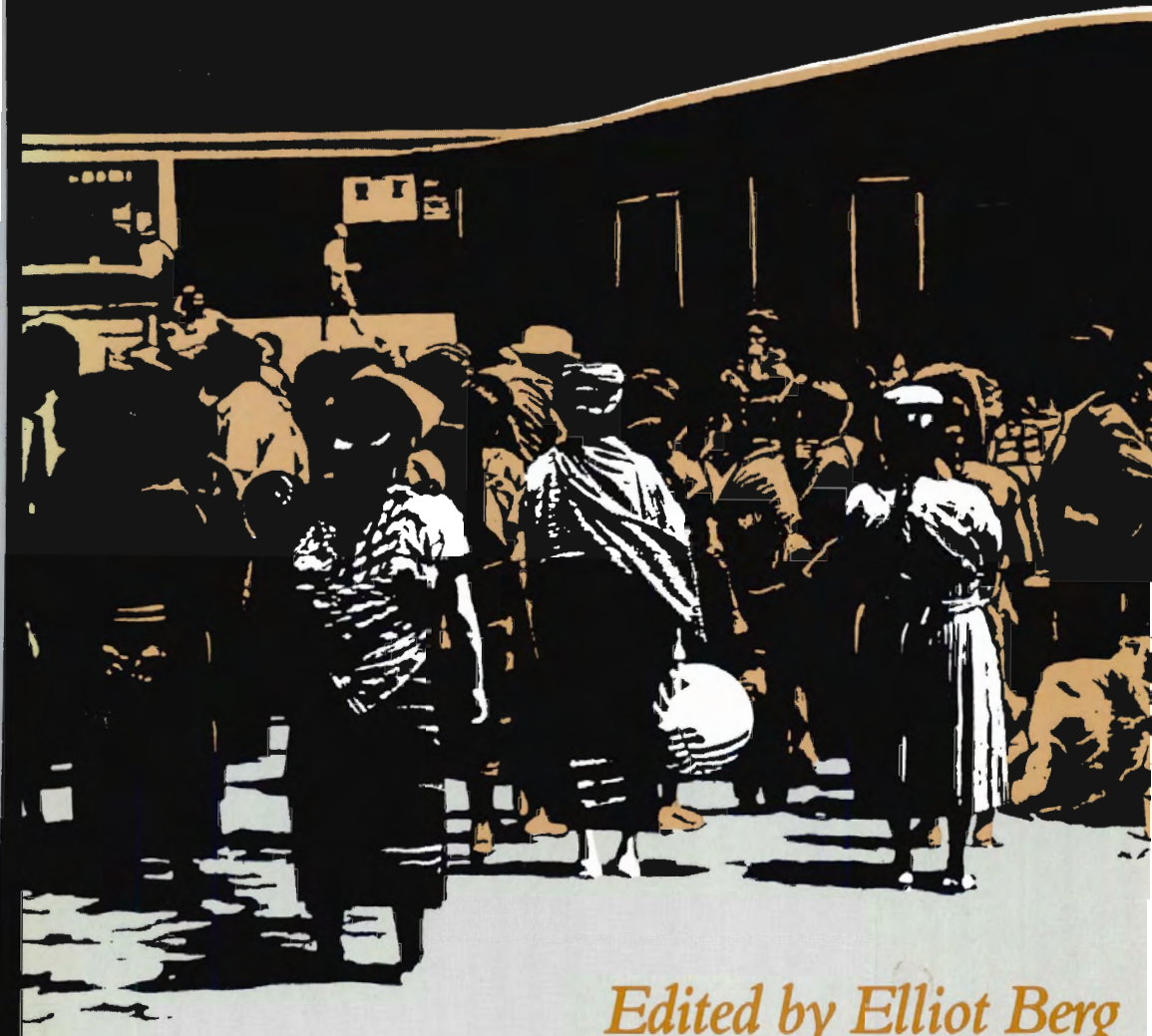
POLICY REFORM & EQUITY

Extending the Benefits of Development



Edited by Elliot Berg

A SEQUOIA SEMINAR PUBLICATION

Policy Reform and Equity

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A Sequoia Seminar

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Elliot Berg

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Policy Reform and Equity

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Preface

As the authors of this volume indicate, economic growth and a more equitable income distribution are inseparable issues for developing countries. Without economic growth there can be no human development, no improvements in human welfare. Thus, it is imperative that all people concerned with improving human welfare be concerned also with policies that will promote economic growth.

One of the important lessons of the development economics of the last decade is that, even if well intentioned, all policies promoting economic growth do not have the same implications for the welfare of the poorest sectors of society. Some policy choices are more likely than others to promote both growth and welfare. Understanding and encouraging such policies is the aim of the scholars and practitioners contributing to this volume.

This publication is the first in a series resulting from seminars conducted by the Sequoia Institute. Addressing the topic *Including the Excluded: Extending the Benefits of Development,* the seminars facilitate the exchange of research, information, and ideas on issues critical to Third World development. The series examines the successes and failures of development strategies, encouraging the reexamination of established principles and, where necessary, the

formulation of new ones. Additional volumes, also to be published by ICS Press, will focus on the issues of the underground economy, international trade policies, and other areas.

Robert B. Hawkins, Jr.
President, Institute for
Contemporary Studies

San Francisco, California
August 1988

Foreword

Jerry Jenkins

This volume is the initial publication resulting from a series of seminars introduced by Sequoia Institute in 1987 and expected to conclude in 1991. The series, whose theme is *INCLUDING THE EXCLUDED: Extending the Benefits of Development*, has two objectives:

a) to shed new light on critical issues of Third World development and economic assistance, and

b) to serve as a catalyst for a new generation of thinkers and ideas that will accelerate the inclusion of *all* people in the process of individual and societal development.

The first seminar convened in Washington, D.C., on May 20, 1987, to address the subject of "Policy Reform and Equity." This book represents the papers prepared for that event and the intensive discussions they generated. The message of this volume is complemented by that of the second seminar, five months later, which

considered "The Informal Sector and Growth in LDCs." These two books are ideally suited for introducing and illustrating the theme of this series.

The initial seminars established that growth and a more equitable income distribution are inseparable issues. They also revealed that exercise of a country's full range of talent and energy often is inhibited by institutions and policies that ensure decidedly unequal opportunities for many. These circumstances prevent the skills and efforts of unfavored elements in the population from contributing to national development. Such exclusions are clearly inequitable, and make for inefficiencies which retard economic growth.

The attainment of policy reform *and* increased equity is as difficult as it is important. Accomplishment of these twin aims by nonviolent means appears to *require* economic growth. But before the reforms most conducive to growth are accepted, a sizable number of decision makers must perceive the reforms as being more likely than not to accelerate development.

Adoption of *equity-enhancing* policies also requires decision makers to conclude that their personal economic well-being will be greater in the post-reform environment than it would be given continuation of the status quo or implementation of *equity-diminishing* policy changes.

The fundamental challenge addressed in this volume, and throughout the series, is that of ascertaining how best to obtain agreement among the many individuals who must design and implement equity-enhancing policy reforms—especially among those who perceive themselves as having the most to lose from any change in the status quo.

Our goal is to enhance prospects for individuals, throughout the Third World, to develop themselves in accordance with their respective preferences. Development of a society cannot occur without development of its constituent parts.

Much of the material in this volume, and in those following, emphasizes the merit of individual enterprise as an alternative to the dictates of political control. This view does not ignore the essential role public policy must play in creating and preserving institutions

needed for enterprise to thrive. But it does reflect a conviction, based on a substantial body of evidence, that private initiative, stimulated by competitive processes and freedom of choice, provides a proven mechanism to harness talent and energy. Recent stirrings in the Soviet Union and Communist China suggest that both this conviction and awareness of the evidence are shared by a very large audience.

Sponsorship of this series by the Agency for International Development (A.I.D.) is an outgrowth of the Agency's policy endeavors during the past several years. The Agency anticipated many of the concerns and problems that increasingly have hindered efforts in LDCs to promote rapid and equitable economic development. Support for these seminars continues a commitment to encouraging the formulation of effective development policy. It also demonstrates an appreciation for the experience of development experts and administrators whose analyses provide the lessons and recommendations considered during these deliberations; and to increase the supply of talent contributing to our understanding of growth issues, approximately ten participants at each seminar are promising scholars who are relatively new to the international development field by virtue of their youth or the concentration of their previous scholarship on other subject matter.

Ironically, this series originated with the candid recognition that success of A.I.D. must ultimately be measured by the Agency's declining importance as countries receiving assistance from A.I.D. strengthen their economies and develop the capacity for self-sustaining growth. The current Administrator of the Agency, Alan Woods, aspires to this result no less than his predecessor, Peter McPherson.

This seminar series could not have been a success without the cooperation of numerous A.I.D. personnel in planning and conducting these programs. In addition to those individuals whose attendance and commentary helped to make our discussions so worthwhile, Alan Batchelder, Richard E. Bissell, and Dick Derham warrant particular appreciation for their efforts pursuant to the successful launching of this series.

Within the Bureau for Program and Policy Coordination, the A.I.D. technical office most responsible for this endeavor, three

project officers—Edwin L. Hullander, Warren Weinstein and Neal S. Zank—have provided both encouragement and valuable technical assistance to the series since its inception.

We were very fortunate to have Elliot Berg serve as general editor and moderator of the first seminar. For many years he directed the Center for Research on Economic Development at the University of Michigan. He is widely recognized as an outstanding development practitioner as well as scholar; the corresponding demands on his time resulted in the establishment, in 1981, of Elliot Berg Associates. It is the good fortune of the seminar series that its requirements were among those which Dr. Berg chose to fulfill.

Elliot Berg joins me in expressing appreciation to ICS Press and Roger Magyar, our editorial assistant, for their efforts to put this material in finished form. Our appreciation is echoed, at least, by the several authors whose work is represented in these volumes.

Finally, it is appropriate to mention that opinions expressed in this and each succeeding book in the series are not necessarily shared by the Agency for International Development or Sequoia Institute. Apart from this conventional disavowal, it is hoped that readers of these volumes will find much to stimulate their thinking and, ultimately, to help fulfill aspirations throughout the developing world.

Jerry Jenkins
Series Editor

Washington, D.C.
August 1988

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1

Elliot Berg

Introduction

Policy reform is the central theme in the development economics of the 1980s. It absorbs the attentions of practitioners and scholars alike, in industrial countries as well as in less developed countries (LDCs). Policy-based lending has become a major vehicle of economic assistance through the stabilization and structural adjustment programs of the International Monetary Fund (IMF) and World Bank, and the nonproject loans increasingly common among bilateral donors. In the case of the U.S. Agency for International Development, the Economic Support Fund (and since 1987 the African Economic Development Fund) and various food aid programs provide a major part of economic assistance, and almost all of it is related to policy reform.

The policy reform programs that have proliferated in recent years—some 25 countries in Africa alone have adopted formal programs in recent years—are not all the same. Reforms recommended for Mexico cannot fit Mauritania. Nonetheless, there exists

a high degree of similarity in most programs, both in their general orientation and in their specific components.

Yet the policy reform agenda of the 1980s rarely includes such measures as land reform or increased public spending for the satisfaction of basic human needs—the kinds of measures most often associated with "reform" in previous decades. The emphasis is on "liberalization," on the adoption of market-oriented policies and instruments. Four general features characterize this new wave of economic reform.

- More intensive use of private agents: individuals and groups producing goods and services mainly for profit. And, since effective mobilization of private sectors requires a suitable set of material incentives and a good climate for enterprise and investment, reform of the institutional environment is emphasized.
- Encouragement of competitive markets and greater competitiveness of the economy in various fundamental ways: movement toward a more liberal, outward-looking trade regime; closer alignment of domestic prices on international prices; removal of obstacles to entry into occupations and industries; lightening of regulatory systems; maintenance of fair competition between public and private sectors and among private actors.
- The reduced use of subsidies, limiting them to clear cases of market failure or the achievement of high priority national goals, with emphasis on fine targeting.
- On the instrumental side, systematic preference for indirect policy instruments over direct controls: auctions, for example, instead of price controls or administrative allotments.

The specific components of "standard" reform programs are familiar. They usually fall into two categories, with much overlap: improvements in the performance of public sector economic institutions, and macroeconomic and sectoral economic policy measures.

"Institutional" reforms usually include:

- improved tax administration;
- overhauling the public expenditure process, from the accounting framework to the programming of public investment;
- strengthened debt management and foreign exchange allocation;
- simplified schemes of export controls and import licensing;
- rehabilitation of the state-owned enterprise (SOE) sector, involving studies such as systematic management audits and analysis of intra-public-sector debt, plans for strengthening performance of enterprises to remain in the public sector, liquidation of nonviable SOEs and privatization of those that are not central to government's objectives;
- civil service reform, including salary structure review and elimination of redundant employees;
- strengthened rural development agencies, such as extension and research units.

On the policy side, the typical reform program includes:

- macroeconomic measures to reduce fiscal and balance-of-payments deficits such as restraints on public expenditure growth, tighter monetary policy, and adjustment of exchange rates;
- introduction of lower and more uniform tariff structures, and reduction or removal of quantitative restrictions on imports;
- increases in producer prices for export crops and food;
- liberalization of markets with greater roles for private trade, or complete elimination of administered prices with alignment of agricultural and other prices more closely on world prices;
- reduction of price controls generally;
- reduction of subsidies on food, agricultural inputs, higher education, housing, petroleum products, power and telephone;
- divestiture of nonstrategic SOEs; deregulation of transport,

marketing, insurance and other services and free entry into manufacturing.

Other elements of reform programs could be cited, but this list is sufficiently indicative.

The institutional aspects of the reform program are the source of little controversy; they are for the most part basic ingredients of better economic management. It is, of course, otherwise with the macroeconomic and sectoral policy reforms. Two basic criticisms are widely raised: that these market-oriented reforms will not work because they are ill-designed to bring adjustment and growth, and secondly, that even if they bring faster growth, it will not be growth with equity.

Whether the liberalizing reform packages will work or not is largely an empirical matter, and hard evidence is still sparse. (Whether IMF-style stabilization programs work is a somewhat different issue, which we pass over.) These new-style structural reform programs date, in large part, only from the early 1980s. They are usually implemented slowly and partially. There is always much "static" in the environment, obscuring links between programs and their socioeconomic consequences. And there is always the counterfactual issue: the "effectiveness" or impact of a reform program has to be measured against the results likely from continuation of existing policies or alternative packages. Thus there are only a few unambiguous successes: Chinese agricultural growth under liberalization policies being the most outstanding.

A number of empirical studies have indicated that the more market-oriented economies, those with fewer price distortions, have performed relatively well in recent years.[1] More studies are needed to illuminate these issues, especially detailed case studies. Some are now underway, and should give more empirical content to the debate over the viability and benefits of market processes in LDCs.

The most insistent set of criticisms of liberalizing policy reforms concerns their equity implications, their impact on poverty and income distribution. This is the central issue in this volume. Each of the papers considers one aspect of the reform-equity connection. Charles McLure discusses various links between fiscal policy and

equity. Erik Thorbecke sets out a framework for looking at income distribution effects of agricultural policy reforms. Gary Fields considers various distributional effects of trade and industrial policy, including wage policy. My paper looks at privatization and equity.

Because each of the papers attacks the problem from a somewhat different perspective, and necessarily partially, it may be useful to outline here the main elements of the general argument that "liberalizing" or "market-oriented" policy reforms will tend to bring about more growth and more equity. It is an argument that receives some attention in discussions of IMF programs, and by the World Bank as well, in its consideration of structural adjustment lending and the poor.[2] But it is a muted argument, and rather overshadowed by the more dramatic concerns over the growth in poverty due to negative growth and the impacts of reductions in public expenditure required by stabilization programs.

Arguments for Market-oriented Policy Reform

Market-oriented policy changes will, first of all, lead to faster growth of output (other things equal), and more responsive economic structures in numerous ways. They increase the volume of resources available for investment and service provision by reducing capital flight and attracting new foreign capital; by encouraging greater use of small-scale technologies that use little capital and few educated people (in transport and trade, notably); by inducing people to work harder and drawing out more fully energies that are underutilized or devoted less than optimally to the underground economy; and by attracting new financing for services and new suppliers of these services, through increasing user fees and eliminating regulations which discourage private supply response.

Not only will new resources thus be generated, but resources, existing and new, will be used better. Resources in the public sector will be used more efficiently because of greater focus on priority tasks and because of greater competition from the private sector. This, in turn, will provide a spur to efficiency at the same time that it reduces demand pressures on public sector providers of goods and services.

Productivity in the private sector will be stimulated by competitive pressures, including those that derive from greater import competition.

Third, where private competition is encouraged, with or without a public sector presence, goods and services are likely to be better in quality. This is perhaps clearest in such vital services as export marketing, transport, and retail trade. These are poorly suited to the complex procedures and centralized decision making of large-scale organizations. Competition-augmenting policies and programs widen options to consumers and producers, make monopolistic behavior more transparent and dilute market power, all changes conducive to greater productivity.

Fourth, removal of regulations such as those aimed at regional self- sufficiency, and new reliance on pricing systems that are based on costs, will encourage internal specialization and trade, with productivity-raising effects.

Finally, market-oriented policy reform, and the more active private sector they promote, will encourage the development of entrepreneurial capacities. In the poorest countries, where lack of entrepreneurship is often cited as a critical constraint to faster growth, reform-induced private sector opportunities provide an indispensable training ground for entrepreneurs.

For all these reasons, growth rates are likely to rise and economies become more flexible and dynamic when market-oriented reforms are introduced into systems characterized by extensive administrative regulation of the economy, legally created monopolies and monopsonies, high protection against competition from imports and other policy biases against exports, and much direct state participation in directly productive activities.

Market-oriented Reform and Equity

But will market-driven growth be "equitable?" Will it first of all reduce absolute poverty, i.e., shrink the percentage of families with income below some poverty line? Will it reduce relative poverty, in the sense of producing a more even distribution of income? And finally, will it lead to a widening of access to new opportunities, and

a broadening of existing channels for individual economic and social advancement?

With respect to absolute poverty, some influential writers in the 1970s argued that the poor were not benefitting even from fast growth. This thesis appeared in the much-cited volume, *Redistribution With Growth* (1974), by Hollis Chenery and others, which begins with the assertion: "It is now clear that more than a decade of rapid growth in underdeveloped countries has been of little benefit to perhaps a third of the population."[3] Other writers went even further, stating that development was accompanied by absolute declines in the average income of the very poor.[4]

But these positions are not supported by empirical studies. Indeed the assertions of Chenery and his associates were not supported even by their own data, which showed growth rates in incomes of the poorest 40 percent of households that were higher than rates of growth of population.[5]

Where rapid growth has occurred, absolute poverty has almost always been reduced. The extent of poverty reduction associated with a given growth rate varies according to the initial distribution of assets, economic and political structures, health and education policies, and other factors. Whereas in Korea, Taiwan, and Singapore the annual per capita income growth of the poorest 40 percent has outpaced that of the wealthier percentiles, the reverse seems to be true in some Latin American countries. But even for the Latin American countries, there are to my knowledge no documented cases of sustained rapid growth (say 2 percent per annum per capita) not accompanied by reduction in the number of families living in absolute poverty.[6]

Available indicators of well-being in Latin America show significant improvements during the high growth period from 1960 to the late 1970s. Average life expectancy in the region rose from 56 to 64 years between 1960 and the late 1970s, population with access to drinkable water increased from 40 percent to 66 percent, access to electricity increased similarly, and school enrollment showed rapid increases. As regards income changes for the poorest groups, data availability permits few reliable statements about poverty trends in Latin America

as a whole. But in at least three major countries (Brazil, Mexico, and Colombia) economic growth was accompanied by substantial improvements for the poorer segments of the population.[7]

What constitutes a "substantial reduction" in absolute poverty is, of course, a judgment call. One observer notes that the percentage of Brazilian households below the poverty line declined by over 12 percent between 1960 and 1970, but dismisses this as not substantial.[8]

The discussion thus far has been about the impact of economic growth on absolute poverty. What about its impact on the distribution of income? Market-oriented policies might conceivably strengthen wealthy or other groups disproportionately. There are some analytic or a priori reasons why this might happen. People who are well placed in terms of asset holdings, education, social, ethnic and political contacts and physical location, and individuals who have ability, ambition, energy and good health, luck, and perhaps ruthlessness are likely to capitalize faster and more fully on the unfolding opportunities that market-oriented policies create. There are also, according to some observers, empirical reasons to be concerned. Economic growth appears to have worsened income distribution in some instances. This is most often said to be the case in Latin America, where income and asset ownership are more highly concentrated than anywhere else in the world, and where institutional, cultural, and political factors have been conducive to growth in income inequalities.

Some studies of Latin American countries do demonstrate increasing inequality in income distribution as measured by increasing Gini coefficients—a standard measure of distributional equity—during various periods in the last few decades. This appears to hold for Argentina, Brazil, El Salvador, Mexico, and, possibly, Panama, Peru, and Puerto Rico.[9]

Two separate issues come into play here. One is whether worsened income distribution actually has accompanied economic growth in the Latin American region. As noted above the available data point to an affirmative answer to this question, though their validity is open to question and they are, in any case, often hard to interpret meaningfully.[10]

The second issue of interest is whether market-oriented policies are the source of this putative negative relationship between growth and evenness of income distribution. There the answer is probably no. Critics tend to categorize growth stemming from market-oriented policies under a larger heading such as "capitalistic growth," though in reality it is doubtful whether the policies of most Latin American countries are appropriately described as "market-oriented." One recent inquiry concerned with the causes of inequitable growth concluded that "initial conditions" (mainly, distribution of asset ownership and natural resources) and inappropriate policies (mainly import-substituting industrialization) are the principal factors accounting for internal patterns of income distribution and their worsening over time.[11]

The consequences of liberalizing reforms on income distribution are in any event likely to be different in most of Asia and Africa than in Latin America. In Latin America, agriculture sectors have shrunk. They employ less than 30 percent of the labor force in most of the region; populations are urbanized and in wage employment for the most part. In much of Asia and all of sub-Saharan Africa, on the other hand, 70–90 percent of the population is typically engaged in agriculture; modern-sector wage labor forces are typically only 5–10 percent of the population and manufacturing rarely accounts for more than 10–15 percent of GDP. In these cases, many of the common liberalization reforms tend to favor the poor majority consisting of smallholder farmers. This is so for reforms such as devaluation, removal of administrative and other obstacles to exports, higher producer prices, removal of controls over movements of goods, shifting of some subsidies from university education to primary education, reduction of subsidies to housing, electricity, petroleum products, and others.

In the heavily agricultural LDCs, then, which include the least developed countries, liberalizing reforms tend to shift terms of trade in favor of agricultural majorities and as a result equalize the distribution of income. The magnitude of the impact will depend on many factors, including in particular the structure of the agricultural sector (big vs. small farmers, net sellers vs. net buyers of food, landless

vs. smallholders). In most of sub-Saharan Africa, where landlessness is not widespread, one would expect the distributional results of reform to be more equalizing than in regions where landlessness and/or large-scale farming is more important.

We have thus far been concerned with general relationships between growth and changes in income levels or shares of the poor. But this is only part of the policy reform/equity story. The equity issue has to be looked at also in a disequilibrium context, that of a control-ridden economy suffering from severe distortions. What are the consequences for equity when liberalizing reforms are introduced into such an economy?

A good general answer would require long and complex analysis beyond our possibilities here. One central and important proposition nonetheless seems defensible. In LDCs the disinherited are rarely the main beneficiaries of state controls and interventions. It is the rich and powerful who benefit most. A shift to a more open economy, more competitive markets and prices that are more closely determined by costs is, therefore, usually equity enhancing.

Three factors explain why the poor benefit less from state controls than those who are better off.

- In the general bargaining process that occurs in all political allocations, it is the visible, vocal, potentially mobilizable groups (who are advantaged to begin with) that defend their interests most effectively: urban wage earners, large commercial and industrial interests, civil servants, for example.
- Equal access to subsidized goods and services is extremely difficult to guarantee. Geography (closeness to roads, schools, dispensaries, fair price shops, etc.), class and ethnic differentials in academic performance, limits on fine tuning or targeting of programs because of administrative weaknesses—all lead to unequal benefit sharing from subsidies.
- Controls generate "rents," which are almost invariably garnered by the rich and powerful.

While the negative distributional impacts of subsidies are receiving growing scrutiny, the generation of "rents" or excess profits

resulting from economic controls, has received most attention. In the typical regulated economy, administrative rationing, rather than prices, is employed to allocate scarce goods and services. Administrative controls regulate the movement of goods and factors of production between markets and sectors. Government officials extract profits from the sale of rights to buy and sell particular goods and services. Low-income people rarely purchase these rights, and rarely benefit from the global rents that the market controls generate. They often do benefit from subsidies, but usually less than higher-income people.

By the time reform programs are adopted, especially in severely distorted economies (such as Zaire, Uganda, Ghana, Guinea, Tanzania, Bolivia at various periods in the past), the benefits of prevailing subsidies and controls are more and more concentrated among the relatively well-to-do. Food subsidies are enjoyed mainly by urban wage earners, especially government employees; others pay inflated, free (black) market prices. Subsidized fertilizers go more and more to favored buyers. Subsidized gasoline supplies become wage supplements for civil servants. Because fiscal pressures mount, fewer aggregate resources are available to finance subsidies, and since governments often hesitate to reduce rates of subsidies, the supply shrinks, forcing up the black market prices paid by now-favored buyers. By the time a stabilization/readjustment program is introduced, most people are paying black market prices for subsidized and controlled goods and services. So subsidy reduction and price increases hurt mainly those who benefited from privileged access under the previous economic regime.

The argument that market-oriented or liberalizing policy reforms will tend to increase equity rests, then, on three propositions. First, they will raise economic growth rates and thereby reduce absolute poverty. Second, they will under some conditions also reduce differentials in income distribution ("relative poverty"). This will happen where access to opportunities and, in particular, education and asset ownership are relatively widely distributed. It will also tend to happen in economies that are primarily agricultural; where smallholder farmers are dominant, the liberal reform package tends

to shift terms of trade in favor of agriculture. Finally, many of the classical state interventions—exchange controls, agricultural marketing regulations, subsidized education and health services in the presence of limited budget resources and restrictions on private provision of these services—tend to benefit the rich more than the poor. Their removal or reduction, therefore, will more often than not be equity enhancing.

Many issues raised in these introductory observations will recur in the papers that follow, and in the discussions of those papers. Differences of opinion and interpretation are to be expected. The issues are at once important for policy and analytically contentious, and the empirical basis for analysis and judgment remains thin. This volume, and the seminar on which it is based, is intended to contribute to better understanding of the relationship between policy reform and equity, and to the growing debate on structural adjustment and the poor.

2

Charles E. McLure, Jr.

Fiscal Policy and Equity in Developing Countries

Introduction

Fiscal policy determines the revenue and expenditure programs of governments. The term "equity," as used in this discussion, refers to the fairness of income distribution among citizens of a nation. Though very much a value-laden concept, the demand for equity is one of the most visible and provocative forces on this planet. The role of fiscal activity in enhancing or reducing equity is the subject of this paper.

Tax and expenditure policies adopted by governments of developing nations can have a major impact on equity. That is, the positive and negative consequences of taxes and public spending can significantly change—for better or worse—the distribution of income.

With respect to tax policy, this claim may come as something of a surprise. Studies of tax incidence in many developing countries suggest that tax burden by income classes is usually substantially proportional, rather than markedly progressive or regressive. The

conventional wisdom is that not increasing poverty is the most important contribution tax policy can make to distributional equity.[1] Regrettably, tax laws often do make the poor worse off, and in ways that standard incidence studies commonly do not detect.

With respect to the spending side of the budget, effects of fiscal policy on income distribution are mixed. On the one hand, certain expenditures clearly do improve the lot of the poor while having relatively little impact on the nonpoor (except as they pay taxes needed to finance the outlays). On the other hand, the few studies of public spending's distributional impact reach quite ambiguous conclusions, largely because of uncertainty about how to allocate among income classes the benefits of "general" expenditures (e.g., national defense, justice, general administration, etc.)[2]

In my view, evidence from studies of benefit incidence is largely irrelevant even if we set aside the problem of how to allocate benefits of general expenditures. This is true either because investigators ask the wrong questions or because their analysis is flawed. But this contention, which is supported by an appendix to this paper, is substantially less important than two policy conclusions:

a) much public spending in developing countries induces a less equitable distribution of income, and

b) carefully targeting expenditures can make the poor better off while reducing the costs of public programs.

The remainder of this paper is devoted to elaborating and defending the above propositions. It examines how taxes and expenditures can help achieve equity objectives. And, it considers the extent to which fiscal policies actually *do* serve that end. The paper does not attempt to be comprehensive in its coverage of countries or in its examination of fiscal programs. Its purpose is to present ways of thinking about problems, rather than to distill existing knowledge about problems. At many points it will emphasize a key lesson: effective policy cannot be formulated without careful analysis of its probable effects in a particular country.

Issues Not Raised. This discussion considers the possibility that public spending should be reduced because it is wasteful or increased because unexploited opportunities for productive expenditures exist;

a compensating change in taxes may be possible or required.[3] But the paper ignores consideration of tax increases or spending reductions as means to reduce inflationary pressures resulting from excess aggregate demand. Nor does it contemplate circumstances in which it may be necessary to undertake adjustments of this type to correct overvaluation of the exchange rate.

This is not meant to imply that inflation, overvalued exchange rates, and efforts to deal with them do not have important implications for equity. Indeed, the poor may be among those hardest hit by inflation and by overvaluation of the domestic currency. (See the brief discussion in this section under "Policy Impact" of how overvaluation often hurts the rural poor.) Needless to say, equity is most likely to be preserved or enhanced if increased taxation required for stabilization does not impinge heavily on the poor and if expenditures eliminated in the effort to restore budgetary balance are not those of primary benefit to the poor.

This paper also does not pay much attention to the possibility that higher taxes could lead to greater public saving, thereby making more funds available for public or private investment. Experience suggests that there are many slips between cup and lip in following that prescription.[4] And, in any case, little needs to be said about raising the level of public investment that is not implicit in discussing unexploited opportunities for productive public expenditures.

Structural Adjustment and Equity. A new twist has recently been added to traditional concerns with fiscal policy and equity. Many less developed countries (LDCs) have been forced to make wrenching changes in their investment priorities, consumption patterns, and borrowing habits. These structural adjustments were necessary because external circumstances have changed (e.g., petroleum prices) or because wrong-headed domestic policies (often leading to insupportable levels of foreign indebtedness) have caused disequilibria that must finally be confronted.

For several reasons, the problem of maintaining equity while undertaking structural adjustment is, perhaps, more difficult than the traditional challenge of reconciling economic growth and equity. Dramatic reduction in public employment may be required as part of

structural adjustment; attention must often be focused on increased production of exportable goods and services, rather than those that are consumed domestically; and it may be especially difficult to maintain public expenditures that benefit the poor in a time of budgetary retrenchment.

This distinction between "structural adjustment with equity" and "growth with equity" is somewhat artificial and easily over-drawn. After all, sensible structural adjustment is consistent with the prescription—and may be precisely the medicine—demanded by a traditional diagnosis of fiscal policy and equity. The primary difference is that structural adjustment is frequently mandated by international organizations or as part of bilateral lending agreements; it seldom occurs when advocated by those with no power to make it happen.

Equity Defined. Cryptic references have been made to "equity" in both the title and the text of this paper. It is now time, before proceeding with the substantive discussion, to elaborate on what I mean when I use this word. Needless to say, there are many meaningful and reasonable definitions of this slippery term.

Most writers using the word "equity" seem to have in mind something to do with the vertical (rich vs. poor) distribution of incomes. For example, the most militant egalitarians seem to think of vertical equity as lopping off the top of the income distribution by confiscatory taxation and other means. Others argue that equity means household income cannot fall below a given level (or levels, depending on size and composition of households). Still others believe vertical equity requires progressivity in rates of taxation and a pro-poor emphasis in targeting public expenditures, so that the income distribution (taking into account both taxes and the benefits of public expenditures) is made more equal by public policy. These views are not mutually inconsistent; indeed, some might think vertical equity involves all three of these elements in some combination.

The obvious problem with using these first two definitions of equity as the basis of policy is that doing so would destroy incentives. They imply 100 percent marginal tax rates on all income above the maximum or below the minimum levels of income.[5] Policies of this

type might be acceptable for an economic system in which productive behavior is insensitive to prices. But overwhelming evidence confirms that economic behavior responds to prices: greater rewards inspire greater efforts, and higher prices reduce quantity demanded. In such a world, it is foolish to ignore incentive effects. Adverse effects produced by poorly designed tax policy can so reduce aggregate output as to impoverish the entire nation.

In what follows primary attention will be devoted to improving conditions for the poor. The focus will be on enabling poor families, or their children, to earn a minimum standard of living; means to augment market-determined (earned) incomes will also be considered. A secondary objective will be to introduce a degree of progressivity into the system of taxation. Deliberately levying confiscatory taxes on poor families or high-income individuals is explicitly rejected on incentive grounds.

Equity has horizontal, as well as vertical, dimensions. Horizontal equity is equal treatment of those with similar incomes who are similar in other policy-relevant ways (e.g., family size, age, health).[6] On the tax side, horizontal equity is relatively easy to define, but the vagaries of tax-incidence analysis sometimes make it difficult to know whether horizontal equity is being achieved; the appendix says more about this.

Horizontally equitable tax policy is also reasonably easy to implement where there is a political will to do so, though administrative realities may frustrate implementation even when political opposition does not. It may be virtually impossible, for example, to collect income taxes on taxi drivers and independent professionals, or to tax imputed income from owner-occupied housing.

Horizontal equity is virtually impossible to achieve on the expenditure side of the budget.[7] Most spending that falls outside the "general interest" category benefits specific segments of the population (e.g., parents of school-age children, coffee farmers, viewers of public television, etc.). Those who have no children do not benefit equally from publicly subsidized education expenditures.[8] Existence of special-interest spending financed from general revenues hopelessly complicates the task of attaining horizontal equity.

In principle, it should be possible for governments to finance from general revenues only the portion of education expenditures (or other outlays) producing benefits for society as a whole. The remainder of such spending would be financed by the private beneficiaries who receive the remaining benefits. In practice, this is rarely done. The result is that private benefits of publicly provided services tend to exceed private costs. This potential for private benefits from public spending justifies the concerted and relentless efforts of special interests in LDCs to influence government budget processes.

Publicly financed expenditures that provide benefits primarily to specific households should be kept to a minimum, unless justified by strong vertical equity considerations. In their place, user charges (e.g., bus fares) or benefit taxes (e.g., gasoline taxes for highway construction) may offer an appropriate means for enhancing both equity and efficient resource allocation.

To the extent that a given income class contains both beneficiaries and nonbeneficiaries of public spending, horizontal equity is not realized. The subsidization of higher education, to be discussed under "Expenditure Policy," provides an example. Because benefits are received by families with students, public finance violates horizontal equity between families with and without students. It also violates most notions of vertical equity if children from more affluent families represent a disproportionate fraction of students enrolled in publicly supported institutions.

Targeting Groups. Though my primary concern is with the poor qua poor, and not as members of particular socioeconomic groups, there are good reasons to pay attention to socioeconomic groupings in discussing the alleviation of poverty in LDCs. Some examples, which have important implications for equity, should make this clear.

Important policy initiatives may change terms of trade between urban and rural sectors, two of the most important socioeconomic divisions in many developing countries. When this happens the urban poor may benefit at the expense of the rural poor. (In principle, the terms of trade could shift against the urban poor; in fact, this seems to occur less frequently.)

For administrative reasons, different systems of delivering public services may be feasible in urban and rural settings. These, delivery systems, in turn, may differ in their effectiveness.

To the extent poverty is associated with unemployment, policies that increase employment will directly reduce the incidence of poverty. Selection of sectors to encourage as a way to develop new jobs invariably has socioeconomic implications.

Finally, it may be possible to economize on scarce administrative resources by targeting transfers to segments of the poor population with characteristics that are relatively easy to identify, such as the aged and women who are pregnant or who have small children. There may also be strong social reasons for targeting assistance to these groups. Disincentives caused by such transfers may be weaker for both these groups than would be the case for nonaged males and for childless females. (This cannot be pushed too far: pregnancy and child-bearing are not totally insensitive to economic incentives.)

Underlying Assumptions. This paper embodies a strong conviction that market forces generally do well in assuring the poor a better (or even adequate) standard of living, eventually if not immediately. This view reflects the beliefs that economic development can help the poor and that such development can occur more rapidly if guided by market forces rather than by pervasive government intervention.

More is involved here than appreciation of the static resource-allocation benefits evident in market-driven economies. Self-interested responses to market forces bring forth innovative impulses that lead to greater productivity and more efficient distribution of output.[9] Unfortunately, there is substantial evidence that government efforts to improve the lot of particular groups (not necessarily the poor) systematically result in the aggravation of poverty.[10] To avoid the adverse effects of interventionist policies, efforts to assist the poor should be carefully designed and should interfere with market forces only minimally.

There is little in the realm of public policy that a public finance expert interested in increasing his hegemony cannot fit within the rubric of fiscal policy. For example, land reform, credit policies,

minimum wages, and the pricing of public enterprises can all be conceived and recast in tax policy terms. Unnecessary regulations, bureaucratic red tape, wasted time, and demands for bribery or kickbacks also have undesirable consequences not unlike those of taxation. Of course, import duties and export taxes have economic effects, with revenue raised often being among the least important. Finally, subsidies are just negative taxes, and tax preferences are now commonly called tax expenditures. Though such quasi taxes are considered in the final section, relatively little is said about them because several are addressed in other papers prepared for this seminar.[11]

Policy Impact. Consideration of public policies intended to further equity objectives reinforces two marvelous truths of economic analysis. First, there is no free lunch; scarce goods always have a cost. Taxes and other policies that may be desirable according to one criterion have adverse effects in other dimensions. Second, it is almost always necessary to employ general equilibrium thinking (not necessarily a general equilibrium model!) if one is to determine the adverse indirect consequences of particular policies.

In addition, it is important to keep a third truth in mind: unless you spend a great deal of time in the countryside in an LDC, you are not likely to see the poor by looking out your window. Let me explain.

Developing countries frequently "squeeze" their agriculture sector by distorting the terms of trade between urban and rural sectors. They do this in a variety of ways: through over-valued exchange rates, differential exchange rates for agricultural products, export taxes, controls on the domestic prices of food, and subsidies to imported foodstuffs. Two commonly offered reasons for following these policies are a desire to invest the surplus created by agriculture in the industrial sector and a need to control food prices paid by the urban poor. In the latter case, a concern for distributional equity has often been cited as the underlying justification.

Policies of this type have unfortunate but predictable results. Incentives for agricultural production are destroyed. When no longer able to make a living in agriculture, rural workers migrate to

cities, increasing unemployment, crime, and demands for subsidized food. Exports fall, imports rise, and balance-of-payments problems intensify. This unhappy scenario is one reason many LDCs have been forced to make structural adjustments in their economies; they simply could not afford to continue a policy based on swimming upstream against strong economic forces.

An appreciation of how market signals constructively direct resource allocation and other decisions should have prevented mistakes of this type. Of course, the adverse effects subsidies for imported foods have on domestic food production may be somewhat less obvious than the impact of export taxes on local agriculture. But it does not take a very sophisticated general equilibrium analysis to see how a bad policy designed to aid the urban poor can have disastrous implications for agricultural output, prices, exports, and rural-urban migration.

Though there may be exceptions based on economic conditions in a given country, there is general agreement that eliminating these distortions of the terms of trade between the urban and rural sectors should increase equitable distribution of income in most developing countries. This agreement is a reflection of one simple fact: in most developing countries the poorest families (and most of the poor) live in rural areas. Their plight, however, is frequently overlooked because the urban poor are more visible and more politically explosive. We return to this point in the next section.

Expenditure Policy

The first comment about using expenditure policies to meet equity objectives almost seems unnecessary, except that it is so commonly overlooked in practice: for spending to be cost-effective, benefits of public expenditures must be targeted narrowly and directly to those segments of the population in greatest need. It is worthwhile examining several policies in some detail for the light they shed on the problem.

Two Examples of Improper Targeting. Among the most blatant examples of public spending that is not targeted to the poor

is the subsidization of university education. Generally lacking both the prerequisite schooling and the resources necessary for subsistence while obtaining higher education, the poor receive little benefit from these expenditures. Rather, members of upper-income groups who do have the education and resources necessary to avail themselves of opportunities for higher education reap virtually all the direct benefits of such programs.

Some may argue that public support of higher education is justified because of external benefits resulting from such education, benefits that accrue to society rather than to the student. While in principle this argument may have substance, in fact it is not very convincing. Even if college-educated individuals can be productively employed in a particular LDC, there is little reason to believe that subsidized education produces substantial marginal external benefits. To the extent that university education would be obtained in the absence of public support there are no marginal external benefits and no good justifications for public support. Because upper-income families could—and would—pay the expenses subsidized by government, public expenditures for postsecondary education detract from vertical equity and do not necessarily make the best use of limited public resources.

The problem with higher-education subsidies does not stop there. Once an overeducated group is produced at public expense, there are often irresistible political forces to provide employment commensurate with supposed educational attainment, especially since members of the group are likely to come from families with political power. Because there may be few private opportunities for employment, these pressures are often translated into increased public employment. This is a crucial problem in many poor countries to which we return shortly.

Another example of faulty expenditure targeting involves food programs. Such techniques as price controls and subsidies, even if limited to the most basic foodstuffs, are extremely blunt instruments to use in fighting poverty. Most aid provided by these schemes is likely to be realized by the nonpoor. As benefits of any program are diffused more widely, budgetary costs are greater and fewer resources are available to assist the truly needy.

Even if price controls or food subsidies do not actually impoverish the already poor population of rural areas, as is often the case, they may do relatively little to improve their lot. The impact will depend on whether the rural poor are primarily landless peasants working for wages (as in much of Latin America) or self-sufficient agriculturalists (as in parts of Asia). If the rural poor, commonly the poorest segment of society, consume little purchased food, holding down food prices will not benefit them greatly.

A variety of techniques can assure that public assistance is targeted to those in greatest need; unfortunately none is without difficulties. In-kind distribution of foodstuffs to the aged, pregnant women, women with small children, and the handicapped has been used for this purpose. This task is often complicated by the administrative difficulties of identifying the poor and limiting benefits to them. Similarly, in many developing countries, it is easy to know that on equity grounds (and probably on efficiency grounds) basic primary education should receive public support, that university education should have low priority, and that provision of free public education is more likely to reach those in greatest need than is subsidization of private education. But beyond these policies, it becomes more difficult to discriminate between the poor and the not-so-poor.

These examples of improper expenditure targeting point out clearly why one must not attempt to help the poor without resort to statistical analysis. Such analysis may reveal, for example, that the poorest families: live in the country rather than in the city, seldom consume purchased foodstuffs, and almost never send their children to a university.

Need for Benefit Finance. In addition to directing expenditures to those most in need, governments of LDCs should consider the merits of greater reliance on payments by beneficiaries of services received. This, in turn, may have important implications for institutional arrangements in developing countries.

If those who utilize public services do not pay the full cost of providing those services, someone else must do so. To the extent that services are provided for low-income households and financed by taxes on high-income households, a progressive redistribution of

income occurs. The opposite effect is likely when expenditures that benefit urban residents are financed by taxes that burden the inhabitants of rural areas, given the rural-urban disparities in income mentioned earlier. Even if this does not worsen the distribution of income, one must question the horizontal equity of using revenues raised in rural areas to provide services in urban areas.

One obvious solution to this problem is to rely more on user charges and benefit taxes for financing public services. It is particularly inappropriate when high-income consumers of public utilities (especially telephone) are subsidized by low-income households. Similarly, users of air transport facilities should be expected to pay their own way.

User charges and benefit-related taxes cannot finance all public expenditures; after all, if the use of market prices were feasible, such services would probably be privately provided. (But one should avoid assuming all public sector outlays purchase genuine public goods. Political influence frequently succeeds in making government the public provider of private advantage.) Where they are feasible, though, user charges and benefit taxes can be a reliable means of increasing both horizontal and vertical equity and improving resource allocation.

Hidden Inequities of Public Employment. A sizeable portion of what appears as public employment in the budgets of developing countries might more accurately be seen as transfer payments to employees, rather than as services provided to citizens. This does not necessarily worsen the distribution of income.

At one extreme, income that would otherwise flow entirely to high-income individuals employed in the private economy or in productive government activities is simply shared with unproductive government employees. Though one might worry about the inefficiency of such a de facto transfer system masquerading as public employment, it can be argued that an equity objective is being furthered. A view of this phenomenon which I find overly generous is that public employment is the LDC equivalent of a negative income tax or other far-reaching transfer system.

At the other extreme, unnecessarily heavy taxes are imposed on poor citizens to provide for highly paid government employees

doing little or no productive work. Neither equity nor efficiency is furthered by this state of affairs. I suspect the more common pattern involves elements of both these extremes.

To see how bad this problem can be, it is instructive to review African experience. The fraction of public expenditures devoted to salaries in much of Africa is roughly twice the proportion spent in the world as a whole. A qualitative difference of this type might not be unexpected, given the abundance of cheap labor in these countries. But civil servant salaries in Africa are also exceptionally high, in comparison with per capita income. In 1964–65 this ratio was 82 to 1 in Kenya, 96 to 1 in Tanzania, and 130 to 1 in Nigeria, compared to 6 or 7 to 1 in the United States. "As a result of high salaries, bureaucrats not only appropriated a high percentage of the state's resources but also ignored the avowed claim of equality inherent in African socialism."[12]

A bare-bones analysis of expenditure policy and equity would determine whether various types of public sector employees are productively occupied and whether their compensation is appropriate for their productivity. Military forces should not be excluded from this analysis; indeed, they may be among the most costly parasites of all.

When either public employment or wages are artificially high, it is important to say so. It is also necessary to determine whether equity is furthered by such a policy.[13] An alternative approach for involving a closer relationship among employment, wages, and productivity in the public sector could prove to be a more appropriate way to redistribute income.[14] Such an analysis may bring us to the heart of the issue, and to the reason public sector payrolls are bloated in many LDCs. I suspect the answer is already available in the traditional literature of public choice: rent seeking by those with influence.[15]

Role of Institutional Change. The discussion of expenditures and equity has considered how policies might be revised to improve equity and resource allocation without specifying how such changes might be achieved. One thing is clear: it may be necessary to alter the institutional structure of government.

Institutional change can produce greater correspondence between benefits received and taxes paid. Whenever public services are

financed through the national budget, there is a high probability of a transfer of real income from the rural sector to the urban sector, given the concentration of services in urban areas. If, however, the provision of urban public services—including their finance—is the responsibility of local government, there is a greater likelihood that taxes will fall on those who benefit from the public services, rather than on poor households in rural areas that do not share benefits. The achievement of this objective may require devolution of both responsibilities for expenditures and financial instruments to lower levels of government.[16] This, in turn, may require decentralization of government.

Existing institutions may not be sufficiently responsive to needs of the people, especially poor people. Governments that are decentralized are likely to be more responsive than centralized ones. Moreover, even quasi-governmental agencies may be superior to governmental ones under certain circumstances. Rules should allow institutional flexibility and should facilitate, rather than prohibit, new approaches.

Experience in developing countries teaches that mere access to public services is an important determinant of the distributional implications of such services. In many cases citizens (including the poor) are willing and able to purchase additional public services, but lack the opportunity to do so. Existing governmental structures may not be able to provide services desired by the poor either for institutional reasons (such as legal restrictions imposed from above) or because those in power have little interest in cooperating, even when the poor bear the cost. In such circumstances it may be possible to employ new governmental or quasi-governmental institutions for this purpose.

An example is the use of what has been called "betterment levies" in South Korea and "valorization" in Colombia. These schemes enable citizens to provide certain public services by dividing the expenses among themselves. While there may be some grumbling about the way such expenses are divided, there is often enough surplus inherent in provision of a badly needed service that even the grumblers go along because they are better off than without the service.

There are good reasons to believe that public employment is generally excessive in developing countries. It would be beneficial to adopt institutional changes that restrain or even reverse this tendency. Particularly important in this respect is the need to reduce reliance on parastatal enterprises in favor of private undertakings.[17]

Finally, it is important to be more realistic—and less optimistic—about what governments can achieve. There is much reason to expect—and much validity to charges—that governments are inefficient producers of many goods and services. Rather than asking them to do too much, and then looking for the waste, fraud, and abuse that is inevitable, we should ask them to do less. Besides reducing the burden of taxation, this will unleash the forces of individual enterprise and competitive efficiency.

Tax Policy

I am going to say relatively little about tax policy as it relates to equity. This is because the primary equity objective of tax policy is to avoid making the poor worse off.

The equity issues on which tax economists spend most of their time, those resulting from use of income taxes, are likely to be relevant only for a relatively small portion of the population in most developing countries. Most of what appears in this section concerns what I call quasi taxes and often ignored aspects of tax policy. This discussion leads directly to the three other papers prepared for this seminar which are devoted to trade and industrial policy, agricultural policy, and privatization. A full discussion of these issues is not possible, but a few points will be noted in the last part of this section.

Excess Burdens and Quasi Taxes. It is customary to examine the tax burden in various countries by comparing tax collections to Gross Domestic Product (GDP) or some other measure of national output. That this is the common basis of comparison is not surprising; these measures represent the only data available in many countries. What is seldom realized is that such a comparison generally understates the burden imposed by taxes and other instruments that have effects similar to those of taxes. The understatement occurs

for at least three reasons: the excess burden of taxation is ignored, tax burdens that go hand-in-hand with subsidies may be understated, and nontax policies that have effects similar to those of taxes are not included. These are examined in turn.

Excess Burden. Economists have long realized that taxes usually impose costs on society that exceed the amount of revenue collected.[18] Taxes do not just reduce disposable income; they also diminish the motivation for earning income by reducing the reward for effort exerted. Likewise, taxes do not just increase the price of a product or service; they also inhibit consumption by increasing costs. Unless both supply and demand are totally unresponsive to price, "excess burdens" result because production and consumption choices are distorted by taxation.

A more realistic measure of the impact of taxation would include these excess burdens. In fact, this is hardly ever done. Because excess burdens increase dramatically as tax rates increase (i.e., with the square of the tax wedge between before-tax and after-tax product prices or factor returns), large distortions in economic behavior are possible. Recent estimates for the United States suggest that excess burden may be as much 35 cents for each dollar of additional revenue collected.[19]

Taxes and Subsidies. The mischief done by tax policy in undermining both distributional equity and allocative efficiency is also understated for yet another reason. This can be illustrated by reference to import duties.

Standard incidence analysis attributes revenues from import duties to consumers of the dutied items, in much the same way as revenues from general and selective sales taxes are identified with purchasers. Where protective tariffs encourage substitution of higher-cost domestic production for lower-cost imports, the results can be quite misleading. The folly of this approach is easily seen in the case of a tariff high enough to choke off all imports. Because no revenue is raised, no tax burden is imputed to consumers. Yet consumers may indeed experience a substantial burden as domestic prices exceed the prices at which imports would be available.

The conceptually correct methodology for treating such protective tariffs would be to analyze them as a sales tax on consumption

of the goods (whether imported or domestically produced) and a subsidy for domestic production of the goods in question. Such a methodology would reveal that in many cases consumers do pay a high quasi tax, the proceeds of which are reflected in higher factor payments in the protected sector. Further careful analysis would be required to determine the incidence of this quasi subsidy among labor, land, capital, and entrepreneurship.

Though the results will differ from country to country and across industries, there is a strong presumption that protective tariffs increase economic rents of either capital or labor employed in the protected sector. Where this is true, horizontal and vertical equity will be reduced. Unfortunately, standard incidence analysis does not reveal the true nature of benefits and burdens flowing from a protective trade policy.

Nontax Policies. Many nontax policies followed by developing countries have effects on income distribution and allocative efficiency quite similar to those of taxes. Yet these effects are seldom considered in studies of taxation and its impact on the economy. The most obvious of these, the pricing policy of public enterprises, is worth considering in some detail.

Prices charged by public enterprises often have much in common with the import duties just described. Consumers pay higher prices than necessary because of the monopoly position of state enterprises; these inflated charges should be seen as a quasi tax on consumption. If monopoly pricing enables the public enterprise to earn a profit, it is appropriate to analyze said profit as a tax using standard incidence methodology. But taxlike consequences of the pricing policies of state enterprises are virtually never considered in incidence analysis.

The more common experience is that profits resulting from excessive prices are frittered away in inefficiency and higher wages for those employed by the public enterprise. As in the case of protective tariffs, economic rents are likely to result, equity is not likely to improve, and standard incidence analysis is misleading.

It should be stressed that public enterprise pricing is only the tip of the quasi-tax iceberg. Other important examples include credit policies that effectively tax savers and subsidize borrowers, minimum wages that tax employers and subsidize workers, price controls that

tax producers and subsidize consumers, unnecessary regulations that tax production and provide employment for participants in the regulatory process, etc. Space does not allow an adequate exposition of how policies such as these should be analyzed in order to gain an understanding of their taxlike effects. But it must be emphasized that any analysis of tax policy which omits the effects of these quasi taxes is incomplete and may be misleading. In particular, conventional figures on tax collections as a percentage of GDP substantially understate the true impact of taxes and quasi taxes on income distribution and allocative efficiency.

Policy Implications. An appreciation of the problems discussed in this section would have a salutary effect. It might give pause to those who call for higher taxes and spending after arguing that the present burden of taxes is low relative to national output. If policymakers realize that citizens often bear burdens greatly in excess of the revenues governments receive, the demand for increased taxes may be reduced. Perhaps more important, quantifying the effects discussed here should also reduce demands for increased government intervention in the economy; indeed, greater appreciation of the taxlike effects of nontax policies might even lead to the reversal of interventionist policies.

Other Tax Issues. There may be a tendency to believe that tax policy will not make the poor worse off if such items as food and medicine are not covered by indirect taxes. In fact, this is far from true. The most obvious examples of how taxes can further impoverish the poor have already been mentioned in the discussion of policies that squeeze the rural sector in order to make resources available to the modern sector or to hold down costs of food consumption in urban areas. These points will not be discussed here because agricultural policies are the subject of a separate paper. I would simply reemphasize that taxing the rural poor in order to benefit the urban poor is unlikely to achieve greater equity.

Sumptuary Taxes. Conventional wisdom concerning sales tax suggests using information from household budget surveys for determining which goods and services should be exempt from taxation to alleviate regressivity. Moreover, it emphasizes that services

should generally be included in the tax base to the extent feasible, since their consumption is likely to be income elastic (as income increases, consumption of services increase even more rapidly).

I believe—and this is not conventional wisdom—that reduced reliance should be placed on sumptuary taxation of alcoholic beverages, tobacco products, and gambling.[20] I am not persuaded by "external cost" arguments that these items should be taxed to reduce consumption and, thereby, decrease costs to society which result from that consumption but are not paid by the consumers. Nor do I think "external cost" concerns motivate the taxation of such activities; taxation is prompted by a desire for revenue. If reducing social costs were the objective, it would make more sense to prohibit advertising of these activities, rather than taxing them; failing that, a heavy tax could be placed on advertising expenditures.

A stronger argument in favor of taxing alcohol, tobacco, and gambling might be found in the literature of optimal taxation; because demand for these activities seems to be relatively price inelastic (consumers are not greatly dissuaded by higher prices), they are more reliable revenue sources than are goods and services for which demand is more elastic. While this argument clearly has merit, it neglects the implications such a policy has for both horizontal and vertical equity. Sumptuary taxes of this type create substantial differences in tax burdens experienced by families that do and do not consume the taxed item. Moreover, these taxes tend to be quite regressive.

Income Taxes. I believe that too much effort has been made over years to incorporate in the tax systems of developing countries notions of tax equity that are more appropriate for developed countries with superior administrative capabilities. For example, in the name of equity the typical income tax of a developing country attempts to differentiate among taxpayers based on number of dependents and allowable deductions for various personal expenditures. This is done even though there is generally no effective means of policing the accuracy of exemption claims or the eligibility for other deductions. Such a system imposes a tax on honesty and breeds contempt for both fiscal authorities and honest taxpayers. It may even undermine general respect for the law. Moreover, the existence

of these allowances diverts scarce administrative talent away from more important income tax issues.

I believe that it would be far better to have less differentiation among taxpayers. A tax system that actually achieves rough justice is better than one that attempts to implement a more refined and theoretical concept of equity but realizes only inequity because of administrative difficulties.

Even worse than deductions that can be justified on a theoretical level are those that, even in principle, detract from the equity and neutrality of taxation. Prominent examples in many developing countries are deductions and credits for home mortgage interest and educational expenses. Such allowances subsidize the deductible spending. We have already seen in the discussion of expenditure policy that subsidies for university education are unlikely to contribute to equity. Outlays encouraged by the income tax system are even less likely to have a positive effect on equity, both because they benefit only the minority of the population that is subject to income taxation and because (at least in the case of deductions) the value of such allowances depends on the marginal tax rate of the taxpayer.

It seems likely that the highly graduated income tax rates found in many developing countries were imported from developed countries. Developed countries are now realizing the folly of highly progressive rates and are moving to broaden the tax base and reduce rates. Developing countries should follow suit; high rates create disincentives and distortions and foster capital flight.

Tax Incentives. Many developing countries provide special tax incentives for investments in specific industries or regions. The ostensible purpose is development of the country as a whole, of industries thought to be particularly important for development, or of low-income areas. In general, such incentives constitute ineffective policy. Even when this is not inherently the case, incentives are often not well structured.

There is little reason to believe that governments can do better than markets in determining which activities are most conducive to economic development of a country. There is thus little reason to believe that tax incentives targeted to particular industries are appropriate. Too often they encourage uneconomic investment of

resources in an effort to swim against the forces of comparative advantage. Their primary benefits are probably realized by those whose incomes are higher because of the tax subsidies.

To some extent the same can be said about incentives intended to spur the development of poor regions. But at least one might make an equity argument that it is appropriate to channel private funds into investment in low-income areas. Unfortunately, most incentives for investment in poor regions are exactly that: incentives for *investment*, not employment. This is anomalous, since lack of employment opportunities, rather than insufficient investment, per se, is the basic problem. Incentives for investment are frequently less effective for increasing employment and income than are incentives based on employment or wages.[21] Moreover, investment incentives appear more likely to result in an increase in economic rents.

Investment incentives often are plagued by administrative problems that increase their cost, reduce their effectiveness, and produce inequities. First, there is a tendency to devote few administrative resources to policing investment incentives. After all, if little or no revenue is to be realized, the reasoning goes, why bother to devote administrative resources to investment incentives? This attitude leads to a multitude of abuses. Related firms involved in both incentive and nonincentive production may manipulate transfer pricing to overstate profits in the incentive activity and understate earnings in the activity that is subject to tax. Preventing abuses of this type can soak up inordinate amounts of administrative resources because it requires domestic tax administration to contend with the kind of transfer-pricing problems that plague fiscal authorities who deal with multinational corporations.

Income Vs. Consumption Taxes. One of the most intriguing debates currently raging in academic circles and occasionally spilling over into the policy arena concerns choosing between income and consumption as the basis for personal taxation. Whereas an income tax (in theory) is applied to all income, a consumption-based tax is levied only on income that is consumed; income that is saved is not subject to tax. An alternative way to look at a consumption-based tax is to see it as one that excludes income from capital, that is, a tax levied only on labor income.[22]

Given that both income from capital and the amount devoted to saving represent a rising percentage of income as income rises, a consumption-based tax is less progressive than an income-based tax for a given rate structure. This apparent defect on equity grounds can, however, be offset by a proper change in the pattern of graduated rates. Moreover, it can be argued that a consumption-based tax that includes both interpersonal transfers (gifts and bequests) received and those made to others in the tax base provides a measure of ability to pay (lifetime income) that is superior to the measure commonly used (annual income). In that view such a tax cannot be faulted on vertical equity grounds.[23] Horizontal equity is also likely to be increased by a shift from the typical income tax, which is riddled with loopholes in the taxation of income from capital, to a tax that explicitly exempts all saving or all income from capital.

A consumption-based tax may also be more conducive to saving than is an income tax, although I suspect that the difference is not significant. Much more important are the administrative advantages of the consumed-income tax. Under such a tax no adjustment is necessary for inflation in the measurement of income and timing issues largely disappear. (Timing issues include not only such obvious questions as the time pattern of allowances for depreciation, depletion, and amortization; but also when to recognize income from production spanning several years and the treatment of self-constructed assets.) By comparison, inflation and timing are extremely important under an income tax.[24]

Failure to allow for inflation in the measurement of income can create substantial inequities, as well as distortions in resource allocation; but providing inflation adjustment adds considerable complexity to income taxation. Similarly, unless complex timing issues are treated satisfactorily, the base of an income tax is not truly economic income; as a result, equity and neutrality suffer.

A final warning must be noted. It is essential to choose between the income and consumption models of taxation, rather than adopting components of both, as is common. We have noted above (and demonstrated in note 22) that consumption-based taxation is equivalent to exempting business and capital income from tax; expensing of capital assets and disallowance of deductions for interest expense

are common elements of a prominent consumption-tax proposal. Combining expensing (or even extremely generous capital-consumption allowances) with full deduction of interest expense—a component of income taxation—produces negative marginal effective tax rates. This means that investments that would be unprofitable in the absence of taxation may be made attractive by such a "hybrid" tax regime.

Summary. In summary, equity as well as efficiency is likely to suffer from misguided tax policies such as import duties, investment incentives, taxes on agriculture, and quasi taxes that are reflected in the prices of monopolistic state enterprises. This suggests that if tax policy is not to make the poor worse off, it should be applied in a neutral fashion, rather than in a discriminatory manner that protects or subsidizes privileged groups in selected industries. Beyond that, the basic objective in income-tax reform should be a system that achieves the goal of rough justice, rather than a more refined system that fails for administrative reasons to achieve a level of equity that may be conceptually preferable. Because of its administrative advantages, a consumption-based system of direct taxation may be preferable to an income-based system.

Appendix: Selected Comments on Incidence Analysis

This appendix discusses a few major issues in the theory and methodology of incidence analysis. Though it covers both the tax and expenditure sides of the budget, it has more to say about the expenditure side, where thinking is less well developed and generally substantially fuzzier.[A1] As with the text, the purpose is to raise questions, rather than answer them. There is no attempt to be exhaustive.

Both policymakers and economists have a natural inclination to want to know how budget policy affects the distribution of income. As a result, studies of tax incidence have been completed for many countries, and a substantial number of countries have benefited from several such studies.[A2] Less common are attempts to determine how the distribution of real income is affected by the expenditure side of

the budget.[A3] The validity of such tax or spending analyses is questionable at best. This appendix raises some questions that are often handled incorrectly, or at least inadequately, in such studies.

What is the Question? The typical study of tax incidence begins with an estimate of the distribution of income. Ideally data are available on the distribution by households, but in many countries income data are collected only for incomes of individuals who are economically active.[A4] Taxes are then attributed to the various income classes, depending on the distribution of factor ownership and consumption across income classes. Such an exercise indicates the fraction of pretax income taken in taxes at various income levels (the effective or average tax rate); some analysts also estimate how taxation changes Lorenz curves and the Gini coefficient. A similar exercise on the expenditure side of the budget attributes the benefits of public spending across income brackets, based on the distribution of beneficiaries of such expenditures.

The thorniest questions of tax incidence involve taxes on capital and income derived therefrom. (The standard way of treating import duties is subject to such shortcomings that this issue is discussed in the text, rather than this appendix.) Even in a closed-economy context, the incidence of the corporation income tax and other taxes on capital is the subject of considerable controversy. The view that the tax is borne by shareholders has been replaced (except in short-run analyses) by the theory that the tax is borne by all recipients of income from capital. The result is almost certainly different in a small open economy facing a totally elastic supply of capital. In that case we would expect incidence to fall on domestic labor, land, and perhaps consumers, and not on capital. Of course, most real-world countries fall somewhere between the two extremes of completely open and completely closed, further complicating the matter.[A5] It seems likely, however, that most LDCs fall near the "open" end of the spectrum.

The incidence of taxes levied on a multinational corporation operating in a developing country may depend critically on how such taxes are treated by the home countries from which the LDC in question imports capital. For example, to the extent that the average

tax rate paid to a developing country importing capital from the United States falls below the average U.S. tax rate paid by the multinational corporation, the incidence of taxation may fall on the U.S. Treasury Department, rather than on either the American multinational or residents of the taxing nation. The need to take account of the sources of foreign investment and the tax treatment of foreign-source income in the various capital exporting countries (foreign tax credits, tax sparing, exclusion of foreign-source income, deduction for foreign taxes, etc.) can add considerable complexity to the task of the careful analyst.

Even if problems such as these did not plague the analysis of tax incidence, interpreting the results of such analysis would by no means be straightforward.[A6] It has long been commonplace to observe that because income fluctuates from year to year for various reasons, the distribution of income in a given year is substantially less equal than is the distribution of "permanent" income.[A7] Thus the socially perceived "need" to reduce inequality is likely to be less than suggested by figures on income distribution for a given year. Moreover, the regressivity of taxation is likely to be overstated (and progressivity to be understated) for similar reasons. This is most easily seen in the case of taxes on consumption, which are commonly allocated among income classes on the basis of estimated consumption expenditures. It is not uncommon for reported consumption in the lowest income brackets in developing countries to exceed reported income. One presumes, of course, that part of the explanation is that households with temporarily low income are drawing down savings or borrowing. Since permanent income is difficult to know, or even to estimate, an attempt is sometimes made to overcome this problem by using consumption, rather than income, as the parameter according to which households are classified.

It is common to note in studies of this type that there are two types of public services, those that can be attributed with little difficulty to particular groups of beneficiaries and those for which such attribution is difficult, if not impossible. Typical examples of the former category would be housing, education, and health services. Among services that are difficult to attribute to specific beneficiaries are the costs of general government and national defense. Though substantial

thought has been devoted to constructing a suitable methodology for dealing with this second category of services, it is probably safe to say that a satisfactory resolution has not been reached.[A8] This is unfortunate, since the answer to that question is likely to swamp the distributional effects of services providing specific benefits.

More than a decade ago an even more fundamental problem of benefit and expenditure incidence was identified. Bird, DeWulf, and McLure, among others, have argued that the entire exercise may be futile.[A9] At the very least, one must ask whether it makes sense to "think away" the entire government, as in the standard conceptual experiment on which incidence studies are based. For one thing, even the most elaborate general equilibrium framework may not adequately capture the effects of such far-reaching changes. The partial equilibrium thinking underlying most attempts to quantify tax incidence is likely to fall even further short of the mark.

The implications of thinking away the entire government are particularly disturbing on the expenditure side.[A10] Would anarchy reign in the absence of government? If so, simply attributing the costs of general government among income classes seems quite inadequate, however the attribution is made. The conceptual experiment is equally difficult in such cases as health, education, and national defense, especially if we consider the analysis for a particular year as being representative of a pattern of expenditures reaching into the past. If failure to make these public expenditures would have resulted in widespread smallpox, polio, and illiteracy, and perhaps even foreign domination, it does not seem appropriate simply to attribute to income classes the amount of taxes paid and the cost of providing health care, education, and national defense, implicitly assuming that private incomes would have been the same with or without government.

There is also little policy relevance to a conceptual experiment in which the "counterfactual" is the absence of government. After all, no responsible person in any country in the world would suggest seriously that the absence of government is a real alternative. Nor are many likely to suggest seriously that the size of government be doubled. What is important is how changes in budgetary policy would affect the distribution of real after-tax income, including the

benefits of public services. Focusing on the distribution of costs and benefits of marginal changes in taxes and expenditures is, of course, quite relevant. Moreover, such a focus encounters fewer conceptual and methodological problems than assuming away the entire government. To be done correctly, analysis of this type should focus on details of particular programs and particular means of financing government, rather than taking a broad-brush view of all government, with little attention to detail.

Factor Incomes and Transfers. One reason mistakes are made in assessing the distributional consequences of the expenditure side of the budget is that analysts do not consider the distinction between benefit incidence and expenditure incidence.[A11] Though there may be cases in which this distinction becomes fuzzy, it is quite clear in the following extreme case.

Suppose that the government either buys bread in competitive markets or buys bread-making facilities and hires the employees necessary to bake bread in public ovens. (The discussion that follows generally will not focus on the differences in these two approaches; they are probably less important than the similarities.) In either event government makes bread available to all residents of the country on an equal basis (that is, one loaf per person per week). It would clearly seem appropriate to attribute the benefits of this program across income classes on a per capita basis; this is the incidence of the benefits of the public expenditure.

Because the baking of bread can probably be accurately described as a constant-cost activity whose inputs are available in highly elastic supply, at least in the long run, this program is unlikely to affect significantly factor payments received for the provision of goods and services. In other words, its long-run *expenditure* incidence would be neutral.[A12] (Of course, in the short run this scheme might very well have a quite different effect on the distribution of private income. Many bakers and private distributors of bread might be put out of business if the government followed the public ovens option. But to the extent that employees of such firms could be reemployed by the government and bakers are absorbed into other sectors of the private economy, expenditure incidence would again be neutral.)

This example helps to clarify the distinction between benefit and expenditure incidence. If the government acquires bread (or the resources necessary to produce bread), it may induce changes in the distribution of income available for private use; these effects are what we call expenditure incidence. Then the government provides the bread to households. The distribution of the benefits of bread across income categories we call benefit incidence.

Transfer payments essentially have only benefit incidence. That is, the transfer provides benefits directly to the recipient, but to no one else.[A13] Since nothing is being purchased, the transfer payment has no other effect on the distribution of income available for private use. Under certain circumstances the incidence of transfers can usefully be examined by considering them to be negative taxes. By comparison, the public provision of goods and services inevitably involves benefit incidence, but whether expenditure incidence is important depends on the extent to which public demand differs from private demand and how such differences in demand affect relative prices (see McLure, 1971).

Two implicit assumptions seem to underlie most estimates of the distributional effects of the expenditure side of the budget: that transfer payments benefit the recipients of transfers, and no one else; and, by comparison, that payments made for the purchase of factor services by governments produce benefits that must be attributed to beneficiaries, but provide no benefits to the recipients of factor incomes per se. Though subject to many qualifications, this does not seem to be a bad place to start, at least for an efficient government that is responsive to the needs of its citizens. But blind adoption of this methodology, particularly in conjunction with conventions borrowed from national income accounting, can lead to quite misleading conclusions. Several potentially important examples indicate the nature of the problem and the type of research that is needed if error is to be avoided.

It seems safe to say that the civil service in most developing countries is substantially larger than needed to provide the services actually being provided. Moreover, many civil servants may be paid much more than would be necessary to attract them from private sector jobs. To the extent that this is true, it is inappropriate to

attempt to assign the entire cost of government to beneficiaries of public services. It would be more appropriate to view part of the wages and salaries for redundant and overpaid civil servants as transfer payments and treat them accordingly for analytical purposes, that is, to assign their benefits to the employees themselves. Similarly, the proper treatment of expenditures on the armed forces depends crucially on whether the military is actually protecting against an external threat (or an internal threat such as drug traffickers), only propping up an unpopular government, or merely acting as an employer of last resort. In none of these cases is it obvious how best to allocate the cost of what is commonly called "national defense." But certainly in the last two cases treating it as a cost of defending the country is, by assumption, wrong.

The mention of military personnel raises yet another issue. Leaving aside the problem just described (that is, assuming the armed forces actually provide a useful service), it is important to know whether military personnel are conscripted or hired in the labor markets and paid a competitive wage. In the former situation, the budgetary cost of national defense understates the real cost, and the implicit tax paid by draftees is ignored. An incidence study intended to reveal the true cost of government and its distribution across income classes would take this into account. Much the same can be said of the quasi tax inherent in forced loans to governments.

The benefits of interest payments on the public debt are commonly attributed to recipients of the payments.[A14] This approach has little to recommend it, since other factor incomes (e.g., wages and rents) paid by the public sector are not treated in the same way. Indeed, mobile capital may earn less economic rents than do many public employees. It would be better to treat interest expense as the factor payment it is, no matter how difficult it is to allocate across income classes the benefits of incurring such expenses.

Even the proposition that the benefits of transfer payments should be attributed to recipients is not valid without careful qualification. If pensions are paid to retirees without regard to earlier contributions and financed by general taxes unrelated to the expectation of future benefits, it is appropriate to analyze incidence of the pension tax in the standard way and to attribute pension benefits to those receiving

them. (Even then, there is an issue of when to make the attribution of benefits: as they accrue or as they are realized.)

But suppose that social security is an actuarially fair deal in which current employees make contributions equal in present value to the expected present value of future benefits. In this situation it seems quite inappropriate to treat social security contributions as normal taxes and to treat the corresponding pensions as transfer payments. By assumption, the program in question has more in common with private insurance than with other taxes and transfers. This pension plan differs from (for example) buying postage stamps primarily because contributions are made at one point in time and benefits are received at another. In other respects, they are private goods and services.

Payments of veterans' benefits raises a similar issue of interpretation. One interpretation treats such benefits as transfer payments; therefore, only the veterans benefit. A different interpretation would consider the provision of veterans' benefits to be part of the cost of national defense, with benefit and expenditure incidence to be allocated accordingly. Under this view veterans would not be beneficiaries, since (at least in the extreme view) soldiers considered the expected value of such benefits in making their enlistment decision. Of course, given that the magnitude of veterans' benefits is likely to be determined after the fact in the political arena, rather than being a matter of ex ante contractual arrangements, truth probably lies somewhere between these two extreme interpretations. Conscription also further complicates matters.

Time and space do not allow a thorough treatment of the issues covered in this appendix. But the above discussion should suggest that incidence analysis cannot be reduced to a standard recipe in an economist's cookbook. There is no substitute for thoughtful analysis that considers the institutional realities and economic conditions found in specific countries for particular taxes and expenditure programs.

Comment

Miguel Urrutia

It is difficult for me to make comments on this paper since I am in broad agreement with many of the conclusions. The general implications of the paper, however, are more controversial.

I would say that most of the conclusions arrived at by Charles McLure are consistent with the present Washington mainstream view that economic development will automatically follow policy reforms that get prices right.

The more controversial point made is that equity will also improve after such policy reform and that broadly neutral taxes and zero subsidies will also lead to more equitable growth.

In many cases the above propositions may be correct. But there are concrete cases where the type of state intervention criticized by McLure can, in fact, improve equity. I will give some examples.

The author mentions the obvious adverse effects of export taxes on agricultural production. However, recent research at the International Food Policy Research Institute (IFPRI) suggests that the rice

export tax in Thailand probably does more good than harm in terms of growth and equity in the economy. So these generalizations must be made rather carefully.

Also, in recent analyses that I, myself, have been involved in on the problems of resource-rich countries, we have emphasized the need to tax agricultural exports during commodity booms and subsidize them in recessions.

A major problem of macroeconomic policy exists in countries that export commodities in a world of particularly unstable commodity prices. Clearly, the issue of export taxes is a crucial concern of economic policy in all countries that still rely to some extent on exports of commodities.

In addition—and this shows my Colombian bias—if you come from a country that is extremely efficient in the production of one good, such as coffee, and you adhere strongly to the free market path, you guarantee you will never have industrialization.

This is what I would call the structural, Dutch-disease problem. You have one line of production in which you are tremendously productive. This sets your exchange rate at a level that makes industrialization impossible. There is something wrong with that situation due to the tremendous instability of commodity prices. There are also problems of price trends; maybe in 1987 it is not so absurd to revive the old Prebisch thesis on declining terms of trade.

It may indeed not be a very good idea to completely rely on such exports. So I don't think the case against export taxes is as clear as might appear from an analysis of the African experience.

An example of non-neutral subsidies which do improve equity is that of generalized food subsidies. The paper mentions specifically the inefficiency of generalized food subsidies, and this sounds like a very logical conclusion.

However, I have been impressed by some of the work done by Shlomo Reutlinger of the World Bank and at IFPRI which suggests that in fact well-planned, generalized food subsidies are probably the only efficient way to increase the income of the poor in developing countries.

Of course, it turns out that governments usually choose the wrong subsidies. Recently, IFPRI did some very interesting work on

the problem of wheat subsidies in Brazil. One of the conclusions of that IFPRI analysis is that a subsidy on rice would be highly desirable. It would have the right effects on income distribution and probably result in no major distortions in the economy. Unfortunately, Brazil was subsidizing the wrong product (wheat instead of rice), but the research suggests nonetheless that some of these generalized food subsidies may, in fact, be the only effective way of doing any income redistribution if one wants to do it.

One of the reasons for this result is that the real poor in the rural sector are the landless peasants who have to buy their food. This runs counter to the idea (which, I must admit, I shared with Charlie) that the poorest sector of society which is in the rural areas, did not benefit from these food subsidies.

So there is a basic, very interesting and straightforward empirical question involved: how many landless peasants do you have, and how many self-sufficient farmers? The answer varies between regions and countries; net buying of food is probably more common in rural Latin America than in Asia. In any case the food subsidy-equity issue is complicated by these considerations.

At present everybody seems to be for decentralization and development from below, and this appears in the McLure paper. It is suggested there that decentralization may lead to greater equity. Participation is the key word; it is very sexy. Historical experience, however, suggests otherwise. The greatest inequities and concentration of power can occur within very decentralized communities. I don't have to talk about this much in the United States because it is clear that much of the problem with racial discrimination in the South was precisely the complete or substantial independence of local communities and the oligarchies that ran them. The progress of racial equity in the United States required, of course, the intervention of the national state.

In South America also, it has been the national government which has weakened the power of local oligarchies, which have operated without restraint at the local level. This is reflected in the area of taxation and land taxation in particular. Charlie has researched that particular subject. He knows that the avoidance of tax, and the

degree of inequity in the tax structure, is greater the further out you go and the more decentralized you are.

So it is not so clear that decentralization will lead to equity. In Latin America, the countries where fiscal systems are most inequitable are precisely the small Central American states, in which you approximate the conditions that would prevail if the larger states decentralized substantially their fiscal systems.

The McLure paper also concentrates on tax regimes that create the right incentives and explicitly mentions that it does not deal with some of the macroeconomic issues. One point that is not made in the paper is that probably the most important requirement for the stimulation of investment is stability of tax arrangements. On this score, I have been rather impressed—and we have people here who know much more about it than I—by the Japanese experience. Japan has an incredibly progressive income tax, which in anybody's book should create all of the wrong incentives and, in addition, discriminate greatly against any kind of saving.

However, if one looks at the savings performance of Japan, one begins to have some questions about those assumptions. One unusual aspect of this rather peculiar tax structure, which was imposed by the Americans, is that it is an imperialist-imposed reform very much defended by the extreme left in Japan. But another unusual aspect is that the tax system has been pretty constant for about 30 years.

This constancy of the tax system, I think, explains much about incentives in Japan, and the example leads me to agree with Charlie: tinkering and fine-tuning that go on permanently may have much worse incentive effects than the actual disincentive effect of specific structural features in any tax system.

Finally, let me add that changes in the tax structures of governments in LDCs will probably have small effects on growth and efficiency. I think this whole issue is marginal. The real issue is the impact of the level of the tax effort. In Latin America, tax burdens are still low and basic services are completely inadequate. Their inadequacy may be the great constraint to economic growth.

So I must admit I don't find terribly attractive the present fashion for revenue-neutral tax reforms. I think that in Latin America, in

particular, the issue is still revenue-producing tax reforms and the reasons are obvious. There are macro reasons: the major macro problems are still due, in Latin America, to very large fiscal deficits and, given the extremely low levels of basic services, it is complete insanity to think that these fiscal deficits can be solved through government expenditure decreases.

In this context, the present fashion of favoring revenue-neutral tax reforms is dangerous. Another point that should be made is that—in Latin America at least—the major disincentive to investment and to economic growth is probably related to problems of violence and internal security. The violence generated by state neglect in certain parts of a country produces a climate where investment is very risky. It is obvious to all of you who have been reading about Peru in the last few days, in which the police force is on strike and Sendero Luminoso active, and about violence in Central America or Colombia, that the issue is not an excessive state but a nonexistent state or a state that quibbles and makes useless regulations.

Very clearly, then, additional funds can be productively invested in health, education and infrastructure and, therefore, I think that should be the subject of tax reform and not the marginal problems of incentives.

I agree, however, with the suggestion that there is a good case for trying to use user charges and to avoid putting any scarce government resources into the financing of the deficits of state companies and of public services when there is no reason why service charges cannot in fact finance these services in an equitable way.

Discussion

MR. McLURE: Many of Miguel's comments are very well taken. He emphasizes something that I alluded to in the paper, but didn't stress enough: one has to look at the situation in each particular country. He mentions the case of the rice export tax in Thailand and the coffee export taxes in Colombia.

Clearly, if you have economic rents, whether it be in petroleum or in coffee, then you may be able to tax those rents without doing the kind of damage that I mention in the paper. You have to know, however, that you are taxing rents, and not cutting into the muscle and the bone.

The poorest in the rural sector may be the landless peasants in some countries, though probably not in all countries. Again, there is no substitute for looking at countries in particular. One needs to know the differences in consumption patterns. Is there something that only the poor consume and the rich wouldn't touch? If so, that is what you want to subsidize if you are talking about food subsidies.

On the question of decentralization, it may be that what you need is not just another government but rather more latitude for quasi-governmental activities. This would reduce domination by the oligarchy. The people can get together and provide for themselves something they actually want rather than having everything done through the existing government, which is dominated by the oligarchy.

MR. KAUFFMAN: With some temerity, I will start this off just so that we can get things going. I must say that I thought the paper and the commentary were most interesting and enlightening, but I was a little disturbed that Dr. McLure just puts aside the issue of fiscal deficit and deals with tax structure, if I understand him.

I think he alluded at one point to the question of deficits, but he said explicitly that he wasn't really dealing with it in his paper. Yet it seems to me, if we are talking about policy reform these days, that is usually one of the number one issues for many countries. The IMF or whoever says, "We have to get this disequilibrium in your balance of payments fixed up and one thing you certainly have to do to achieve that objective is to cut your fiscal deficits."

Mr. Urrutia argued that, in Latin America at least, it would be foolhardy to cut deficits by cutting expenditures. At the same time we seem to always say: if you do it by raising taxes, that is a terrible evil.

I would like to hear some discussion of this issue and the question of dealing with this deficit problem in developing countries as part of their reform measures via the elimination, say, of subsidies. Food subsidies may be general and therefore help both the rich and the poor, but they do help the poor, though perhaps at some cost. If you have to reduce those costs, is it worthwhile to think about ways of doing so that will retain at least some of the benefits to the poor? Are there things like targeted subsidies that would be more efficient in achieving your objectives and still be compatible with reducing the fiscal deficit?

MR. BERG: That is a pertinent point, and you remind me that I should perhaps make one observation that I think fundamental: when we talk about reform we are dealing with disequilibria situations. We wouldn't have policy reform concerns if the economies in question did not have big fiscal deficits or balance-of-payments

deficits, high inflation rates, slow growth and generally troubled and distorted economies. So the question is always, how can relevant deficits be narrowed, while restoring growth and avoiding inequitable sharing of adjustment burdens? Cuts or restraint in real expenditures will almost always be needed. So the question is, where do we cut on the expenditure side, or, if you close a deficit, what are your options?

We are not starting from scratch in these analyses, and it seems to me that this conditions the way we look at fiscal policy or other policy areas.

MR. VERNON: I would like to come at this issue from a very different direction, probably a reflection of my advancing years.

Over the past 60 or 70 years we have lived through a series of experiences in which one or another economy has shifted from the near absence of government, if you like, to one in which there was just too damn much government, with what looked to laymen like myself as rather remarkable implications for the very poor.

The two cases are the obvious ones; they are China and Cuba. In the case of China, to the layman who relied primarily on the *New York Times* and *Foreign Affairs* for his information, among the consequences of the revolution in the late 1940s was the apparent disappearance, or at least the apparent absence from sight, of the very poor.

Now it could be argued that they were buried in the countryside and we couldn't see them, but anyone who had traveled in the China countryside before the poor disappeared would have said that there were lots of the poor in the countryside even then.

In the case of Cuba, the same phenomenon appeared to occur. The very poor disappeared from the streets of Havana. A variety of social indexes seemed to show improvement, substantial improvement, and this raised a question in the minds of many people. We hold aside for a moment (though you may not be able to do this for very long) the question of whether there were enormous costs with what you saw in terms of political freedom, that dimension is not being discussed today, and for the moment, I think I am entitled to hold it aside. We ask the simple question whether some form of the exercise of state power can, in fact, deal with the dreadful problems

of the last decile in the income distribution more effectively than the private sector can do it.

These two cases come to one's mind. You might want to reject them on other perfectly good grounds and indeed I do in this case. But I am still left with the question: without depriving the public of such precious things as personal liberty, is there some exercise of state power that can somehow remove the very, very poor not only from the streets of the various cities but from the countryside?

These two cases suggest that if we stretch our minds really hard, we may be able to find the formula. I have a suspicion that a wistful hope that it can be found sits in the minds of an awful lot of people. These people are fewer now than before, because most people today can't even remember what happened in Cuba and in China. But some of us who are as old as myself retain this wistful hope that maybe the judicious exercise of state power can achieve that phenomenon once again.

Therefore, the questions that McLure has raised strike me as sort of second-order questions in which I have no very great interest while still poking around for this objective.

MR. STOCK: I think the question about the nature of state power is interesting. It also seems to me, to get back to the point in McLure's paper, that if anyone ten years ago had foreseen the consequence of these particular state policies, they would not have been adopted; that is, surely an appreciation of the power of market forces should have led to the conclusion that those were inappropriate policies.

However, an appreciation of market forces was irrelevant to the institution of those policies, and the institution of those policies had a great deal to do with the way states evolved and the pattern of economic rents that accrued to various individuals and groups within them.

The nature of the states that were begotten as a result of those policies means that you have a different kind of state in those countries than you might have had in Cuba or in China. You have large state sectors in Africa, with heavy bureaucracies. Two essential questions deserve attention: how these kinds of states came to be relative to the way in which the states came to be in Cuba and China

and how the different interests of the poor are addressed in particular state bureaucracies.

MR. McLURE: Let me comment on Ray Vernon's question by asking a question. Were the poor taken off the streets in those countries simply by hiring them, perhaps to do things that were not very productive? If so, it may be that the China/Cuba experience is an extreme version of what I talk about in the paper, the use of public sector wages partly as payment for output and partly as transfer payments.

If one wanted to help the very poor in developing countries by what we call a negative income tax or a very wide far-reaching income support program, the question immediately arises: could you implement it? The usual answer, of course, is that you couldn't. In many LDCs you can't even effectively implement an income tax.

One way governments can implement a far-ranging transfer payment system is by hiring people. For better or worse, most governments can implement public payrolls. So perhaps what happened in China and Cuba was a system of transfer payments by another name. I don't know to what extent this occurred—whether it was 90 percent payroll and 10 percent transfer or vice-versa—but that is one way it could have been done.

MR. BERG: That public sector jobs have some transfer payment element is certainly true in many countries; the overmanning problem in state-owned enterprises is a reflection of this. But it seems to me unlikely that it explains poverty reduction in China in a major way, since wage employment is such a small share of total employment in that country.

MR. SAWYER: I wanted to make a comment related to the question that has been raised about historical experiences with the quest for equity. My comment has to do with points raised in the paper, and the discussion about institutional arrangements.

Traditionally we have had the notion that there are two poles, centralization and decentralization. The conventional view has been that when we move away from centralization, equity increased because people presumably participate more in decentralized decision units. But various commentators noted that decentralization in

some instances provides the opportunity for local bosses to clamp down on people, so it may not be equity-inducing.

I think this is an umbrella under which most of the issues discussed today have relevance. The question in my mind is how to organize (or advise on organizing) the kinds of institutional arrangements that facilitate the kinds of reforms that are deemed to be necessary. Whether one is talking about general fiscal policy or specific issues such as the use of food subsidies, the larger question of institutional arrangements has to be grappled with at the level of policy formulation.

We need to begin to conceive of complex organizational relationships where various layers of institutions become important in organizing society.

Some things are better done at the center, others in local government or self-help units, others in middle organizational levels. I think that the idea of people's involvement in terms of different levels of authority relationships will require some further investigation. But it is rarely clear-cut whether decentralization brings inequity and centralization brings equity, or the reverse. I think social organizations have to be more complexly organized and that should be recognized.

MR. MORSS: Just a couple of quick comments. Today the public-choice group is in vogue. As a result of a lot of research on how democracies choose their governments and how those governments behave, they conclude that governments are going to be bought off by special interest groups.

I regret these findings, but I am not ready to give up on democratic processes. I believe that if the public is well educated and good people can be motivated to run for office, the governments that might be doing bad things today can do good things tomorrow. Hence I take exception to the view that seems to run through these papers that the government cannot play a positive role.

Another point: I differ with Charles on the role of government employment in sub-Saharan Africa. Certainly at the higher echelons, government employment is educational and a means of advancement. It is a way of bringing a small group of people in Africa into the international world complex in which, at some point, later generations are going to have to work, and that employment is

probably the cheapest and most effective form of education that they are going to get.

MR. WOLGIN: Do you really mean that? I find that last statement mind boggling! I don't know if you think that such was the intention of government employment—that it was a conscious effort to educate—or more just an effect. But the kind of training and acculturation that takes place in most governments rarely prepares African civil servants for an international world community in which effort is supposed to be related to reward. In fact, it leads them to become more dependent on a welfare-state mentality where you are rewarded no matter what you do.

The next step beyond that is the fact that as the governments become fiscally unsound and are unable to pay these people, everybody finds other ways of learning by generating other kinds of employment.

What I see happening in most of the governments of sub-Saharan Africa is that the most efficient people that are hired learn a lot in a hurry and are quickly bought by the private sector. The good managers move from African public sectors into the private sector.

That is the sense in which I see this transfer process taking place. Remember that different countries have different ways of elevating people. The U.S. system is a private sector system. In current thinking, the dregs end up in public service. The French system and the Japanese system operate in a different way. The very best trained people in France start in the public sector; this is also the case in Japan. As a reward at a later stage in their career, they move to a higher-paying job in the private sector.

MR. STOCK: You can talk, it seems to me, about the ways in which the government is serving a social function for the people who move through it. Civil servants' interaction within government and with local people still seems to be based on their perception about who they are with respect to the local culture.

I recently read a book by Robert Wade about irrigation organizations in South Korea. This was right after I had been looking at irrigation organization in India. Wade describes a striking kind of interaction along an irrigation canal in South Korea. He saw four people down in the ditch and observes that there would be no way

to tell which one happened to be the local irrigation official, whereas, in India, it would be very, very clear because that person would not be down in the ditch. Nor would that official be down in the ditch in most of sub-Saharan Africa.

MR. WOLGIN: It would be one guy in the ditch and three guys on the bank!

MR. STOCK: It seems to me that one might argue that government may serve useful functions in Africa for the people who go through the government selection process, but the interactions of the government with local populations still often takes place in ways that are not positive.

MR. BROCK: I want to return to fiscal reform issues. I think we need to think more about a positive theory of why governments in developing countries wind up acting the way they do. I know that's easy to say. But I want to focus on one aspect that I think might be promising for research: the problem of time consistency.

Most of what you read in the macroeconomics literature basically says that governments like lump-sum taxes, and they like them because there are no dead-weight losses associated with collecting lump-sum taxes. A lot has been written on this in regard to inflation tax, with unanticipated jumps in the price level that impose a lump-sum tax on money holders. But you can think about the same thing with regard to people who own capital.

At any point in time, if a government has the welfare of the country in mind and wants to raise revenue to finance welfare-increasing activities, it should obviously tax capital that is already installed because, when it is installed, a lump-sum tax can be imposed. No dead-weight losses result. So when you think about developing countries and about why their tax systems are in bad shape, you can get some mileage from thinking about this aspect of tax policy and the problem that governments can't commit themselves *not* to tax capital that is already installed. One example that makes this question concrete is Chile in the last 15 or so years. That country has had a substantial trade reform so that if you look at the sum of exports plus imports over GDP, it has risen from about 20 percent of GDP in the 1960s to about 40 percent right now.

The Chilean economy has become very open. Among the things that have happened is a big investment boom in the export sector. There has been a big increase in investment in the fruit sector, for example: lots of fruit trees and grapevines have been planted. Chilean grapes now represent about one-quarter of U.S. table grape consumption, and there has been a very big investment in those sectors.

Now if you think about this problem of time consistency, maybe not the Pinochet government but perhaps the government coming after is going to find it very attractive to tax that capital that is already in place. It can be taxed either by a direct levy on the capital installed or indirectly by higher export taxes or import tariffs. They all have the same effects of taxing the capital that is in place.

I would argue that the problem of the private sector not being sure that the government is going to refrain from taxing capital in place is something that is a disincentive to investment. In fact, in these sorts of models, if a government can't commit itself to not taxing this, often these theoretical models degenerate into an equilibrium that is consistent over time but inferior, with a high level of taxes on income from capital. You get results that look similar to what goes on in many developing countries.

In these situations the private sector knows that such fiscal reforms are transitory and not sustainable. They try to rationalize everything but may not be time consistent in the sense I have been talking about. This may cause the private sector to engage in activity that is harmful.

So I would say that before you undertake a fiscal reform, we obviously need a lot more theory about why it has gotten to this point in the first place.

MR. BERG: May I raise what may be a second-order question since I see no eager hands in the air?

I have here a table taken from an IMF study of its adjustment programs between 1980 and 1984. The study looks at 32 countries representing different regions of the world. It shows, among other things, the recommendations of these Fund programs on tax policy. In the light of what Charles has told us about desirable and undesirable taxes, what do we see?

There are two major recommendations in all these programs. One is to improve or reform tax administration, which means do better on the whole range of taxes in existence. The second is to raise excise taxes mainly on beer, cigarettes and similar purchases. This is, of course, what you are arguing against. There are also 17 recommendations on tariff reform in the 32 programs. So there is a little bit of disharmony, perhaps, between what the reform agenda of the typical IMF mission is, and some of the ideas you are putting out.

There is one other not-so-trivial observation about Fund programs on the tax side. I think, with respect to the impact of Fund programs on the role of government, a close study would show that, most often, countries that have had Fund programs have larger shares of GNP in the state sectors than countries that don't have Fund programs. The reason for this is that the revenue recommendations tend to be more often well implemented, and the expenditure-cutting recommendations most often imperfectly applied.

If you look at what has happened five years after the introduction of Fund programs, you see bigger government, not smaller government, which is presumably not the intent of these programs. The present tax reform efforts of the IMF are hardly leading to the withering of the state.

MR. MORSS: Having worked in the Fiscal Affairs Department of the IMF, I just want to say a couple of things on that. Back in the late 1960s we undertook a series of comparative studies of tax burden and tax effort.

Our basic measure was taxes as a percentage of GNP, and we used regression analysis to control for a few other factors. These studies were used to convince certain countries to increase taxes. Stanley Please of the World Bank argued that our efforts would lead these countries to increase the role of government. We disagreed with Please, arguing that the first order of business for these countries was to reduce the size of the government deficit.

MR. McLURE: I would like to comment briefly on that and then come back to Ken Kauffman's comment that he was surprised that I didn't cover this in the paper.

I would tend to agree that if the United States wants to do something for capital formation, it should cut the deficit. It shouldn't

tinker with structural tax policy to increase private savings. That is going to be a second-order effect, I think, compared to just having higher taxes and getting rid of the deficit.

To some extent one can say the same thing in the developing country context, as several people have suggested here. I have a certain amount of sympathy for that view. But then one says, "Well, what lies down that road and how far down that road does it lie?"

I think that the real concern, certainly in developing countries and probably in this country, is this: suppose we do what the Fund says? Suppose we raise taxes and reduce the deficit? How do we know that that is not just going to lead to more public expenditure, largely wasteful, and within a few years we will be back to having the same deficit but with more resources flowing through the public sector?

I am rather pessimistic on this score. To some extent, I guess, this comes from walking into too many government offices in LDCs and seeing too many people on the public payroll just sitting around doing nothing. Maybe it's better to be a public retainer sitting around doing nothing than just being poor sitting around doing nothing. But it is not obvious that it is better for the country, or that a better solution cannot be found.

MR. WOLGIN: I think you raise an interesting research question, especially in light of the linkages between the IMF and the Bank and stabilization and structural adjustment programs. It is probably much easier politically to raise taxes and to raise them inequitably than it is to reduce subsidies or fire people or close parastatals. It's easier to raise indirect taxes on things that have little political impact or aren't seen, like sumptuary or excise taxes. But stabilization programs with these kinds of quick fixes are in theory working together with structural adjustment programs which are aimed at privatization, at reducing subsidies, at getting public expenditures under control.

It would be interesting to look at the last five years and see if, in fact, what you said is true: that after five years of a joint stabilization/structural adjustment program, governments are actually bigger or smaller and more or less efficient.

MR. URRUTIA: It's worth noting that tax systems decay. There is a whole population fighting against a very small number of

Ministry of Finance people and thinking up ways of not paying taxes. So I am not sure that in the case of developing countries you do see increasing tax burden. There is no question that, in the developed countries, there was a very clear tendency toward increasing the tax burden. But in many of the developing countries you have ups and downs. For example, in a country that Charlie knows well, in Colombia, the tax burden has been between 8 and 12 percent for 40 years. This is not unusual. Tax reforms and tax changes are necessary because people learn how to avoid the taxes, and one must innovate in order to get back on track. So I am not absolutely convinced by the argument that if you do have a fiscal deficit, and you solve it, you will have a permanent rise in the tax burden.

What one sees, I think, is quite the contrary. The horror is to see decreases in tax burden which is what one tends to see in Latin America.

Finally, I would like to emphasize one point that Charlie made which has to do with Latin America also: that is his very interesting and, I think, original point about the problem of timing. In the hyperinflation experiences that have just taken place in Latin America in the last couple of years the incredible thing was that when inflation stopped, tax burdens increased radically. This should have made stabilization possible, but they messed it up.

The point emphasized in the McLure paper that the income tax is particularly inadequate to take care of the problems of rapid inflation is very pertinent, and I think it's a persuasive argument for looking more at the consumption side of taxation.

Response

Charles E. McLure, Jr.

I do not find anything in this discussion that would make me change the basic thrust of my paper, though I might want to be somewhat more cautious about some of the statements in it. (I will, however, take the opportunity of postconference revisions to expand on the discussion of quasi taxes.) I would qualify more carefully some of the generalizations, for example, by mentioning explicitly the possibility of taxing economic rents without affecting economic decisions—a topic I have written on in other contexts. This point and others raised by Miguel Urrutia, including cross-country differences in the rural poor, serve to emphasize a basic point of my paper: that there is no substitute for careful observation and analysis of conditions in a particular country. Urrutia's comments on food subsidies also point in that direction.

Whether it is appropriate to talk about revenue-neutral tax reform depends, I think, on the context. I believe that the United States now has a better tax system, in part because the guideline of revenue

neutrality helped constrain the urges of the Congress to be fiscally irresponsible. But this does not mean that I believe that tax reform should have been revenue neutral. Frankly, I would like to see the United States raise taxes by enough to cut the federal deficit substantially.

Whether taxes should also be raised in LDCs is not so obvious; that depends on the actual situation in each country. But if I were to throw caution to the wind and generalize, I would say that there is a presumption that there is substantial fat in the government budgets of LDCs and that many public employees should either be fired or put to work before taxes are raised. But this presumption is clearly not applicable in those countries where the government is sleek, lean, and efficient, yet starved for funds. In such cases tax increases might be proper.

Finally, I would just like to reemphasize a point that ties together the four topics of this conference. Trade policy, agricultural policy, and policy toward state enterprises all have effects on economic efficiency and equity that resemble those of tax policy. Indeed, their effects may often be more pernicious than those of tax policy, if not as pervasive. Before arguing for greater intervention in any of these areas (or for higher taxes), it is sobering to ask what reason one has to believe, based on prior experience, that such intervention would generally make matters better, rather than worse. I see little historical support for that proposition.

3

Erik Thorbecke

Impact of Stabilization and Structural Adjustment Measures and Reforms on Agriculture and Equity

Introduction

This paper analyzes the effects of stabilization and structural adjustment policies (including liberalization) on the agricultural and rural sectors of less developed countries (LDCs). These policies are likely to affect the level and composition of agricultural output, the pattern of employment and relative prices, and the distribution of income among socioeconomic groups in both the short and long run. Because the emphasis of this seminar is on equity, what follows develops a conceptual framework to explore the ultimate effects of adjustment measures and reforms on income distribution and poverty, with specific reference to rural areas.

Section II reviews the major instruments which normally constitute a stabilization-cum-adjustment package; it also outlines the mechanism through which these instruments affect agriculture and rural areas. Section III develops a conceptual framework based on the Social Accounting Matrix to trace the impact of adjustment policies on household income through the circular flow of income.

Finally, Section IV explores in some detail the effects of several specific policies and reforms on agriculture and rural areas and provides concrete examples of these effects selected from countries that faced very different initial conditions. The question of adjustment with equity is examined, and methods to improve conditions of the poor during the adjustment process are reviewed. A number of these methods integrate poverty alleviation with structural adjustment so as to minimize possible conflict between these two objectives. In some instances, though, compensatory measures may be necessary to relieve the transitional negative impact of adjustment measures on poverty (e.g., decreasing food consumption).

Impact of Stabilization and Structural Adjustment on Agriculture

Reasons for Stabilization and Adjustment. What are the underlying conditions of most countries whose governments have adopted a package of stabilization and structural adjustment policies? This is the key question which has to be raised at the outset. The answer is fairly simple: an external disequilibrium normally accompanied by an internal disequilibrium will cause (force) a country to adopt such a package. These imbalances typically manifest themselves in (1) an external balance-of-payments deficit, artificially bridged through a variety of exchange control measures and import controls and/or through short-term borrowings abroad, entailing an overvalued exchange rate; and (2) an internal budget deficit, artificially bridged through money creation and/or borrowing from the central bank, reflected by domestic inflation. In a few exceptional cases governments have undertaken appropriate measures early on and thereby avoided serious balance-of-payments and budgetary disequilibria.

In most instances, a disequilibrium is triggered by inappropriate policies, in particular by countries trying to live beyond their means through excessive reliance on foreign and domestic borrowing. But in some instances, the disequilibrium may have been caused, or worsened, by external shocks. An obvious example is a sudden and large change in the international terms of trade such as what occurred when the price of oil took a quantum leap under OPEC.

Thus, just as a sick patient with high fever may have to be treated with unpalatable pills, a developing country displaying a fundamental disequilibrium, marked by such symptoms as an overvalued exchange rate and high inflation, may be forced to adopt an unpleasant but necessary adjustment package.

The process leading to a crisis is by now well known. As foreign exchange reserves are gradually depleted, the country may for awhile support its deficits through foreign borrowing. Extended reliance on foreign credit may result eventually in an unmanageable external debt burden. Increasingly, a variety of exchange and import controls are imposed to reduce imports artificially. This process may continue until the government is no longer capable of meeting current payments on its debt servicing, at which time it approaches the IMF. One could speculate about a country going on without adjustment. In fact, this is not an option. As Guitian put it,

> . . . In most circumstances, adjustment will take place with or without policy action, in the sense that claims on resources eventually have to be limited to those resources available. The issue at stake, therefore, is not whether it will be carried out—because it will be—but whether it will be carried out efficiently, that is, without involving unwarranted welfare loss.[1]

Domestic conditions will change with or without a formal stabilization program. The unsustainability of the original disequilibrium means that changes in the underlying conditions are inevitable, including changes in the distribution of income.

Conceptually, we seek to analyze (1) the prevailing situation in a country prior to adoption of an adjustment package, (2) the situation likely to prevail sometime (say 1–3 years) after implementation of adjustments, and (3) the situation that would have prevailed in the absence of structural adjustment.

A comparison of (2) and (3) would then indicate the net impact of stabilization and structural adjustment policies on future socioeconomic conditions. Alternatively, a comparison of (1) and (2) would reveal how the economy changed over time under an adjustment regime; but such comparison could not separate the effects of the new policy package per se from those that would have been caused by the initial preadjustment disequilibrium. A comparison between (1) and (2) might show an increase in unemployment and poverty, and unfairly attribute the worsening conditions to the policy package when, in fact, a continuation of the preadjustment trends would have led to a situation (3) worse than (2). In that case, the net effects of the adjustment measures would have been favorable rather than unfavorable.

Stabilization and Adjustment Measures. We next examine various measures which come under the umbrella of stabilization and structural adjustment. Stabilization programs introduced by the IMF and structural adjustment loans extended by the World Bank both aim at assisting a member country to restore and maintain a viable external balance. While the Fund generally focuses on the short term and the Bank on the medium term, there is no clear line between the actions of these two institutions. When the Fund and a given member country agree on a financing facility, the policy measures to be taken extend over what is considered the medium term. For such a program, generally, the Fund also seeks participation of the World Bank in evaluating the country's investment priorities over the medium term. As interpreted by the Fund and the Bank, the viability of the balance of payments means reduction (or elimination) of the external current account deficits to a level compatible with reasonable price and exchange rate stability, a sustainable level and rate of economic growth, and a liberal system of multilateral payments.

Whereas stabilization per se attempts to eliminate or reduce the imbalance between aggregate demand and aggregate supply, both externally and internally, it has become increasingly apparent that this imbalance is often accompanied or caused by distortions in relative prices and other structural rigidities that tend to keep supply

below its potential. For example, structural maladjustments in production and trade caused by price distortions may prevail initially and contribute to the external and internal disequilibria. The resolution of such problems hinges on improving the allocation of resources and increasing productive capacity. These acts invariably require a combination of structural adjustments such as a devaluation, removal of artificial price distortions in product and factor markets, deregulation, trade liberalization, and institutional changes at the sector level (e.g., improving the agricultural extension service). These measures, which are typically in the World Bank's domain, act to stimulate production and thereby contribute to aggregate supply.

It is an oversimplification, at best, to state that the IMF's stabilization program helps to restore equilibrium by constraining aggregate demand in the short run, whereas World Bank loans increase aggregate supply in the medium term. In fact both parts of the package jointly affect aggregate demand and supply over time.

The impact of the major components that together constitute a typical stabilization-cum-adjustment package (from now on referred to as "adjustment package") on agriculture is examined next. The brief examination which follows provides a general introduction to the treatment undertaken in Section IV where effects of specific adjustment measures on agriculture and rural areas are concretely illustrated through a number of country experiences.

The principal components of an adjustment package are: (1) exchange rate adjustment, (2) wage and price policies, (3) trade policies, and (4) monetary and fiscal policies.[2] How do these various measures affect the agricultural sector and, through it, the rural income distribution?

Exchange Rate Adjustment. Devaluation is an integral part of the great majority of adjustment packages. Its immediate purpose is to improve the balance of payments current account through its influence on both aggregate supply and aggregate demand. Whether devaluation succeeds depends on the strength of two effects: *expenditure switching* brought about by an increase in the relative price of traded goods and a *reduced domestic expenditure* caused by the increase in prices of tradeables. Because prices of traded goods are determined on the world market and are taken as given by most

developing countries, a devaluation increases their prices denominated in local currency while initially not affecting prices of nontraded (domestic) goods.

The impact of devaluation on agriculture will depend, of course, on which agricultural goods are traded and on the supply responsiveness of these products to higher prices. In this regard, an important distinction should be made between tree crops or perennials (e.g., tea, coffee, rubber) and traded annual food crops. An increase in relative prices (denominated in domestic currency) of exports such as tea, coffee, or latex may not lead to higher output in the short run. It may take three to five years before new trees begin to yield these products. In other words the supply elasticity may be very low in the short to medium run.

In contrast, annual food crops such as rice and wheat may show supply elasticities with regard to price of 0.2 (i.e., output would increase by 2 percent in response to a 10 percent increase in price). By now there are many examples of countries, such as Indonesia and Sri Lanka, which in a few years moved from being very large net importers of rice to self-sufficiency as a result of import substitution with domestically produced crops.

Section III presents a conceptual framework based on the Social Accounting Matrix, which will trace the impact of changes in the structure of production (including technology) on the demand for factors and, thereby, the factorial income distribution. It shows, in turn, how a household income distribution arrayed by distinct socioeconomic groups can be derived. At this stage the likely effects of devaluation on income distribution are explored in a more approximate fashion. The question is addressed more rigorously in Section III.

Following a devaluation, the implications of changing patterns of agricultural production on employment and income distribution depend on the structure and organization of agriculture. If production of the tradeable food crop is in the hands of small producers, devaluation would improve income distribution. Alternatively, if production is divided between large farmers using relatively capital-intensive methods and small subsistence farmers using labor-intensive methods, the income distribution might shift in favor of the large

farmers because of their superior productivity; even so, absolute poverty might be reduced as all farmers, regardless of farm size, benefit from higher prices.

Incidentally, the higher prices of traded food crops might have a positive effect on the demand for substitute (nontraded) domestic crops such as sorghum and millet. These crops tend to be produced by subsistence farmers, particularly in the African context. Therefore, devaluation would accrue to the benefit of these subsistence farmers assuming that they have the capacity to increase output. Evidence from a number of quantitative studies undertaken in Mali, Burkina Faso, and other African countries indicates that although the supply responsiveness of the subsistence crops to higher prices is limited, farmers there benefited from higher prices for competing traded food crops.[3]

If the main agricultural exports of a country consist of tree crops or other commodities requiring a long gestation period, any significant increase in output would take place only after an extended time lag. In this intermediate period, during which new trees would be planted and livestock fattened, there might still be opportunity for greater short-run output through more intensive cultivation (e.g., application of more fertilizer) and better harvesting practices. The impact on income distribution would again depend on the division of production between large plantations and smallholders. Plantations rely extensively on hired (landless) workers whereas smallholders rely on family labor. The ultimate effect on income distribution would hinge on what happened to the real wages of the hired workers and the net farm operating surplus of the smallholders. Whereas the latter are likely to be better off, landless workers could suffer if their incomes increased relatively less than the prices of their staple foodstuffs.

One possible bottleneck to supply responsiveness in agriculture following a devaluation is excessive reliance on imported intermediate inputs required for agricultural production. For instance, if fertilizer has to be imported and its price rises following the devaluation, the higher cost could impede its application by farmers and dampen the rise in agricultural output.

Wage and Price Policies. Minimum wage legislation is much less prevalent and effective in rural areas than in urban areas. In most developing countries, even when rural minimum wage legislation has been passed, it is rarely enforced. Therefore, elimination of this wage distortion as part of a liberalization package will have very limited effects on the operation of labor markets. In the newly and semi-industrialized countries the story may be different. Where these distortions prevail, elimination of minimum wages is likely to encourage the adoption of more labor-intensive technologies, particularly when combined with liberalization of the credit market as is discussed below in connection with monetary and fiscal policies.

Price policies are pervasive in the food sector. The gamut of price policies and other regulations controlling exchange of staple foods is enormous. Some countries use a two-price policy or some variant thereof, offering a low price to consumers and a high support price to producers. Other countries use a support price for producers and attempt to subsidize food consumption more or less selectively. Finally, still other countries unabashedly follow a one-price policy favoring consumers at the expense of domestic producers. The costs of controlling food prices, covering the margin between subsidized producer earnings or expensive imports and low consumer prices, have repeatedly placed an intolerable fiscal burden on many, if not most, governments of developing countries. Some examples discussed in Section IV will show there are instances where current costs of these food policies represent as much as 6 to 7 percent of Gross Domestic Product (GDP).

A key issue from a distributional standpoint is the effect of these policies on different groups. Reducing controls is likely to benefit net producers at the expense of net consumers. In a setting where food is produced by a large number of small farmers and where most poverty is located in rural areas (e.g., Kenya) the increase in incomes of the smallholders should more than offset the worsening conditions of poor urban residents (the net food consumers).

It should, however, be recalled that price controls often engender the creation of "unofficial" food markets where operations parallel those in the regulated sector. Exchange occurs in these markets with prices that are very different from the official prices.

Depending on the degree to which authorities can enforce maintenance of official prices, the distributional consequences of decontrol may vary from the scenario just described. Here again, the particular conditions and institutions in different countries usually yield different results. But, if consumers have to purchase most of their food through parallel markets at higher than official prices, an increase in the official consumer price may have little bearing on their incomes.[4]

Trade Liberalization. Most adjustment packages call for trade liberalization that reduces tariffs and quantitative restrictions on imports. The impact of trade liberalization on agriculture depends on the degree of protection enjoyed by different commodities and sectors at the outset. A high positive correlation has been observed between the effective rate of protection (i.e., the ratio of the domestic price to the world price) in agriculture and the degree of development of the country; while to some extent an inverse association seems to prevail between the effective rates of protection (ERP) of manufactured goods and the degree of development. In other words, high farm prices (compared to world prices) are most often found in developed countries; high prices for manufactured goods are the rule in LDCs. Poor countries tend to display low ERPs for agricultural products (usually considerably less than unity) and high ERPs (higher than unity) for nonagricultural goods.

A major reason for keeping agricultural prices artificially low relative to prices of industrial goods and services is to transfer resources from agriculture to nonagriculture. The state can thereby capture the so-called net agricultural surplus which is used for capital formation in the nonagricultural sectors. One problem with this development strategy is that if agricultural prices are pushed downward too sharply or too early in the development process, agricultural production can be discouraged. In this case one could talk of agriculture having been squeezed before it had an opportunity to contribute to capital formation.

As countries go through the development process, discrimination against agriculture in favor of industry is gradually reduced to the point where agriculture becomes protected on a net basis significantly more than nonagriculture. The classic examples of Taiwan and Korea illustrate this trend. After having transferred capital from

agriculture to the rest of the economy by maintaining a low price of rice until the early sixties, the relative price of rice in these countries was gradually increased to a present level of about three times the world market price. It appears that the more developed and industrialized the country, the greater the protection enjoyed by agriculture as the European Economic Community so vividly demonstrates.

Under these circumstances it can be expected that trade liberalization in a poor country where the agricultural ERP is 1 or less would encourage agriculture by turning the terms of trade (the relative prices of agricultural goods vis-a-vis nonagricultural goods) in its favor. A devaluation would increase the domestic price of agricultural tradeables. The impact on output would be greater the larger a country's food deficit at the outset of the adjustment process. Growth of agricultural output would bring about increased employment, and, even in a dualistic setting of large commercial farms existing side-by-side with traditional smallholders, the net impact on poverty alleviation would likely be positive.

One important question that should be raised here concerns the implications of agricultural protectionism in developed and some semi-industrialized countries on the pattern of agricultural trade worldwide and on world prices. Agricultural protectionism in the industrialized countries encourages production in excess of domestic demand and leads to surpluses which in some instances are dumped abroad (i.e., exported at low prices to food-deficit developing countries). The availability of cheap food from abroad has in the past, especially in the sixties and seventies, discouraged domestic agricultural production in a number of LDCs.

To the extent that prevailing world prices reflect subsidized exports from developed countries, they may not provide an incentive for developing countries to exploit their comparative advantage in agriculture. The present agricultural trade pattern is so distorted that high-cost producers in Western Europe, Japan, and other developed countries tend to be self-sufficient or net exporters and many low-cost LDC producers are prevented from becoming net exporters.

A hypothetical worldwide process of agricultural trade liberalization would be likely to benefit agricultural production in poor

countries. This question is among the subjects of the third seminar ("Trade and Development: Development Priorities in the Uruguay Round") in this Sequoia Institute series.

Monetary and Fiscal Policies. To the extent that aggregate demand has to be curtailed to reduce external and internal disequilibria, monetary and fiscal instruments have to be geared to achieve this objective. This means that domestic consumption has to fall in the short run to reduce imports and leave a larger part of domestic output available for exports that help bridge the external gap. It also means that the budget deficit occasioned by an excess of government spending over revenues has to be eliminated either through a reduction in government spending or an increase in taxes. Because it is unrealistic in the setting of most LDCs to assume that taxes can or should be increased, most of the required reduction in aggregate demand should come from curtailment of government expenditures and use of more restrictive monetary policies.

The fiscal and monetary instruments which are likely to affect agriculture and rural areas most are changes in (1) subsidies and transfer payments to rural households, (2) current government expenditures on services to agriculture, (3) government capital expenditures benefiting agriculture either directly or indirectly, and (4) the availability and terms of rural credit.

Perhaps of more special concern with the first instrument above are changes in subsidies for food and intermediate inputs. A reduction in food subsidies could affect the landless agricultural workers negatively if the reduction in food subsidies resulted in a new price for the staples proportionately higher than increased incomes (following from a devaluation). Because landless households may spend 60-70 percent of their income on food, the impact of a relative increase in food costs could have serious unfavorable repercussions. This issue is taken up in more detail in Section IV. Incidentally, the same analysis applies to small and marginal landholders whose farm production is less than their consumption.

One general research finding is that food subsidies tend to be inefficiently targeted in the sense that a disproportionate share of the benefits accrue to the nonpoor. In such instances, a reduction in government food subsidies combined with better targeting (e.g.,

replacing a universal food subsidy with a food stamps program) need not worsen poverty. It is fair to say that curtailment of food subsidies are much more likely to have unfavorable short-term repercussions on the urban poor than on the rural poor.

Many governments have experimented with subsidies for inputs—particularly for fertilizer. Unfortunately, low subsidized prices increase quantity demanded, foster waste, limit availability, lead to rationing, and encourage the development of parallel black markets. Lowering the subsidy in such cases is likely to have beneficial effects.

A reduction in some categories of government expenditure could affect agriculture negatively. This is notably true with regard to cutting spending for agricultural extension services or for health services which could improve the productivity of agricultural workers. Likewise, a drop in expenditures on education in the rural areas could reduce the development of human capital. A few concrete examples of the impact of changes in these government services are given in Section IV.

Reducing a budget deficit normally requires a cut in government investment. The impact on agriculture and equity will depend not only on which sectors are affected but also on the choice of projects within sectors. It will be seen in Section IV that some countries (e.g., Indonesia and Sri Lanka) were able to reduce public investment by curtailing initiation of large capital-intensive irrigation projects and switching to much more labor-intensive rehabilitation of existing irrigation facilities.

A more efficient use of capital funds can increase employment, improve equity, and promote growth. This calls for greater selectivity in accepting capital projects funded through foreign aid because these projects often impose long-term budgetary burdens on recipients for maintenance after construction has been completed.

Restrictive monetary policy will bring about either directly or indirectly a rise in interest rates. To the extent small farmers and landless producers have limited access to official credit markets (for institutional reasons which include insufficient income or limited collateral) and borrow in the traditional (curbed) market, a rise in official-market interest rates may not have significant impact on traditional agriculture.

A great deal of credit in rural areas is of a nonmonetary form, such as barter transactions for seed and fertilizer. Hence, smallholders may be better protected against the effects of credit restraint than are large commercial farmers. When monetary restraint is accompanied by credit liberalization and institutional measures that give marginal and small farmers easier access to official markets, fragmentation will be reduced and small producers may, in fact, receive better terms than in the curb market usually dominated by money lenders.

If the liberalization process includes promotion of financial intermediation, two important advantages may flow from monetary restraint-cum-liberalization. First, it will encourage rural savings and thereby contribute to economic growth. Second, it will help insure that factor prices are more in line with factor endowment and thereby lead to selection of more appropriate technology in agriculture. Where large producers benefit from price distortions such as subsidized interest rates, they may adopt technologies that are too capital intensive. Higher interest rates, which better reflect the productivity of capital, would encourage adoption of more labor-intensive technologies and yield desirable consequences for the landless and smallholders who may suffer from underemployment.

Structural Adjustment and Its Impact On Income Distribution: The Social Accounting Matrix as a Framework to Capture the General Interdependence within an Economy

Whereas the literature is replete with studies analyzing macroeconomic effects of adjustment policies, there is a paucity of research examining their more disaggregated sectoral production and distributional effects. To present the initial conditions and to trace through the effects of adjustment measures on income distribution and rural development, a framework is needed which incorporates the structure of production (production activities, especially those in agriculture and rural areas) and the resulting factorial and household income distribution (by socioeconomic groups). The framework must also supply the initial values of variables in other accounts

(capital, rest of the world, and government) which are directly or indirectly influenced by the adjustment measures. In other words, a comprehensive and consistent disaggregated general equilibrium data system is required to grasp the initial conditions.

Social Accounting Matrix. The Social Accounting Matrix (SAM) provides such a conceptual framework. In addition, the SAM framework has at least two other advantages: (1) the classification scheme can be designed to fit closely the issues which are scrutinized, and (2) the major transformations among base-year accounts are crucial in organizing a comparative static or dynamic model through which the impact of adjustment policies can be traced. For instance, the allocation of value-added to factors (labor and capital) by production activities yields the pattern of factor use and the consequent factorial income distribution. In turn, given the household resource endowment and factor ownership (in particular, the amount of land owned and the amount of human capital possessed by households), the factorial income distribution is mapped into the distribution of household income earned by various socioeconomic groups. Thus the SAM can be very useful in forcing investigators to think through and identify the categories appropriate to the research at hand and, eventually, in the design and calibration of a more formal adjunct model.

The present problem consists of developing a methodology which entails comparing a postadjustment SAM for a given country (including the new structure of production, pattern of employment and income distribution) with the preadjustment SAM, or alternatively, with the SAM which would have prevailed given no adjustments or different adjustments. To the extent that adjustments are likely to affect the structure of production (e.g., sectors producing tradeable goods may grow at the expense of sectors producing nontradeables), the models or approaches used to generate values of the endogenous variables appearing in the new SAM should be able to capture the supply response.

A logical starting point is to verify that the SAM framework includes all relevant socioeconomic relationships which would be influenced by adjustment. This framework can then serve as an

organizational basis for discussing major transformations necessary to map the income distribution and for suggesting an appropriate classification scheme to explore the impact of alternative government actions (or inactions).

Framework for Analysis. Table 1 presents a basic SAM. It can readily be seen that it incorporates all the transactions which are potentially affected by adjustment measures. Whereas the SAM in Table 1 is a snapshot of the economy, Figure 1 which reproduces all of the transformations appearing in Table 1, can be interpreted more broadly as representing flows (over time) which, in turn, have to be explained by behavioral relationships. By identifying these flows among and within accounts, the key relationships which have to be focused on and explained are brought out explicitly.

The first question to address in a SAM-based framework is which accounts should be considered exogenous and which endogenous. In the present context, the government account is the only obvious exogenous one. All measures included in a stabilization-cum-structural-adjustment package are carried out and implemented through government action; the entry point of the package is through the government sphere. For example, a devaluation would affect relative prices of tradeables vs. nontradeables and, thereby, the composition of output and demand and the pattern of employment and income distribution.

It will be shown shortly that changes in the structure of production towards, for instance, an increase in output of rice would generate a flow of value-added (flow 1.5 in Figure 1) to family labor and imputed return on land; this will yield the returns accruing to various factors of production and the factorial income distribution. The latter, in turn, will be mapped through flow 2.1 into household income distribution broken down according to socioeconomic criteria, one of which being smallholders. Incomes accruing to socioeconomic groups will be spent on domestic consumption through flow 5.2. This consumption flow will provide an indication of the standard of living of the various socioeconomic groups. To take another example, a reduction in government expenditures could affect transfers and subsidies going to the socioeconomic

groups (arrow 2.3), government consumption (5.3), and the sectoral allocation of public investment via relationship 5.4.

The next step is to use the SAM flow diagram (Figure 1) as an organizational device to identify and examine the major transformations which are required to obtain the income distribution and to suggest an appropriate taxonomy capturing the effects of adjustment measures on agriculture and rural areas.

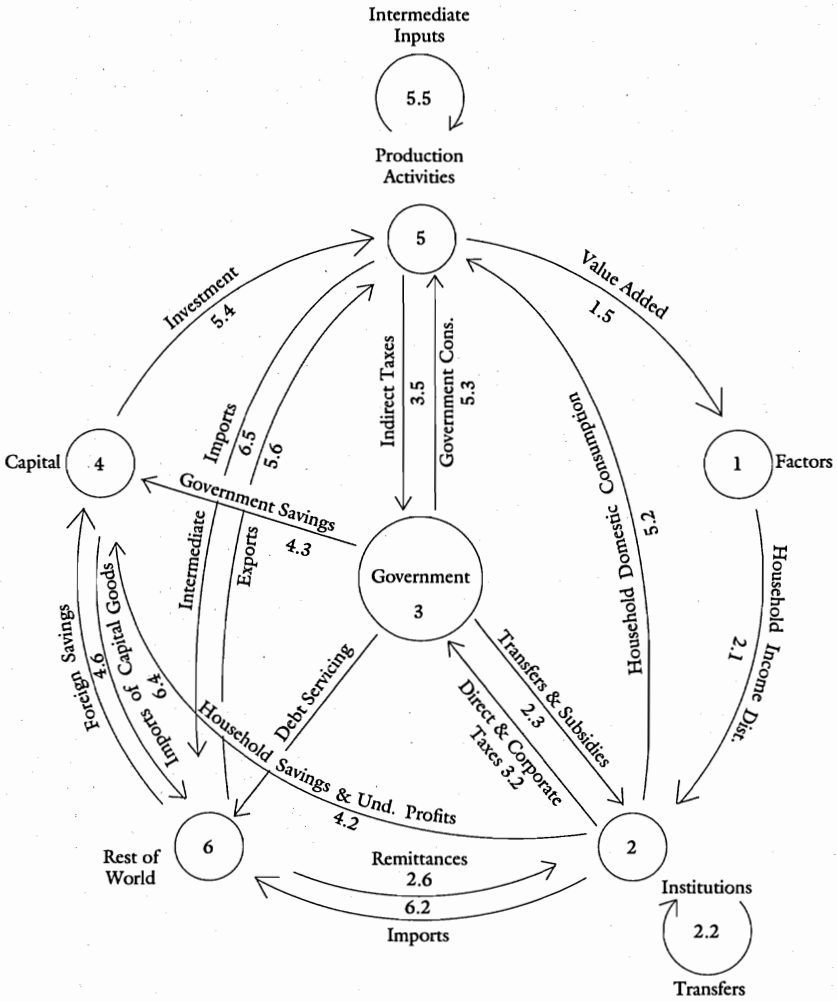
To illustrate how the SAM approach lends itself to deriving the ultimate income distribution by socioeconomic groups following adjustment, distinguishing between the determination of primary and secondary income distributions is useful. Thus, a distinction is drawn between ". . . *primary* claims on resources which arise directly out of the productive process of work and accumulation, and *secondary* claims which result from the transfer of primary claims."[5] The former results from prevailing patterns of (1) production and (2) resource endowment (land, human capital, and physical capital) among households. The primary income distribution is determined through the triangular interrelationship linking production activities, factors, and households (Figure 1 and reproduced in truncated form in Figure 2). The secondary income distribution may work through the family, village, or, more important, through the state in the form of transfers and subsidies (2.3) and taxes (3.2).

Classification Scheme. It is crucial in analyzing the triangular interrelationship among production activities, factorial income distribution, and household income distribution, to design a classification scheme appropriate to the articulation of the three mappings appearing in Figure 2. Starting with the module of production activities, three criteria suggest themselves in deriving an appropriate classification: (1) whether the commodities are tradeable or nontradeable, (2) the type of technology used in terms of labor and capital intensity, and (3) the form of organization underlying the production process (i.e., farm or firm relying on family labor and self-employment, corporation, partnership, or state enterprise). The first criterion is critical in distinguishing the consequences on output of a devaluation or any change in relative prices, whereas the last two criteria are important in mapping the impact of changes in the

Table 1
A basic social accounting matrix (SAM)

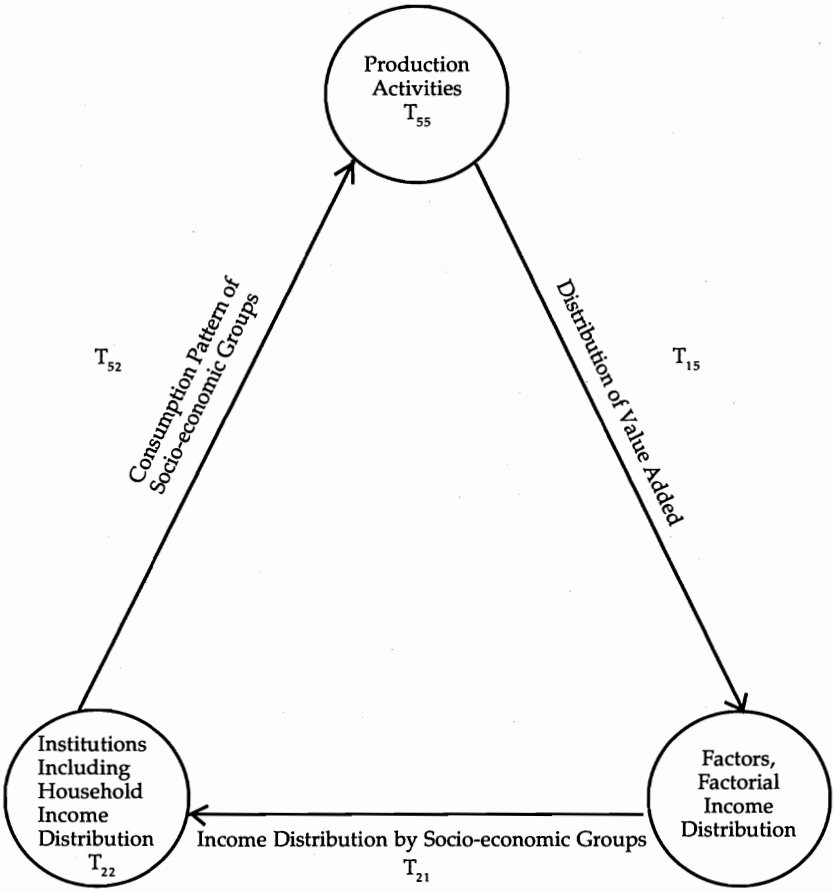
				Expenditures							
				1	2a	2b	3	4	5	6	
				Factors of production	Institutions				Production activities	Rest of the world combined account	Totals
					Current accounts			Combined capital account			
					Households	Companies	Government				
Receipts	1	Factors of production							Value added payments to factors	Net factor income received from abroad	Incomes of the domestic factors of production
	2a	Institutions, Current accounts	Households	Allocation of labour income to household	Current transfers between households	Profits distributed to domestic households	Current transfers to domestic households			Net non-factor incomes received from abroad	Incomes of the domestic institutions after transfers
	2b	Institutions, Current accounts	Companies	Allocation of operating surplus to companies			Current transfers to domestic companies				
	3	Institutions, Current accounts	Government		Direct taxes on income and indirect taxes on current expenditures	Direct taxes on companies plus operating surplus of state enterprises		Indirect taxes on capital goods	Indirect taxes on inputs	Net non-factor incomes received plus indirect taxes on exports	
	4	Institutions	Combined capital account		Household savings	Undistributed profits after tax	Gov't current account surplus			Net capital rec'd from abroad	Aggregate savings
	5	Production activities			Household consumption expend. on dom. goods		Government current expenditure	Investment expenditures on domestic goods	Raw material purchases of domestic goods	Exports	Aggregate demand — gross outputs
	6	Rest of the world combined account			Household consumption expend. on imp. goods			Imports of capital goods	Imports of raw materials		Imports
	Totals			Incomes of the domestic factors of production	Total outlay of households	Total outlay of companies	Total outlay of government	Aggregate Investment	Total costs	Total foreign exchange receipts	

Figure 1
Flow Diagram of SAM Transactions[1]



[1]The flow diagram reflects exactly the transactions and transformations appearing in the SAM on Table 1. Note that transactions are numbered in a way consistent with the numbering of the Accounts in Table 1. For example, the allocation of value added is a receipt for the Factor Account (#1) and a payment by the Production Activities Account (#5); hence, the corresponding transformation (matrix) is denoted by 1.5.

Figure 2
Simplified Interrelationship among Principal SAM Accounts
(Production Activities, Factors and Institutions)*



*T stands for the corresponding matrix and flow in the SAM which appears on Table 1 and Figure 1. Thus, for example, T_{15} refers to the matrix which appears at the intersection of row 1 (account 1), i.e., "factors" and column 5 (account 5), i.e., "production activities."

structure of production on incomes accruing to different socioeconomic groups. On the basis of the criteria, the following classification of production activities might be suggested.

A) In agriculture and the rural areas:

Tradeable—(1) export and cash crops (e.g., tree crops and plantation crops), (2) traded food crops (e.g., wheat or rice which is presently imported but could be domestically produced and, given sufficient output, exported), (3) food processing.

Nontradeable—(4) traditional domestic food crops (e.g., millet and sorghum in some African countries).

For the sake of completeness, a suggested classification of activities outside of agriculture might look as follows.

B) Nonagriculture:

Tradeable—(5) mining, (6) consumer goods, (7) intermediate goods, and (8) capital goods.

Nontradeable—(9) construction (a pure investment good), (10) social overhead (utilities, transportation, and housing), and (11) services (retail, wholesale, government, and banking). Note that this last sector could perhaps be subdivided further into urban formal services, urban informal services, and rural informal services.

This classification is responsive to a) the differential effects of adjustment on tradeable vs. nontradeable sectors; b) the differential supply elasticities of different commodities, particularly in agriculture; and c) an income distribution distinguishing between rural and urban areas. In the final analysis, the appropriate breakdown of production activities depends on the specifics of the country that is examined.

Next, the classification of factors and households should be consistent with our interest in employment and equity issues as they relate to rural areas. With the qualification that any ultimate taxonomy should be country specific, the following classification of factors may be suggested: (1) family labor (unpaid and self-employed), (2) unskilled labor, (3) skilled labor (which could be subdivided into organized and unorganized), and (4) capital (which could be land or other capital). This classification of factors would, in broad lines, correspond with the segmentation prevailing among different labor markets and with the sensitivity of these markets to adjustment

measures. In particular, it exhibits the crucial distinction between family labor which receives imputed labor income from production on its own farm and paid unskilled labor which receives wages.

Finally, a possible classification of households by socioeconomic groups might look like this:

A) Rural — (1) agricultural employees (landless workers and marginal farmers), (2) small farmers, (3) medium and large farmers, (4) rural nonagricultural households (which could be divided into formal and informal categories).

B) Urban — (5) industrial and service workers (perhaps subdivided into organized and unorganized), (6) informal-sector households deriving a large part of their income from self employment, (7) employers and capitalists, and (8) professionals. In general, the household's rural and urban status, its endowment of land and human capital, and the head of household's occupation would predetermine which socioeconomic group a household would be placed in. (Of course, members of a given household may receive income from sources other than the head of the household.)

Use of the Model. We can now verify that the above taxonomy captures reasonably well the differential effects of adjustment measures on the primary household income distribution. Two examples should suffice.

First, assume that consequent to adjustment the output of paddy (rice) increases within a country where smallholders dominate (as in the majority of the Asian countries). The impact of this development on the primary income distribution can be followed with the help of Figure 2. Higher paddy output leads to a more intensive use of land and family labor and to a correspondingly larger flow of value-added accruing to family labor and land rent. (Note that with smallholder agriculture, it is very difficult to distinguish smallholders' income which should be imputed to labor from that which can be attributed to rent on land). This transformation is represented in Figure 2 by T_{15}. The mapping from the factorial to the household income distribution occurs via arrow 2.1. Smallholders will receive income commensurate with the amount of land they possess and with the amount of family labor used in the production process. Finally, the

household domestic consumption pattern is given by 5.2 which provides the best reflection of the smallholders' standard of living.

The second example projects a more intensive cultivation of tea or rubber on large-scale plantations subsequent to adjustment. Plantations would have to hire additional workers or additional person-days of unskilled labor. This would result in a larger flow of value-added accruing to the factor "paid unskilled labor" and to returns for land and capital (again through flow 1.5). In turn, landless workers would receive higher nominal incomes (through transformation 2.1) while plantation enterprises would gain increased profits and rent income. The ultimate impact on living standards of the landless would hinge largely on the trend in food prices, which consume the bulk of their income, compared to their new higher nominal incomes. Their real standard of living could be judged from 5.2.

To obtain the final household income distribution by socioeconomic groups, the secondary distribution has to be superimposed upon the just-described primary distribution. As mentioned previously, an adjustment package is likely to affect the agricultural sector with a variety of food-price policies and a reduction in subsidies received by producers (e.g., on fertilizer and fuel) and consumers (smaller subsidies for food or better targeting of subsidies).[6]

At this stage one qualification needs to be made. Whereas a Social Accounting Matrix approach explains the determination of total incomes accruing to socioeconomic groups, it does not generate the intragroup income distributions. To the extent that poverty tends to be concentrated in a few groups, such as the landless in rural areas and the informal sector workers in urban areas, between-group variance is likely to explain a reasonably high proportion of total income variance in society. If one wants to approximate more exactly the effects of adjustment on poverty, knowledge of the income distributions within socioeconomic groups is necessary because poor households (those with incomes below a given normative poverty line) are likely to be found in more than one group.

For many developing countries, it should be possible on the basis of survey information to obtain the approximate intragroup income distributions in the base year. A methodology has been developed to

estimate the incidence of poverty for various budgetary allocation processes.[7] In any case, there appear to be significant advantages to using policy-related socioeconomic groups as an organizing framework, with an emphasis on those that include the poor. As Addison and Demery (1986 II) have indicated, "The identification of those groups which are most vulnerable to recession and corrective macroeconomic policies can then be the basis of designing appropriate poverty alleviation programs."

Other Analytical Models. It appears desirable, at this stage, to review very briefly some general equilibrium approaches, based directly or indirectly on a SAM framework, which have been built to explore effects of adjustment on agriculture. First, there are existing models of the agricultural sector which start with the farm household as a producing and consuming unit and then aggregate across farmers. These models are able to simulate closely the impact of different policy instruments (such as the effect of changing procurement prices, export taxes and devaluation on output, household incomes and equity). A good example of this type of model is that of Singh, Squire and Kirchner (1985). The model, by developing supply and demand systems and allowing for market intermediation within a multimarket setting, appears to be "specially geared to taking account of some of the realities in the African context: pervasive government interventions via marketing boards and parastatals and the existence of dual and segmented formal and informal markets that often result from such intervention."[8]

The Singh et al. model distinguishes between food crops and export crops and derives production (supply) functions for base crops. In turn, the land is broken down into urban and rural. The marketed surplus is calculated, and equilibrating prices and quantities are computed. Still another interesting application is that of de Janvry and Subramanian (1986) who used simple computable general equilibrium models of two countries (Egypt and India) to simulate the effects of different food and nutrition policy packages.

Most models assume that agricultural markets clear through price adjustments in contrast to nonagricultural markets where, typically, markup-pricing behavior leads to market clearing through quantitative

adjustments. An interesting prototype model which includes five sectors (two in agriculture and three in nonagriculture) and follows the above approach is the India model of Taylor (1983, Chapter 4). Its specification contains a mixture of neoclassical and structuralist behavioral assumptions. One key issue in estimating the effects of adjustment measures relates to the degree of substitution which exists among inputs, particularly between domestic and imported intermediate inputs. Excessive reliance on imported intermediate inputs may lead to domestic recession and a serious worsening in the income distribution as Taylor has shown in a number of examples applied to Portugal, India and other countries.

The most extensive empirical work on devaluation and distribution is that reported in Dervis et al. (1982), who use a general equilibrium model (based explicitly on a Social Accounting Matrix) to analyze the effects of alternative adjustment policies. They specify three arch economies: primary-product exporter, manufacturing exporter, and "closed" economy. It is interesting to note that in all three economies, devaluation leads to an improvement in the income share of smallholders. But, shares received by marginal agricultural labor and unorganized urban labor deteriorate in the closed and manufacturing-exporter economies as devaluation-induced price increases erode their real incomes. In the primary-exporter economy, the real-income share of the agricultural sector expands, and the increase in the sector's nominal income exceeds the rise in prices.

Specific Examples of Impact of Adjustment Measures on Agriculture and Equity

Many case studies examine the effects of adjustment on macroeconomic variables (e.g., trade, balance of payments, inflation, and growth), but there are only a few studies that explore at the country level the sectoral and distributional consequences of adjustment. The evidence comes from the following sources: a) a comparative study undertaken by the United Kingdom's Overseas Development Institute (ODI) in collaboration with five country-based researchers covering India, Jamaica, Kenya, Sri Lanka and Zimbabwe; b) mostly

indirect evidence from World Bank sources and studies; and c) mainly indirect evidence coming from specific country studies.

The results of the ODI country studies have been summarized and synthesized in Addison-Demery (1986 I). The ODI authors also reviewed the impact of stabilization policies and structural adjustment loans on poverty alleviation at the request of the World Bank (see Addison-Demery 1986 II). These two sources are used extensively in the present review and are supplemented by examining other indirect country experiences.

There are at least two approaches that can be used to explore effects of adjustment on agriculture, and through it on equity at the country level. The first one takes various components (measures) constituting an adjustment package and examines their individual effects on agriculture and equity in different countries. Thus, this approach would start by looking at the impact of a devaluation, followed by specific monetary and fiscal instruments and so on, as was done at the conceptual level in Section II.

The second approach consists of organizing measures of adjustment effects into different categories defined on the basis of the mechanisms through which they affect the poor. This second approach was suggested by and used in Addison-Demery (1986 II), and is the one we adopt here.

This conceptual framework identifies five ways through which adjustment policies can affect equity and poverty. First, poverty can be alleviated through increasing the *access of poor groups to productive assets* (such as land) thereby raising incomes by increasing their output of tradeable goods. Although this may well be the most effective means of improving equity through adjustment, it is also the most politically controversial.

Second, adjustment can *better the rate of return on assets held by the poor* through increasing prices of the output produced, reducing input prices, or boosting productivity. The assumption here is that the relatively poor do hold at least some productive assets such as land. To the extent output of tradeables produced by poor groups can be increased, the objectives of adjustment and equity both may be met.

Third, measures and schemes that *assist the poor in gaining employment*, especially in the expanding tradeable sector, can likewise achieve both distribution and adjustment objectives.

Fourth, adjustment can *enhance the access of the poor to human capital* by targeting better education, extension, and health services.

Finally, if the poor are not economically active or if they cannot be encouraged to produce tradeable goods, *income transfers* may be the only means of assisting them during adjustment periods. In this case, utmost care should be exercised that benefits be targeted as closely as possible to needy groups such as women, children, and the aged.[9]

It is important to note that the first four preceding methods for reducing poverty operate, and help the poor, through the primary distribution of income described in Section III. In each instance, incomes of the poor are increased through the triangular interrelationship—shown in Figure 2—linking production, factors of production, and household incomes. Thus, in principle, no conflict needs to exist between output growth and equity in the above four cases; in fact, it is through output growth and employment that equity is achieved.

It is only in the case of income transfers and subsidies to the needy that a conflict between these objectives may arise at least in the short run. This is, of course, why these benefits should be targeted as precisely as possible.

In what follows, concrete instances of country experiences are reviewed under each of these headings.

Access to Productive Assets. The income distribution of socioeconomic groups is largely determined by the assets they hold, i.e., land, human capital (education and skills), and other tangible or nontangible assets. Within agriculture, the distribution of income among the rural population is strongly correlated with the distribution of land. This relationship links factors of production to socioeconomic groups and appears as 2.1 in Figures 1 and 2. We have two good studies of land reforms as integral components of adjustment packages.

The first one relates to land reform in northeast Thailand. This program was initiated in part because the price reforms under Thailand's structural adjustment adversely affected the poor farmers in rice-deficit households of the northeast. Many farmers located in affected regions were cultivating land illegally. Although the land was classified for forestry, it appeared suitable for permanent agriculture. Under the adjustment program, an effort was made to increase the security of tenure for such farmers by changing the land classification and issuing them "right to farm" certificates. As long as these farmers could also obtain institutional credit, normally requiring land collateral which they did not possess de jure, such a land reform could succeed. An evaluation of this land reform by the World Bank undertaken by Feder et al. (1986), concluded that "the results of the study suggest that the provision of full legal ownership to squatters in rural Thailand is a socially beneficial policy as the productivity gap between squatters and legal owners is substantial" (p. iv).

A second study concerns an attempt to regularize the de facto subdivision of large farms in Kenya as part of a structural adjustment loan. In an evaluation of this program Addison-Demery (1986 II) indicate that political problems got in the way of such a reform:

> The revision would entail basing land tenure on a system of individual titles, particularly with regard to state-owned land and cooperative and group-owned farms. If effectively implemented, there is little doubt that this would increase agricultural productivity and go some way in alleviating rural poverty. However, whilst the government under SAL II agreed to prepare a program by March 1983, this has not yet been prepared. The reasons for the failure to proceed with this reform are undoubtedly political, and most observers are not optimistic that much land reform can be achieved in Kenya over the foreseeable future.

The potential contribution to both growth and equity of land reform is very significant, particularly when agricultural production is characterized by decreasing returns to scale as in such countries as Kenya, Colombia, and India. It is also by far the most politically difficult measure to implement. The more unequal the initial land distribution, the more difficult any change in the land tenure system

becomes. This has obvious implications for most of Latin America where ownership of land is extremely concentrated.

Enhancing Returns on Assets Held by the Poor. The most effective way of raising the incomes of rural poor—at least those who possess some land and are net producers—is to increase the prices of their products. It was seen in Section II that to the extent smallholders do produce or could produce tradeables, they can benefit from an adjustment package, depending on the supply responsiveness of the crops they grow. Comparative ODI studies indicate that increases in producer prices brought about in Sri Lanka (especially for paddy), Kenya, and Zimbabwe, enhance the incomes of smallholders. The other side of the medal is that some rural poor who are food-deficient (consume more than they produce) and those urban groups whose wages are not indexed (as in the informal sector) may suffer from higher food prices given the importance of food in their consumption basket.

A detailed study of adjustments in Ivory Coast indicated that the macroeconomic target for the first half of the 1980s had been reached by the adjustment package and that the policy changes "hit the urban formal sector hardest, and benefited agriculture the most." The adjustment program, by improving agricultural prices, raised rural incomes above what they would otherwise have been and cushioned farmers from some of the more adverse effects of stabilization. To quote Addison and Demery (1986 II):

> By 1984, the ratio of urban to rural income had declined to about 2.5:1, compared to 3.5:1 in 1980. This was achieved in the face of the 1983–4 drought. In 1985, the ratio had fallen even further, to about 2:1. By restoring agricultural incentives, the government has improved the rural-urban terms of trade, reduced rural-urban income inequalities and established a basis for long-run recovery (p. 11).

There is another important impact of adjustment on the landless and near landless: where adjustment encourages agricultural output and indirectly the demand for labor, these groups will benefit. In this connection, a study of higher maize prices on landless workers in Kenya showed the effects were mixed because of conflicting forces.

Rising employment in the production of maize resulted in increasing monetary wages; but these changes were partially offset by higher food costs and decreasing employment on non-maize-growing farms. If the growth of maize output leads to a rise in employment of the landless, the net benefits are likely to be dampened by the higher prices which landless workers would have to pay for maize, the main item in their diet.[10]

Increasing Employment Opportunities. A first observation is that removal of price distortions in markets, particularly labor markets, is likely to have a positive impact on employment. Even if minimum wages are typically not enforced in rural areas, the reduction of credit subsidies would lead to adoption of more labor-intensive technologies in agriculture. It is difficult to measure these effects at the country level because of the relatively recent nature of adjustment packages.

Another way of providing employment to the rural poor is through a variety of schemes, including emergency or relief employment programs. Experience with these programs tends to be mixed. Addison and Demery (1986 II) review a series of emergency employment measures in Chile. Despite their shortcomings, it appears that expansion of public works (such as roads, housing, and urban infrastructure) can play a positive role in increasing employment and incomes.

In Kenya, rural road construction was successful in reducing seasonal underemployment in rural areas during off-peak agricultural periods (i.e., not at planting or harvest time). Other schemes were used in Brazil and Gambia to increase the geographical and occupational mobility of civil servants affected negatively by budgetary cuts. The use of clearing houses to relocate workers met with some success in these countries.

Maintaining Expenditures on Human Capital. There are at least two large countries that were relatively successful in maintaining expenditures on education, extension, and health during adjustment periods. The Indonesian government, as a consequence of weakening oil revenues, adopted an austerity budget in 1983-84 which included significant changes in the allocation of investment and

current government expenditures. A very large government deficit turned into a surplus. In the fourth development plan covering the period from 1984 to 1989, investment priorities were shifted in favor of social sectors, with housing, education, and health all receiving substantial increases in their shares. In turn, the shares of some directly productive sectors were substantially reduced (manufacturing, mining, and transport), while the shares of agriculture and infrastructure rose, but by less than that of social investment.

This pattern of public expenditures has two major advantages: it directly or indirectly entails fewer imports, and it tends to generate more employment. One study, which converted functional budget categories into corresponding sectoral categories and used an input-output framework, estimated that employment effects would be positive notwithstanding an absolute fall in the total level of expenditures. More specifically, it was estimated that every rupiah invested in the social sector requires half as many imports and generates three times as much employment as a similar investment in industry, mines, or energy.

In Brazil the adjustment packages in the first half of the eighties had a strongly recessionary impact with the average real wage of rural workers falling by about 32 percent between 1980 and 1983. Evidence indicated that declining incomes worsened the nutrition and health picture, including a reversal of the long-term downward trend in infant mortality. The government was able to maintain and, in some instances, increase health expenditures. It thereby alleviated some of the transitional costs of adjustment on the poor.

A key issue to consider in planning expenditures on such items as education, extension, and health is that they develop human capital and improve workers' productivity, but they cannot do it immediately. As long as the time lag is relatively short, there need not be a marked trade-off between increasing output through productivity gains and reducing equity to fund the necessary investment spending.

Targeting Income and Consumption Transfers. This method obviously entails, at least in the short run, conflict between the expenditure-reduction and output-expansion goals of adjustment

and the objective of improving equity. Minimization of this conflict calls for carefully targeting benefits to those who really need them.

By far, food is the most important transfer from a welfare standpoint. Two country examples can be rehearsed here. The first one is that of Sri Lanka which adopted a major adjustment package starting in 1977 with the new UPN regime. In the previous socialist regime, in power between 1970 and 1977, rice rations, either subsidized or free, were universally available to all households regardless of incomes or assets. The cost of these food subsidies became enormous, reaching at one time almost 30 percent of total government expenditures and 4–5 percent of GDP.

The evidence indicated that although the poor definitely benefited from these rations, the bulk of the aid accrued to the nonpoor. As a consequence, one of the new government's first actions was to replace the old scheme with a food stamps program based on a means test. Even though the total cost to the government fell drastically, the new program had drawbacks which weakened its effectiveness. The value of food stamps was not indexed to the high inflation rate so the purchasing power of the stamps eroded over time. Also, the program tended to discriminate against landless rural workers earning money wages which could easily be verified and in favor of paddy producers, a significant part of whose income was in-kind and therefore not easily measured. There is some evidence that the nutritional status of the estate workers worsened after the late seventies.

Morocco provides a second example of compensatory programs for reducing food subsidies. Because subsidies account for an average of 11 percent of current government expenditures, substantial budget savings could be achieved through the introduction of targeted food programs. The World Bank estimated that only 16 percent of the total food subsidy helps the poorest 30 percent of the income pyramid, while in contrast, the upper 30 percent receives 47 percent of the subsidy value. Consequently, the Bank recommended a new and better targeted intervention program consisting of three parts: a) direct food assistance programs, b) marketing new food products, and c) cost reduction measures. It urged that the food-for-work program be increased in its coverage from about 120,000 to

almost 600,000 beneficiaries and that an extension of rural development projects be directed to the seasonally unemployed.

The proposal regarding marketing new food products relates to developing a low-cost, nutritionally abundant food which could be substituted by poor households for currently available staple foods as the subsidies on the latter are eliminated. The beauty of this approach is that this yet-to-be-determined foodstuff would be an inferior good for the rich, so a lower relative price for this good would not encourage greater consumption by the nonpoor. Subsidizing food products which are nutritious and palatable to the poor but considered inferior by the other groups is a good way of targeting benefits to the poor. In this connection it has been suggested that Indonesia consider subsidizing cassava which is consumed by the poor while being regarded as an inferior good by the nonpoor.

Pinstrup Andersen (1986) has analyzed in detail program and policy options for compensating the poor for negative effects of macroeconomic adjustment programs. He develops a scheme which, starting with household real incomes and relative prices, links to household food consumption and from there to food consumption of individuals at risk (i.e., different categories of the poor); this, in turn, helps determine the physiological utilization of ingested food by these individuals and their consequent nutritional status.

Pinstrup Anderson reviews for each link of this chain different types of compensatory programs and policies, and the extent to which the latter interfere with the adjustment process. He concludes that, in general, explicit consumer food subsidies targeted to the indigent need not have adverse effects on agricultural incentives as they increase effective demand for food. On the other hand, implicit consumer food subsidies, such as a controlled price applying to all consumers, are likely to be harmful to producers. Clearly, mechanisms exist presently to better target some minimal level of food consumption to the needy without entailing a conflict with the overall objectives of an adjustment package.

Comment

Rolf Gusten

My comments will be made mainly from the point of view of sub-Saharan Africa's experience as this is the area I am most familiar with. I will start with a general comment on the paper, followed by some specific comments and a number of second-order or technical points picked up here and there.

The paper very ably summarizes the current state of thinking on the subject of equity implications of adjustment policies and provides an analytical framework, following in its latter part the useful classification developed in the ODI study of Addison and Demery and interpreting the somewhat meager factual evidence available to date. Following Addison and Demery, one general conclusion is that most stabilization-cum-adjustment policies have favorable consequences for employment and income distribution in rural areas. I have no disagreement with this but just want to pause and compare this comforting message with what we observe in sub-Saharan Africa today. No doubt, the adjustment process has not yet gone far enough

in many countries, and in some it has barely begun; but in a number of countries incisive measures have been taken in some respects. However, there has been, so far, more stabilization than adjustment.

The discussion of the paper is largely in hypothetical terms ("what would be the consequence if"), assuming that there *will* be effective redeployment of resources and resumption of growth if the required stabilization/adjustment measures are taken. On the one extreme, with perfect elasticity of export demand and supply and flexible factor prices, adjustment can be nearly painless; at the other extreme, where many structural rigidities and adverse external conditions retard the process, the bottom line will be less encouraging. But the structural features and the circumstances that will place a country closer toward one end of the spectrum rather than the other, although of considerable interest, are outside the scope of this paper.

The paper makes the important point that hardships and negative equity effects manifesting themselves in the adjustment process, more in the urban than in the rural areas, are not attributable to the stabilization and adjustment packages and make adjustment inevitable—one way or the other. The choice is only between orderly and disorderly adjustment. A further important point is that many of the adjustment effects, not only the negative ones but also some positive ones, have already been absorbed beforehand as a consequence of the parallel market progressively gaining in importance, in food production in particular. This explains why in many countries, for instance Tanzania or Madagascar, incisive measures were absorbed with very little public protest or unrest. (The Zambia case is an exception for reasons discussed below.)

A portion of the paper is devoted to a discussion of the use of Social Accounting Matrices (SAM) for the analysis of adjustment effects. Two observations on this:

- SAMs are useful as an expository device and to help organize the framework of your enquiry; they are also perhaps useful as a consistency check. But they are not an analytical device and, in comparing an economy "with" and "without" an adjustment program, they do not "explain" the determination of income

flows, or of changes therein. The analytical results are only as good as the models on which they are based.

- I also wonder how much they can contribute to tracing the equity effects of adjustment policies (even assuming we have a reliable model with good elasticity estimates, etc.). Statistical weaknesses are such that only a very rough classification of income or household groups can be established, and most equity effects would have to be traced to the crucial *intra*-group differentiations, for which data are mostly lacking.

With respect to the review of empirical evidence, I want to emphasize that the time span of observation is still too short to allow many conclusions. In the first place, there is a data-reporting lag of often around 18 months; this shortens the available observation time, which spans at best five to six years since the beginning of adjustment programs in or around 1981. Secondly, it takes a number of years for significant results to materialize. While there is certainly scope for short-run production increases wherever farmers, due to past disincentives, have produced well within their production possibilities, the effects of factor substitution in response to exchange rate and interest rate adjustments may take time. Also farmers will not immediately proceed to capacity-increasing investments that change their production function. The speed of farmers' reaction will be a function of the length and intensity of the recent history of antiagriculture policies and their impact on farmers' confidence. Given the record of frustrated hopes and false starts of recovery programs, it is surprising and gratifying to see even the degree of supply response experienced in recent years. If governments stay the course, the full response is still to come.

Finally, a number of second-order points.

- I don't see much justification for a distinction between tree crops and annual crops with respect to speed of supply response since in many cases the scope for short- to medium-term increases in tree crop output from better husbandry is quite substantial.

- The distinction between tradeable and nontradeable sectors is crucial for the adjustment process, but it has its limits. Nontradeable sectors such as transport, energy, etc., are vital intermediary inputs for the production of tradeables and should not be neglected, in public investment programs for instance, for the benefit of tradeables since supply bottlenecks would soon develop. It is more useful to stress the need to increase the use of nontradeable factors of production (ultimately labor).
- The use of social sector public expenditure (health and education) to mitigate any adverse income effects is a very important point, particularly in Africa. While the scope for increasing the share of these sectors in the budget is mostly very limited, there is often considerable scope for redistribution of expenditure *within* each sector, for instance by introducing fees for higher education and shifting the freed resources to primary education in rural areas (and analogously for health). Thus, equity objectives can be tackled from both ends.
- The paper also suggests that switching public expenditure to education and health services will have a positive employment effect and reduce import-intensity of public outlay. But in many countries the constraint is not staff in social services but the lack of operating expenditure to make them useful. Therefore, any increment of resources made available should go toward this type of expenditure.
- Finally, in an African context the possibility of using subsidy schemes and rationing to protect vulnerable groups is limited. Therefore, self-targeting assistance through subsidies for inferior foodstuffs (cassava, some types of millet, some derivatives of maize) has much to recommend itself for its simplicity. But even this has its pitfalls, as the recent Zambian experience shows. Government liberalized the price of the (superior) breakfast maize meal while maintaining a substantial subsidy on the inferior roller meal. This caused a shift in demand. Unfortunately, government had removed the subsidy on maize (formerly administered through the marketing parastatal NAMBOARD) without replacing it with a subsidy at the maize

milling level. Thus a powerful incentive was created not to produce roller meal—at the same time demand surged as a consequence of the liberalization of breakfast meal prices. Hence, even the simplest possible subsidy scheme needs some economic and administrative know-how.

Discussion

MR. WOLGIN: On the last point about the subsidies, I think the lesson from Zambia is make sure you know what you are doing when you implement a scheme. The problem was that they were moving the subsidies from the NAMBOARD to the mills, and they never got there. They also announced the prices ahead of time and, as a result, everybody acted rationally and there was no meal left. So the problem there was implementation.

Another point bears on the speed of adjustment. A.I.D. has done some fairly quick and dirty studies of responsiveness and impacts of structural adjustment in agriculture in a couple of countries, and in particular in Zambia. In a country like Zambia where there is substantial access to land and there is no real land constraint, I think one of the effects of past policies has been a substantial underutilization of resources, both land and labor.

So the result of freeing up markets and increasing producer prices has been a substantial increase in total production, not just shifting

from one crop to another. According to some indications in the smallholder sector, there has been an increase in acreage of maybe 25 to 30 percent. There have also been desirable shifts in techniques: movements away from capital-intensive techniques and from import-intensive techniques, for example.

One of the tragedies is that all these things were happening at the micro level and had no impact at the macro level, and perhaps weren't perceived by the political leadership.

But I think in a lot of countries, particularly in Africa, the imposition of past policies has reduced production so far below production possibility frontiers that you can find very substantial increases, at least in the short run, of total production before you have to worry about new investment.

MR. BATES: I have been listening since this morning from the point of view of somebody who is at least as interested in the politics as the economics of what is going on, and I really welcome some of the shift that has taken place. The political issues are getting clarified at this point.

This morning's discussion rested on an implicit model: that governments are really interested in the best economic interests of society, are trying to maximize the efficiency with which resources are used in the society, and possibly are willing to entertain for high-minded reasons some trade-offs with regard to equity to attain those objectives. So if you could frame recommendations in terms of their efficiency implications and their distributional implications, you would make a persuasive political argument to these governments. I found that not terribly convincing.

What we have done now is to move to a form of analysis which, while highly imperfect, is much more useful. It actually looks at the micro incidence of policy reform proposals on specific groups within these countries.

This is an urgent matter to governments. The first thing a government looks at when it considers a proposed policy reform is the implications for taxes and, perhaps, foreign exchange availability over the next planning period. And then, probably, it is going to look at the incidence of the impact on groups that mediate that government's political fortunes over the short and intermediate run.

Governments really need to know in a very precise way what the incidence of these policy changes are. However, there are some problems in satisfying this need, obstacles to making economic analysis more politically interesting. One is that the groups aren't refined enough. The kind of analysis that we saw this morning is not really able to get it refined enough so we can look at the precise incidence of policy reforms on, say, the welfare or the future consumption possibilities of a farmer who is producing rice on an irrigation scheme as opposed to one who is producing rice in an upland, dry, rain-fed environment.

But we need to get down to that level of detail to gain some insight into the political problems that are facing a government that is trying to introduce the reforms we are trying to get them to introduce.

My question is this: can the SAM model or a similar technique yield an analysis that is fine-grained enough, in terms of specific impacts? If you wiggle one or another economic variable affecting the consumption possibilities of groups, where those groups are defined precisely enough so that we can recognize them as actors in the political environment facing policy decision choosers, can you really predict how they will be affected?

If so this might be a powerful economic result. But it would probably not be terribly convincing to the people concerned. First of all, they are suspicious of the economics, and I think we should be too. Second, they have a certainty equivalent, and the certainty equivalent might be lousy, but it is what they are living with on a day-to-day basis right now. What we are asking them to do is to take enormous gambles.

Now let's add a third level of complication, which is that an individual can't introduce these reforms. These reforms have to be introduced collectively. If you have a bunch of reluctant individuals, each one hesitant to gamble on his own, how are you going to combine them to act as a group in order to get the kinds of reforms we are talking about?

MR. WOLGIN: I agree with everything you said, Bob, except that I don't think you defined the issue correctly. There's no need to convince most people that action has to be taken, because the certain

equivalent of where they are, in most cases, is terrible. So they are going to take action and the relevant question is what kind of information you can feed to them to take actions which are the most efficient, the most equitable, the most politically sellable. To take the Zambia case, the Zambians had a number of choices, all hard, and they never got a political consensus on any of them. But they were certain that where they were was no longer a viable position, and that forced them to make choices.

MR. BERG: I would like to comment on that, too. In your paper, Erik, you started out by saying that the preexisting situation is critical to analysis. In fact, by definition of policy reform and structural adjustment, the preexisting situation is very bad or intolerable since governments don't undertake these changes unless they have to.

We are dealing with a universe of severe distortions in which, by virtual definition of the policy reform problem, things can't go on as they are. In such circumstances, incidence to measurement has special meaning.

By the time reform is undertaken in many of these deteriorated systems, the official pricing system no longer tells us much. Parallel markets are pervasive: for foreign exchange, for food markets, even for export crops. There have been adjustments which are unobserved all through the system. So we no longer know who is benefitting by how much from the existing regime, and who is losing, or by how much. The classic case is perhaps food prices. When most transactions take place on parallel markets, what conclusions can be drawn from official price and marketing information?

We can't really tell what the impacts are of the changes introduced by a reform program. In this case, decision makers, in recognition of an intolerable situation and in recognition of the adjustments that have already occurred, have a different set of parameters to look at than these uncertainty questions.

MR. NORTH: I may be on a little different track but it seems to me that an important thought is Erik Thorbecke's distinction between the productive poor and the poor that are not economically active.

That distinction needs to be accented more. The set of policies one considers and the set of policies and programs that you need and

should be adopting for those who are not economically active are quite distinct from policies for those who are productive but poor. Perhaps it's also important to look even further up the scale and see how policy changes affect those we call the productive poor and those who are in the higher income brackets.

I think our experience in the Famine Relief Operation was that the targeting aspects of famine relief were far more efficient than more generalized relief operations. It insured that hungry people were really getting the food supplied. The issue of subsidies becomes critical when "leakages" appear. You think you are getting to the productive poor with the subsidies, but in fact, you are benefiting the higher income brackets.

MR. WOLGIN: I think one of the things in looking at these incidence questions, especially in the rural sector, is to be aware of the second-round effects, which may be as important as the first-round effects.

There is a lot of evidence that much nonagricultural rural activity takes place, usually performed by the poorer groups. Its further expansion is held back by basic demand constraints, i.e., constraints related to agricultural cash incomes. Therefore, policies that raise agricultural incomes, for example, by increases in food prices or export prices, will lead to a derived demand for those nonagricultural services and have some substantial impacts on employment and incomes in the rural sector at large.

MR. MORSS: Just a more general point on the whole question of structural adjustment versus policy dialogue that I think this particular set of agricultural issues brings to focus. AID is not often in a position to impose its will through a structural adjustment loan. That is something that the World Bank and the IMF are in a position to do. AID's dialogue should be less oriented to using what little leverage it has to force policy reform and more oriented to getting people to think sensibly about what their policy should be.

I think the record of Westerners telling the developing countries what to do is not a record I am particularly proud to stand behind. So often, our policy prescriptions have been wrong. Policy dialogue should be a process for the exchange of viewpoints among individuals who respect each other. The primary goal should not be imme-

diate policy change but, instead, an increased understanding of the important economic forces at work so that, over the longer term, policies will be more enlightened. In such an exchange not all the attention would focus on policy shortcomings in developing countries. In my view, most (maybe 73 percent) of the problems facing these countries can be traced to unenlightened Western policies.

If this is, in fact, the case, it would seem to me that we shouldn't be talking about policy dialogue strictly in terms of developing countries' policy shortcomings. Unfortunately, this paper is oriented entirely to things we have seen that the developing countries have done wrong.

Now consider this paper if it was written from the viewpoint that I am talking about. I think in agriculture some 90 percent of the problems of the Third World are attributable to Western agricultural policies. The world glut in agriculture, for example, is the result of misdirected Western agricultural policies. In these papers the focus is on listing all the things that developing countries are doing wrong, and getting them to change. It seems to me in terms of what AID can do, we need to focus much more on what we are doing wrong and use that as a basis for a policy dialogue.

MR. BERG: Why don't we make that the subject for another conference? And I love the 73 percent, Elliott.

MR. RUTTEN: I think actually that issue can be linked to Bob Bates' point, which is that we don't understand how to fix the agricultural problems in the United States. Academic economists have a lot of suggestions about what should be done about agriculture in the United States. But, we don't have a way of making those ideas politically viable. It seems to me you could combine these two perspectives to say that to make advice from developed countries believable as policy advice for developing countries, we have to show that we understand what is going on in the United States. The fact that we can't even control policy here makes advice of the developed countries less credible.

MR. THORBECKE: It is not necessarily that economists in the United States do not know what to do; the political constraints are such that whatever advice is given is unlikely to be followed. In some instances the political constraints in a developing country may not be

quite as binding as they would be in a more developed industrialized country. So there may be a better chance that if we have something to say, it might be followed in LDCs.

MR. McLURE: I think the extreme version of what Elliott says borders on the silly. What he is saying is that if we were going to Mars, we would set up a different system and therefore, we should do that here, too. It seems to me that to go to a developing country and say that if we were going to Mars we would do it differently is just not very helpful. The developing countries have to live in a world in which silly policies are adopted by the developed countries, and they have to adapt to them, the same way they adapt to the weather or whatever.

I just don't see what you gain from wringing your hands with your colleagues from the developing world saying, "Oh, gosh, it is a shame things aren't better in the United States." We know and they know that we have silly policies in the United States.

MS. KRUEGER: On the same point, I was a little surprised at Bob. He talked about a government in the singular, and I thought Bob doesn't do that very often. He normally says, and I believe rightly, that there is no such thing as a government. There are a collection of interests, institutions and people, and pressures. Within governments, there are some groups who are interested in the economic well-being and economic growth of the people. When those groups comprising a government get into discussions on these subjects, knowledge is an important input. There is some knowledge which can sometimes be applied in a country. Some of it in fact does get applied in various ways, though not as much as we would like and not as effectively.

To say that because there is a political process, what economists have to say about how these things will work out shouldn't be considered, doesn't strike me as getting us very far. In many instances what has happened is that the group that wants improved economic performance has gotten the upper hand when they have undertaken reforms. They have then failed in one way or another because there has not been sufficient understanding of the way markets would react or of other particular constraints in the situation.

It seems to me that one cannot and should not ask the question, should we tell a government what to do? The right question is, is there some useful knowledge that can assist those in the country who want to make changes? I have no difficulty in responding yes.

We have seen it happen. We have seen it happen over and over again. What is the argument? I would also quarrel with the 73 percent figure, but that is another thing.

MR. BATES: I agree with Anne's statement, but I think policy reform is a two-stage game both in terms of the players and in terms of time. The first stage is economic analysis in dialogue with host country economic analysts, and there economic arguments are persuasive arguments. But then there is a second stage where the players change. The host country analyst then has to dialogue with the politicians and the policymakers, and at that point more refined incidence analysis showing who is going to win/who is going to lose becomes more relevant.

Anne makes the point that economic arguments often are apparently very persuasive because we have seen governments change. I think they are when the governments have no choice, as Elliot Berg was pointing out. They have to change because it is not economically sustainable to maintain the kinds of policies that have gotten them into the problem that brings them into dialogue with the foreign donors to begin with. At that point you would get reform.

But then there is the sustainability of that reform over time once these economies get back into yielding a taxable surplus that is available for redistribution. Then, again, politics comes into play, the distortions get reintroduced and there are things worth fighting for politically, and once again political analysis becomes more relevant.

So in the second stage of the game, with the entrance of new players who are political players when issues of political sustainability arise, purely economic analysis has to be blended with a more political economy kind of analysis.

MR. MORSS: What are the most important things we are doing that impact negatively on developing countries? The most important is the failure to coordinate monetary and fiscal policies to reduce global unemployment. The second thing is peddling arms all over the

world. We are subsidizing the purchase of arms all over the world. If you look at Ruth Sivard's numbers, it would appear that developing countries import more armaments than they receive in economic assistance. The mess in the agricultural sector is number three.

MR. FIELDS: The beginning of Erik's paper and the end of the paper both do extremely good jobs of presenting two different strands of literature.

What strikes me is that those two strands of literature aren't tied to one another. What Erik tells us in the beginning of the paper, and I think he is absolutely right about it, is that a proper conceptual framework in looking at adjustment has to include the question, what would have happened had countries not adjusted? We have to compare the factual with the counterfactual. He puts forth the SAM as one framework, and I think it is indeed a potentially useful framework for doing precisely that.

In the latter part of the paper he then presents the evidence, primarily from Addison and Demery and some others, which is oriented towards what, in fact, has happened in different countries. That evidence is not evidence on comparing factual versus counterfactual. It is simply saying what they did. Many of the things they did in those countries could have been done without any sort of adjustment: things such as land reform in Northeast Thailand, to take one example, or the freeing up of the economy in Sri Lanka, to take another.

All of those are things that could have been done and so to attribute them to adjustment, as Addison and Demery do, is saying, "this happened here and this happened here and these things go together."

When we ask, What effects has adjustment per se had in the agricultural sector? the answer I get from Erik's paper is that we know precious little about that and we have a lot more to learn.

MR. WOLGIN: I'd like to ask Gary what he means by structural adjustment. When you say they could have liberalized in Sri Lanka without structural adjustment, what do you mean?

MR. FIELDS: Let's put it this way. An adjustment or reform situation comes about when, usually suddenly, a country finds itself

out of reserves and has to do something in order to qualify for an IMF loan. Some shock occurs first, and then we observe what happens afterwards in terms of emergency employment programs, land reform and so on.

My point only is that such changes are often attributed to the need to adjust in order to get new loans from the IMF or something of the kind. But had the country not taken out loans from the IMF or not stabilized its economy or done whatever it did, it would have had to do other things in order to stay within its new budget constraints. It can't borrow from the rest of the world. It has to adjust to that. So it is Erik's 2(a) versus 2(b) scenario.

MR. BERG: You are using the term "adjustment" to describe something that takes place in the framework of a formal program of the Fund or the Bank.

MR. WOLGIN: Who knows how the adjustment would have taken place? The counterfactual notion, I agree with you, is the right framework, but I am not sure how you attack it.

MR. THORBECKE: I think Gary is absolutely right. I raise the issue of factual versus counterfactual, and I did not elaborate on the counterfactual case. The reason for that is that nobody to my knowledge has really done it except within the framework of simulation models. I did indicate a few examples of these simulation models which are only as good as the relationships which underlie the models. It is well known that the so-called closure rules (e.g., the assumptions underlying the savings and investment behavior) predetermine the results of the simulation exercises.

Incidentally, the OECD Development Center is just embarking on a series of something like eight country studies of the impact of adjustment (defined in the same way as we have done it here: stabilization, structural adjustment, liberalization) on employment, poverty and rural development.

The objective is to follow a common methodology and select countries at different levels of development in different regions (East/West Africa, Latin America, Asia), and, hopefully, to try to say something about the counterfactual case.

This is going to be a very difficult exercise, and I am not sure that it is going to pan out. But at least conceptually it's the only fair way

of trying to separate the effects of adjustment policies from the effects of trends which existed at the outset of the disequilibrium which triggered the adjustment package.

MR. BERG: We will have a chance to continue this interesting discussion during the next session. But first I want to allow Erik time for some closing comments.

Response

Erik Thorbecke

If I could, I would like to take just a few minutes to reply to some of the points made by Mr. Gusten. First, my analysis applied to the developing countries in general and not, exclusively, to Africa. It is clear that the impact of structural adjustment and stabilization measures is likely to affect African countries (and particularly Sahel countries) differently from South and Southeast Asian countries. Some of the generalizations which are made in the paper are probably more appropriate and valid in the context of Asia and Latin America than in the context of the Sahel. By limiting his comments to the specific case of Africa (mainly the Sahel countries) Mr. Gusten paints a more pessimistic outcome for the rural areas than is likely to occur in most of Asia.

Secondly, I am, of course, fully aware that the SAM per se is not a model but rather a conceptual framework and data set which makes explicit the circular flow of income in an economy, i.e., mapping between production, the factorial income distribution, the income

distribution by socioeconomic groups and, ultimately, the expenditure pattern of these groups. One extremely useful feature of the SAM is that it forces the investigators to design a classification scheme for production activities, factors, and socioeconomic household groups which corresponds to the specific structure and behavior of the economy being studied. The SAM helps to answer questions such as, What is the source of income (e.g., from what type of employment in what productive sector) accruing to a given household group? and How is the primary income distribution determined as opposed to the secondary income distribution?

Finally, the question of the most appropriate distinction to make regarding agricultural tradeables is one which can only be answered given the specific production conditions which prevail in each country. In general, distinguishing agricultural products on the basis of supply responsiveness appears essential—whether it be in terms of seasonal food crops vs. perennial tree crops or some other classification.

4

Gary S. Fields

Trade Strategies and the Poor: Adjusting to New Realities

Introduction

The theme of this seminar is policy reform and equity. Because neither term has an unambiguous meaning, it is worth saying a few words about how policy reform and equity shall be used.

I start with "equity" and offer two examples to help illustrate two different notions.

> Example 1: In the great majority of successfully growing countries, the real incomes of all income groups increase. In quite a number of these countries, real income has grown by a larger percentage in the top deciles than in the bottom deciles. Yet, in real terms, the poor are less poor than before. Has growth been equitable?

Example 2: In some countries, real national income has fallen substantially. In some of these "development disasters," the rich have exported their financial capital and the skilled professionals and merchants have left, either by choice or by compulsion. Those who remain are poorer than before, and more uniformly so. How does equity in the new situation compare with that in the old?

If there is uncertainty about how to answer these questions, it is because the concept of equity is imprecisely defined. Users of the term "equity" typically have either (or both) of two concepts in mind.

One notion of equity is a relative one. Viewed this way, equity is a matter of the relative income positions of different groups. The further apart are their incomes, the more unequal the situation (or in some parlance, the "more inequitable" it is). From this point of view, "equity" arises when incomes are brought closer together. By this relative conception, conditions have gotten less equitable in Example One and more equitable in Example Two.

The other notion of equity is an absolute one. By that conception, growth is equitable if the poor are helped absolutely and inequitable if they are not. By the absolute conception, Example One describes an equitable change and Example Two an inequitable change.

I personally favor an absolute approach to assessing who benefits from economic activity. This is because alleviation of poverty is what I think most development policies, and hence most policy reforms, are all about. To this way of thinking, what is of primary importance is whether the poor get richer in real terms; a secondary consideration is whether the rich get richer faster than the poor do. But I must stress that this is a value judgment with which some agree and others disagree. This paper will focus on improvements in absolute incomes, and make only passing reference to changes in income inequality.[1]

The other term requiring clarification is "policy reform." Ordinarily, when one speaks about a reform, one speaks about something which starts out faulty and is then fixed. But to speak in such terms

requires that both the speaker and the listener have a clear understanding of when something is flawed and when it is improved. When it comes to replacing a damaged system with a properly functioning one, or a corrupt system by an honest one, few disagreements would be expected. But when we take up the matter of economic policy, it is difficult, if not impossible, to be unambiguous about such judgments. "Reforming the tariff structure" means one thing to a protectionist seeking relief from import competition and quite another to a free trader; however, "lowering tariffs" means the same thing to both, even if they disagree about the desirability of lower tariffs. To avoid confusion, I shall speak in terms of "strategies" and "policy changes," rather than "reforms," in what follows.

The major policy issue examined in this paper is that of a country's choice of a trade strategy in the context of helping the poor. As the end of the 1980s approaches, developing countries face a much more difficult economic situation than that which they confronted at the end of the 1970s. The paper begins by reviewing these new realities and the need for adjusting to them. After mentioning some non-policies, I proceed to consider both successful and unsuccessful country experiences and draw lessons from them. One policy singled out for special attention is wage policy and its interaction with trade strategy. I then analyze the package of policies for outward-oriented, labor-intensive, broad-based growth in one country (Costa Rica) and the possibilities for policy redirection in others. The major findings appear in the conclusion.

What New Realities?

As developing economies plan their policies in the late 1980s, they must face four new realities on the international scene: a secular worsening of the terms of trade, the inability of some and the diminished ability of others to accumulate additional debt to finance growth, the reduced likelihood of sustaining previous standards of living without further adjustments, and prospects of continued sluggishness in the international economy.

Worsening Terms of Trade. Figures 1 and 2 depict the time paths of prices for nonoil commodities and for oil, respectively. In real terms, nonoil commodity prices have fallen by nearly one-third between the mid-1950s and the mid-1980s. The secular downturn was interrupted only in the mid-1970s. Meanwhile, the real price of oil more than doubled since 1973. Because most developing countries export manufactured and primary products and import oil, these figures imply that the terms of trade have shifted against the developing countries. Other things being equal, the developing countries are poorer than before. This impoverishment would be expected to be felt among all socioeconomic groups. In particular, workers will be poorer to the extent that their marginal products are lower and/or their labor less in demand.

Difficulties in Sustaining Debt-Financed Growth. In the 1960s and early 1970s, the developing countries of the world borrowed at modest rates to sustain their economic development. But 1973 proved to be a watershed. In that year, the first oil price shock was felt. The oil-importing developing countries of Latin America, Africa, and Asia sought to reinvigorate their economies by borrowing from abroad. At the same time, the oil-exporting countries suddenly found themselves with unprecedented levels of earnings and the consequent need to invest them where they could accumulate rapidly. Petrodollars were loaned to developing countries via banks in the major industrialized countries, often at low or even negative real rates of interest. Governments in less developed countries (LDCs) found the temptation to borrow irresistible. Debt accumulated. By 1979, LDC debts to commercial banks had reached $160 billion.

With the second oil price shock (1979), the oil-importing developing countries faced a yet higher import bill, coupled with a worldwide recession which limited their ability to export. Rather than adjusting their policies at that time, most continued to borrow as long as they could. Real interest rates jumped, as did debt-service ratios. By 1982, for all LDCs taken together, the ratio of debt to exports had reached 131 percent and debt-service ratios had reached 19 percent of exports. By 1984, the overall debt for Latin America

Figure 1
Nonoil Commodity Prices in Nominal Terms and in Real Terms

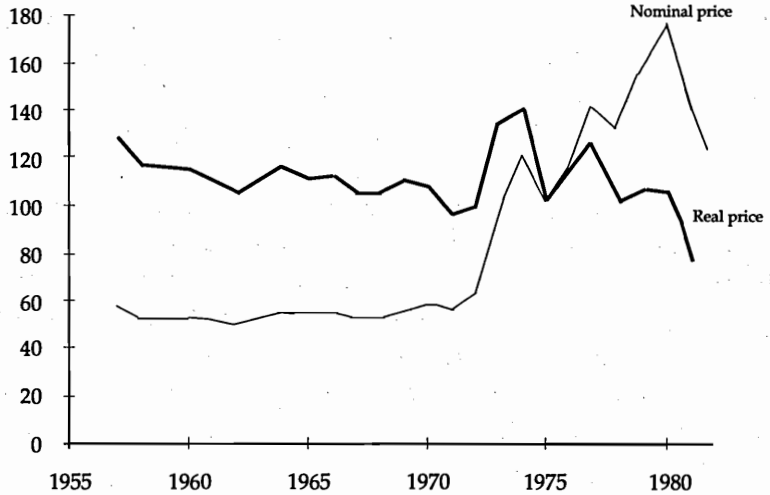
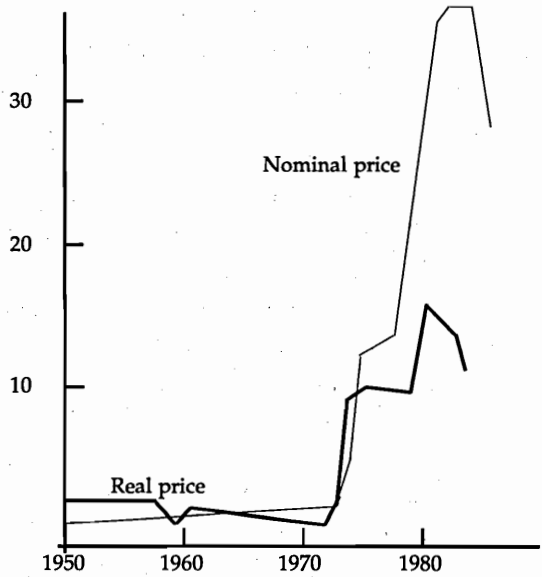


Figure 2
Crude Oil Prices in Nominal Terms (1970 = 100) and Deflated by the U.S. GDP Deflator



Source: Chichilnisky and Heal (1986), Calculated from data in *World Development Report 1984*.

had increased to U.S. $360 billion, up from U.S. $41 billion dollars just eleven years earlier (Tokman and Wurgaft, 1987, p. 40). One country after another drew down its foreign exchange reserves in an attempt to avoid economic contraction, though not in Mexico or in many of the newly industrializing countries (NICs) of Asia.

As net reserves eroded to the point of elimination, and as it became clear that many developing countries could not repay loan principal or, in some cases, interest, loans suddenly dried up. Most developing countries could no longer postpone adjustment by borrowing unconditionally from abroad. More than forty developing countries have postponed debt payments. Peru has announced that it will limit its debt service to 10 percent of exports. Brazil has halted payments altogether. Net capital inflow into the developing countries has virtually dried up. For most developing countries, debt-financed growth is over.

Reduced Likelihood of Sustaining Previous Standards of Living Without Adjustment. Because of the rise of import prices, the fall of export prices, the rise in real interest rates, and global recession, the developing countries of the world were genuinely poorer. Had they been willing to accept this, they might have scaled down some of their plans and kept their economies growing at a slower but nonetheless positive rate. But for the most part, they did not. Instead, they attempted to postpone the day of reckoning. (See, for instance, Inter-American Development Bank, 1985; World Bank, 1986; and Geller and Tokman, 1987.) However, when their foreign reserves disappeared and foreign loans dried up, one developing country after another had no choice but to undergo a wrenching process of contraction and adjustment.

The macroeconomic declines were severe. In Latin America and the Caribbean as a whole, per capita Gross Domestic Product (GDP) fell by 11 percent between 1981 and 1983. When output is adjusted for changes in the terms of trade and for net factor payments abroad, income per capita fell even more sharply (World Bank, 1986, p. 4). In sub-Saharan Africa, per capita GDP, which had grown at just 1.3 percent per annum in the 1960s and 0.7 percent per annum in the 1970s, declined by 11 percent between 1981 and 1983 (Aboagye

and Gozo, 1987, p. 78). In Asia, however, the situation was more favorable: real GDP continued to grow, albeit at slower rates than before (Lee, 1987, p. 100).

According to experts on the various regions, the equity effects were equally severe, though hard data are difficult to come by in many countries. Overall, living conditions in many places have gotten markedly worse (Addison and Demery, 1985; UNICEF, 1987).

In Latin America, open urban unemployment rates increased by more than 50 percent (Tokman and Wurgaft, 1987, p. 62) and real wages fell by as much as 40 percent (World Bank, 1986, pp. 15-18; Tokman and Wurgaft, 1987, p. 70). The share of the the informal sector in total employment increased from 29 percent to 32 percent. (Tokman, 1986, p. 535). Government budgets have been sharply cut and so too have social services (World Bank, 1986; ECLAC, 1986).

In sub-Saharan Africa, Aboagye and Gozo (1987) and Addison and Demery (1985) give examples of groups whose employment and/or real wages have fallen; but in the absence of comprehensive household surveys, they do not know (nor do we) how representative these experiences are.

In Asia, "Our main concern in analysing the effect of the recession has been to gauge the extent to which it has aggravated poverty in developing countries. While absence of data has prevented any quantitative estimates from being made, it is nonetheless clear that the recession has had adverse effects on the poor in developing countries" (Lee, 1987, p. 130). A similar conclusion is reached by the International Labor Organization's Asian Regional Team for Employment Promotion (Edgren and Muqtada, 1986).

The effect of adjustment per se on these declining macroeconomic and microeconomic conditions is very difficult to assess. Logically, one has to compare what did happen under the existing set of policies with what would have happened under alternative policies. Such analyses do not yet exist. Also, we must be careful when we look at who loses, that we also take fair account of who gains.[2]

Empirical evidence is of some help. Krueger (1984) has recognized the equity aspects head-on, writing (p. 422):

> The major problem with liberalization, as with so many other economic policy problems, is that politicians, government officials, and the informed public can readily foresee those interests that are likely to be damaged in the short run by any liberalization effort; they cannot as readily see the economic activities that were harmed, and hence did not prosper, because of regulations. Moreover, even some who would in the long run benefit by liberalization (as for example the Korean businessmen who became exporters in the 1960s but were entrepreneurs in import-substitution industries in the 1950s) perceive the short-run harm that it would cause their interests and fail to recognize the new opportunuities that would arise in the longer run.

A World Bank study of trade liberalization by Papageorgiou, Michaely, and Choksi (1986) presents "preliminary evidence" revealing no obvious relationship between unemployment and liberalization in either direction. In general, trade liberalization is not found to cause unemployment nor does unemployment influence the efficacy of liberalization. They also report themselves unable, because of data limitations, to assess the poverty and inequality consequences of liberalization.[3] The *World Development Report 1987* gives no further information on this. However, Sachs (1987, p. 40) takes the international agencies to task, urging that the standards of living of the poor be maintained through tax increases:

> The World Bank and IMF should realize that increases in taxes, especially on upper incomes and property, rather than cuts in public expenditures, can often bring about more equitable adjustments to the current crisis and perhaps increase the chances of success for stabilization programs...There is simply no evidence for the proposition that spending cuts, rather than tax increases, are to be vastly preferred on efficiency grounds as the method of adjustment.

A debate on such issues is raging among the international agencies, with the World Bank and the IMF taking one side and the ILO and UNICEF taking the other. A synthesis of positions has not yet emerged; possibly, one never will.

Sluggish International Economy in the 1980s. The world economy has grown slowly in the 1980s. Real GDP in industrial market economies grew at an average annual rate of 4.7 percent between 1965 and 1973, slowed to 2.8 percent between 1973 and 1980, and slowed again to 2.2 percent per year between 1981 and 1985. For developing countries, the corresponding percentages are 6.6 percent, 5.4 percent, and 3.5 percent (*World Development Report 1986*, p. 24). Summing up the situation from the perspective of workers in developing countries, van der Hoeven and Richards (1987, p. 135) conclude:

> It was not only the external shocks that caused the crisis but also the nature of the adjustment policies which all countries in the North and the South applied . . . [T]wo facts may be worth identifying. One is the almost unanimous switch in the early 1980s to restrictive policies which resulted in slow economic growth and a massive increase in unemployment. The second is the absence of efforts within the OECD countries to arrive at concerted economic stimulation.

The economic outlook is for continued slow growth.[4] Developing countries must plan accordingly.

Adjusting Trade Strategies to the New Realities

Economics is concerned with constrained choices. When the constraints change, so too must the choices.

The new realities of the international economy imply that many developing countries face a new, more tightly binding set of constraints. The appropriate response is *not* to attempt to keep on the same course at all costs. Nor is it to give up in the mistaken belief that nothing can be done in today's environment. Rather, the appropriate response is to assess the constraints, take stock of the options, make the best choices, and design policies accordingly.

Nonpolicies. Nonpolicies are embodied in wishes or conditions which developing countries earnestly desire but cannot obtain, strident voices notwithstanding. It is a nonpolicy to wish that the terms of trade could be shifted in favor of the primary products

produced by the developing countries. It is a nonpolicy to hope that energy prices will stay low or fall further. It is a nonpolicy to wish that multinational corporations were more socially oriented. And it is a nonpolicy to wish that the industrialized countries would offer larger fractions of their national products in aid to the poorer countries of the world.

What these nonpolicies have in common is that the wishes are not matched by any corresponding policy instruments. There is nothing developing countries can *do* to make these things happen. So although the first-best outcome from the point of view of those countries would be for some of these things to take place, exhortations are no substitute for action. It is with actions, not ideals, that the policy alternatives analyzed below are concerned.

External Resources. Two simple facts prevail: (a) most developing countries cannot accumulate additional debt, and (b) either they must service the existing debt or not service it at their peril.

The most straightforward response would be to accept these facts and to adjust to them. If such a decision were to be made, the country would have to rely on the resources it could generate to service the debt, meet pressing current needs, and use whatever is left for economic expansion.

The straightforward response is also the most difficult. The reason is that for many countries, if they were to proceed in this fashion, they would never get through the stage of meeting pressing current needs. Indeed, many of these would be unmet. The social effects especially on the poor, would in many cases be devastating. Knowing this, the countries involved have responded in two ways: they seek external support in other ways such as structural adjustment loans and economic support funds, and they try new methods of dealing with their debt.

At the moment it appears that the external assistance and new approaches to debt are bringing some relief to a number of developing countries. At the very least, they are able to forestall some of the ravages of sharp cuts which would otherwise be required in the absence of these measures. Without the infusion of external resources, the equity situation would probably be even worse.

Trade. Trade offers the only practicable way out of the dilemma developing countries are facing. The more they can earn from what they export or from what domestic suppliers produce efficiently to substitute for imports, the less they will have to cut expenditures to remain within their budget constraints. Standards of living can be higher as a result.

What can developing countries do? The answer, very simply, is that they should do what is efficient in today's circumstances. But "efficient" does not necessarily mean GNP maximization. Rather, efficiency should be defined in terms of overall development goals. One such goal is poverty alleviation. As we know from various studies, labor incomes (including the income from small-scale farming and self-employment) are primarily responsible for variations in standards of living (Fields, 1980). The question, then, is how to shift the demand for labor to add to national production, create jobs and raise real wages, and thereby lessen poverty. Increased production for the world economy offers such a possibility.

The call for increased trade as a vehicle for adjusting to the new realities may seem strange to some. It is said that with a sluggish world economy and with world demand barely increasing, the developing countries can hardly expect to find new markets or expand sales. The counterargument is that those countries which are doing very well in today's environment — Japan and Korea, for example — are doing so precisely through export expansion. If world markets are not closed to exports from those countries, why should they be any more closed to the products of Jamaica, Peru, or the Philippines? The answer, I contend, is that they are not. The arguments for alleviating poverty by choice of an outward-looking trade strategy occupy much of the balance of this paper.

Benefits of Export-led Growth: The Asian Experience

As is well known, many Asian countries—among them, Japan, Hong Kong, Singapore, Korea, and Taiwan—have pursued economic growth by expanding exports. They pursued export-led growth, because that is what comparative advantage dictated. Of course,

these economies grew very rapidly: average real economic growth was at least 7 percent per capita in each of the five economies for more than two decades. In the 1970s, when these economies had fully embarked on outward-looking economic growth strategies, exports grew at annual rates ranging from 5 percent in Hong Kong to 29 percent in Korea.

The East Asian economies adjusted to external events such as oil price shocks much better than did the economies of Latin America; see Balassa (1984), Hasan (1984), and Sachs (1985) for a comparison of the adjustment experiences of the different regions. One reason for this successful response was that the East Asian NICs did not stick with the same strategies. Rather, they changed what they did in response to *changing* comparative advantage, both by using different production methods (in particular, capital-deepening) and by switching to different products (e.g., allowing their textile industries to decline, thereby freeing up labor for use in other sectors).[5]

Export Substitution and Export Promotion. Many outsiders believe, mistakenly, that the newly industrializing countries of East Asia followed essentially the same policies. In reality, they sought to expand exports in quite different ways (see Galenson, 1985, particularly the paper by Krause; and Lau, 1986, particularly the paper by Scitovsky, for overviews of some of these differences). In Ranis' terminology (1981), Korea adopted a policy of "export promotion" while Taiwan chose a policy of "export substitution." Because this distinction in terminology is not widely familiar, and because the term "export promotion" is not used consistently in the literature, I shall elaborate upon the differences between "export promotion" and "export substitution."

"Export substitution" means that the country in question is trying to substitute production for the world market in place of production for the domestic market, the former being more profitable for firms and/or more remunerative for workers than the latter. Its essential elements are (1) relying heavily on the private sector so that individual firms and entrepreneurs provide the driving creative force for economic growth; (2) eliminating price distortions ("getting the prices right"), so that (a) market prices of products reflect social

profitability and (b) inputs in the productive process are valued in accordance with true economic scarcity; (3) producing according to comparative advantage, which typically means the manufacture of labor-intensive products; and (4) exporting to the world market, which will happen in a free and open market if and only if companies are able to compete on the basis of quality and cost.

"Export promotion," as I shall use the term here, means that the country seeks to increase exports by actively stimulating particular sectors through direct action (e.g., building an export processing zone) and/or targeted fiscal policy (e.g., tax credits, protection against foreign competition). Some elements of export promotion are similar to those of export substitution: reliance on the private sector, price incentives, comparative advantage, and production for export. However, export promotion does not leave resource allocation decisions to the private sector alone. Rather, the defining characteristic of export promotion is the active targeting of export activities. One way of doing this is by direct government intervention, for instance, by an industrial policy of "picking winners." Another mechanism of export promotion is to tamper with market prices, for instance, through protective tariffs, input subsidies, credit rationing, or tax breaks for certain export activities.

Among the developing economies of Asia, Hong Kong is the one whose policies are closest to the export substitution regime. Taiwan is also largely of that type. By contrast, Japan, Singapore, and Korea engaged more in export promotion.

Trade Strategy. Despite their differences, what the economies of East Asia have in common is a trade strategy oriented toward the world market. One shared attribute of their successes with export-led growth is the unremitting drive of firms in those economies to penetrate foreign markets and earn profits thereby. Throughout those economies, the world market is viewed as an *opportunity* for profitable sales and not as a hostile force keeping those countries in perpetual dependency. Public policy is committed to export-oriented growth. Those countries welcome foreign companies and foreign capital as partners in the development process, seeking especially to benefit from foreigners' technologies, expertise, and managerial

skills. The business environment is conducive to entrepreneurial activity; profit is not a dirty word. And political stability, though maintained at considerable social cost, nonetheless has the favorable economic consequence that both domestic and foreign firms know the rules of the game.

Some other aspects of the East Asian successes bear mention. They believed that if they produced good products at low prices, that foreign markets would be open to them, as indeed they turned out to be. The products they exported were those which had a pre-existing demand. One has to think very hard to come up with a single good created by the East Asian NICs which had not existed before. Also, market prices reflected comparative advantage. Wages have not been artificially high nor capital artificially cheap. Finally, openness stimulated competition and hence efficiency. In the words of Anne Krueger (1985, p. 23):

> The fact of openness itself, rather than of export growth, is a critical ingredient for rapid increases in output and productivity. This consideration is significant in evaluating the prospects for future growth of developing countries in the context of a potentially slower expansion of world trade: if it is openness itself that conveys benefits due to competition and the nature of policy instruments employed, the gains from export orientation will be almost as great (provided the world economy remains open) with slower growth of world trade as with more rapid growth.

The East Asian NICs were not always outward-looking. Both Taiwan and Korea were much more inward-looking in the 1950s. But they liberalized their policies in the 1960s. In Taiwan, the two key elements of the policy reform were (1) recognizing the potential for exploiting opportunities afforded by international trade and investment rather than continuing to operate behind protectionist barriers, and (2) setting realistic, positive real interest rates (Tsiang, 1984). These changes were occasioned by the relatively small size of the domestic market, the continued pressure of surplus labor, and the drying-up of the "easy" phases of import substitution (Ranis, 1979). The result in Taiwan was rapid export-led economic growth, virtually uninterrupted for a quarter century (Kuo, 1982). In Korea, the story

was largely the same in essential respects (Frank, Kim, and Westphal, 1975; Hong, 1981; Balassa, 1985; Scitovsky, 1986).

Benefits of Trade. Judging by the record in the newly industrializing countries of East Asia, seizing the opportunity presented by the world market has had a very high payoff indeed in terms of equitable growth. As shown in research studies by myself (Fields, 1980, 1984) and others (e.g., Turnham, 1970; Squire, 1981; Krueger, 1981), both export substitution and export promotion can extend the benefits of growth to the masses by improving job opportunities and consequently raising living standards. Hong (1987, pp. 292–3) puts it this way:

> In Korea, the efficiency gains associated with the long process of the opening up of a semiautarkic economy to semifree trade have materialized not only in the form of rapidly rising real wage rates but also in the form of high rates of return on investment. These enhanced rates of return in turn seem to have kindled the 'animal spirit' of Korean entrepreneurs and generated a vigorous pace of investment activities in Korea during the past twenty-year period.

Contrariwise, the employment and income distribution experiences under import-substitution industrialization have generally been less favorable and the benefits of growth less widespread (Prebisch, 1964; Baer and Herve, 1966; Morawetz, 1974; Bruton, 1974; Krueger, 1981 and 1986; and others).

Data on the experiences of Hong Kong, Korea, Singapore, and Taiwan are presented in Table 1. Their improvements under export-led growth have been sensational. Let us take Taiwan as a case in point. Full employment has been attained, the unemployment rate reaching just 1.3 percent. Much of the employment growth that took place was in the manufacturing sector, the key source of export-led growth. Among manufacturing workers in Taiwan, real wages increased *fourfold* in twenty years. The mix of jobs improved in other ways as well: fewer workers were unpaid family workers and more were paid employees.

The attainment of full employment, the rapid growth of real wages, and the improved mix of jobs led to a sharp decline in the rate of absolute poverty, the number of poor falling by more than half in

Table 1
Changes in Labour Market Conditions and Income Distribution in Seven Small Open Economies

	Barbados	Hong Kong	Jamaica	Korea	Singapore	Taiwan	Trinidad & Tobago
I. Unemployment rate	1960: 12% 1965–66: 13% 1970: 9% 1976: 16% 1980: 13%	1961: 1·7% 1971: 4·4% 1976: 4·3% 1980: 3·7%	1960: 13·5% 1968: 19·4% 1972: 23·0% 1980: 30·0%	1963: 8·2% 1967: 6·2% 1971: 4·5% 1976: 3·9% 1981: 4·1%	1957: 5·2% 1965: 9·1% 1969: 10·4% 1971: 7·0% 1977: 4·8% 1980: 3·5%	1955: 6·3% 1963: 4·3% 1972: 1·5% 1981: 1·3%	1970: 13% 1975: 15% 1979: 12%
II. Employment composition							
A. Agriculture as a % of total employment	1970: 21·3% 1975: 9·9%	1961: 7·4% 1971: 4·0% 1976: 2·5% 1980: 1·4%	1972: 33·4% 1979: 33·6%	1963: 63·2% 1970: 50·4% 1980: 34·0%	1957: 6·9% 1970: 3·5% 1979: 1·5%	1964: 50·0% 1970: 36·8% 1979: 21·5%	1970: 22·7% 1977: 13·4%
B. Employees as % of economically active population	n.a.	1961: 83·8% 1971: 87·3% 1980: 89·4%	n.a.	1963: 31·5% 1971: 39·3% 1980: 47·3%	1957: 73·7% 1970: 76·5% 1979: 83·5%	1956: 36·8% 1964: 39·2% 1970: 50·7% 1979: 63·7%	n.a.
C. Professional & tech., administrative & managerial, clerical, and sales occupations as % of economically active population	1960: 5·1% 1970: 9·2%	1961: 27·5% 1971: 26·8% 1976: 28·3% 1980: 32·5%	1968: 14·6% 1978: 21·9%	1963: 16·9% 1970: 22·9% 1980: 29·5%	1957: 36·8% 1970: 39·4% 1979: 42·5%	1964: 22·4% 1970: 26·9% 1979: 30·0%	1970: 22% 1975: 18% 1978: 20%
D. % of employed workers with no schooling [% illiterate in brackets]	n.a.	1961: 20·2% 1971: 16·2% 1976: 13·9% 1980: 10·4%	1970: 3·5% 1979: 1·7%	1960: 44·7% 1970: 23·8% 1980: 16·0%	1966: 54·1% 1972: 20·6% 1977: 35·2% 1980: 22·5%	1965: [26·0%] 1970: [20·7%] 1975: [15·9%] 1980: [9·0%]	1970: 19·6% 1975: 21·9% 1979: 9·2

III. Real wages or earnings	Index of avg. real wage, 1976 = 100: 1976: 100·0% 1980: 125·7%	Index of avg. real manufacturing wage, 1948 = 100: 1960: 105 1965: 157 1970: 167 1975: 194 1980: 253	Index of avg. wages, 1975 = 100: 1980: Men: 69 Women: 76	Index of real earnings, 1975 = 100: 1966: 52 1972: 88 1978: 154 1980: 159	Index of real income per worker, 1966 = 100: 1966: 100 1975: 100 Index of real weekly earnings, all industries, 1975 = 100: 1975: 100 1980: 120	Index of real manufacturing earnings, 1954 = 100: 1954: 100 1960: 102 1970: 183 1979: 400	Index of real weekly earnings of production workers, 1971 = 100: 1971: 100 1978: 124
IV. Poverty	n.a.	% of households with annual incomes less than HK$3000, in constant 1966 HK$: 1966: 18% 1971: 11% 1976: 7%	% of labour force with weekly incomes less than J$20, in constant 1973 J$: 1968: 70% 1973: 72% 1979: 80%	% of households with incomes below a constant real poverty line: 1965: 41% 1970: 23% 1976: 15%	% of persons with incomes below S$200 per month in 1975 Prices: 1966: 37% 1975: 29% 1980: 18%	% of households with incomes below specified figure in specified year: NT$20,000 1964: 35% 1972: 10% NT$40,000 1964: 80% 1972: 35%	Average income of specified group in constant 1971/72 TT$: poorest quartile 1971/72: 89% 1975/76: 94% Median: 1971/72: 198 1975/76: 196
V. Inequality, as measured by Gini coefficient among households [Gini coefficient among individuals in brackets]	n.a.	1966: 0·487 1971: 0·411 1976: 0·435 1981: 0·447	1968: [0·628] 1973: [0·651] 1980: [0·655]	1964: 0·34 1970: 0·33 1976: 0·38	1966: [0·499] 1975: [0·452] 1980: [0·455]	Early 1950's: 0·5 1968–72: 0·3 1976–78: 0·27	1971/72: 0·539 1975/76: 0·474

n.a. Time series information not available.
Sources: Fields (1981; 1982).

just eight years. The income inequality picture that emerges is excellent. Taiwan has the lowest income inequality (as measured by the Gini coefficient) of any country in the world! Similar patterns of improvements in labor market conditions and reductions in poverty are recorded for Hong Kong, Korea, and Singapore also. However, unlike Taiwan, inequality in the other NICs has been at moderate but not low levels.

Many observers have concluded that the policies leading the East Asian economies on the path toward rapid, equitable, export-led growth should be copied by other developing countries. This view, which is expounded by such leading luminaries in the trade and development fields as Bhagwati and Srinivasan (1978), Krueger (1981), Little (1981), Balassa (1982), and others, asserts that other countries could succeed similarly if they too were to try to produce for the world market.

These export successes demonstrate a path that developing countries might pursue to their advantage: growth led by export of manufactures. Of course, international trade is not enough; it is a means to an end, not an end in itself. The essence of economic development is the improvement in standards of living of the people. While it may be that standards of living are affected significantly by such publicly provided goods and services as public works, government housing, educational systems, public health facilities, and the like, it is nonetheless true that the basic determinant of a person's economic well-being is the amount of earnings obtained from his or her labor. Very simply, most families derive the majority, if not all, of their incomes from the work they do. If they benefit from economic growth, it is because more job opportunities are created and/or wages increase in existing jobs.

Do such export expansion activities as manufacturing Hyundais in Korea or sports equipment in Taiwan bring about more jobs and higher wages? The simple fact is that nobody is forced to take jobs in those sectors if employment opportunities are better elsewhere. It is precisely because jobs in export firms are better than jobs elsewhere that export-led growth improves living conditions.

Lessons from Less Successful Experiences

There are some obvious circumstances in which development will not succeed. Among them are pervasive corruption, excessive regulation, and nonoperational bureaucracies. An illuminating if depressing catalogue of these dysfunctional conditions is presented in Harberger (1984). I shall not try to recapitulate all his points here. Instead, I wish to emphasize a few "less obvious" barriers to economic development and growth.

Failure of Exclusionary Policies. Among the deleterious trade and industrial policies which a country can institute are actions which diminish its access to badly needed complementary factors of production. One of these is to eliminate essential economic groups in the name of other perceived goals. This took place, for instance, in many African countries when Asians and Europeans were expelled in pursuit of Africanization. Uganda under Idi Amin was both a human tragedy and an economic tragedy. That country is still suffering from the excesses of those years.

Another policy with adverse economic effects is to push multinational corporations so far that they find it more profitable to abandon existing operations rather than accede to the conditions host countries attempt to impose on them. This occurred in the mid-1970s in Jamaica when a leftist government attempted to impose a large bauxite levy. Rather than paying it, Reynolds Aluminum and the others closed their Jamaican operations and relocated elsewhere. This should have come as little surprise. While orthodox and radical economic theorists disagree in a great many respects, they fully agree that corporations are motivated by the pursuit of their own interests (orthodoxy calls this "profit maximization," radical analysis the "drive for capital accumulation"). Analysts of both persuasions would predict that if push comes to shove, multinationals will have no compunction about seeking greener pastures elsewhere. To think otherwise is to ignore the multinationals' very reason for being.

The lessons here are basic. More often than not, what makes poor countries poor is the lack of productive inputs with which their people can work. To create an inhospitable environment may well force the country to do without the inputs it needs. Unfortunately,

the poor are those who would be expected to be hurt the most by such policies, because it is the demand for their labor which is reduced first.

Need for Labor-Intensive Production. Another mistake is to presume that export-led growth will invariably have favorable equity effects (or, alternatively, to presume that it will not). Not all exports are the same. When export-led growth has succeeded in extending the benefits of growth widely, it has done so when the products exported make intensive use of that resource which the poor have the most of: their labor. Broadly speaking, two classes of exports fall into this category: manufactures and agricultural products. The successes of East Asia have entailed the employment of large numbers of workers in the production of manufactured goods. But it is also true that poverty is substantially lessened when large numbers of persons have been put to work in the tea industry of Sri Lanka, the banana industry of Costa Rica, or the fishing industry of Peru (and, one suspects, the drug industry of Colombia). When export-led growth has failed, it has often been in circumstances where the products exported make very little use of labor. This is most common when the export good is a mineral product. Oil, copper, and aluminum are examples.

The lesson appears to be that export-led growth does *not automatically* have a sizeable effect on the poor. It does when exports are labor-intensive manufactures or agricultural products; it often does not when exports are mineral-based. When it comes to choosing trade and industrial policies for widespread development, planners and aid agencies should be careful not to draw the wrong conclusion. The conclusion is not that trade per se helps the poor. It is that the poor are helped by trade when it shifts the demand curve for their labor, and seldom otherwise.

A last lesson from some of the less successful cases is the critical role of wage policy in influencing or even reversing a country's "natural" comparative advantage. Because of the importance of this topic, it is treated separately in the section which follows.

Labor Market Policy and Export-led Growth

The wage policies in the newly industrializing countries of East Asia differ from those in most other developing countries. Of greatest importance is their reliance on market wage determination, which means that wages in those economies are determined primarily by supply and demand.

Policies in Most Developing Economies. Often, in the developing world, wages are not determined by supply and demand, but rather by any or all of a number of nonmarket forces. These nonmarket forces often have potent influences in key sectors of those countries' labor markets. *Minimum wage laws* are common in many developing countries, at least in certain major sectors (e.g., large factories). When these laws are enforced, wages may be very much higher in the affected sectors than they might otherwise have been in the absence of minimum wage laws. *Labor unions* often are very strong, and are able to use their strength at the bargaining table to secure above-market wages for their members. *Pay policy with respect to public sector employees* frequently results in higher wages being paid to government workers than to comparable workers in the private sector. *Multinational corporations* sometimes are encouraged to pay high wages to local workers, lest those corporations be expelled from the country if they do not. Finally, *labor codes and protective labor legislation* may add substantially to the costs employers must pay when they hire workers. These institutional forces are found in varying degrees throughout Latin America, the Caribbean, Africa, and South Asia.

Policies in East Asia. By contrast, wages and other labor costs have *not* for the most part been inflated artificially in East Asia. Economic development in those economies has depended on low labor costs. Policymakers in Hong Kong, Korea, Singapore, and Taiwan realized that if they were to gain and then maintain trade positions in world markets, the basis for doing so would be low price, and they then pursued policies that had the effect of restraining wage growth to market levels.[6]

Generally, wages have not been permitted to rise above market-clearing levels in East Asia. Minimum wages exist in some of the countries, but their levels are so low as to be meaningless. Trade unions bargain over wages, but only in Hong Kong does the bargaining take place free of government restraint. Public employees receive wages comparable to those in the private sector, but not higher. Multinational corporations also follow market forces. But although market wage determination has dominated in East Asia in the past, there are signs that conditions may be changing. In 1985, Taiwan introduced a new labor law which sought to push wages up above market levels. The Korean government is committed to introducing a minimum wage in 1988.

Some exceptions to market wage-setting bear mention. In the case of Singapore, wages were repressed between 1972 and 1979 through direct government involvement in the tripartite National Wages Council. However, labor shortages became so severe that this policy was later abandoned. In its place was put a "wage-correction policy" designed to raise real wages, encourage capital-labor substitution and technological upgrading, reduce dependence on foreign labor, and ultimately achieve a "Second Industrial Revolution." But this so-called "high-wage policy" went too far. It ". . . contributed to declining international competitiveness, and thus to the decline in manufactured exports and employment and in economic growth generally by 1985, when the external economic environment weakened, resulting in large-scale layoffs" (Lim, 1986, p. 11). A wage freeze was then imposed. As Prime Minister Lee Kuan Yew put it: "Only after we have made up the ground lost in the years of negative growth in 1985 and, I fear, also in 1986 . . . can we afford to loosen our policy of wage restraint, and then we must peg future increases in wages to increases in productivity" (*Asian Wall Street Journal*, June 24, 1986). Thus, government involvement in the wage-setting process has been an important feature of Singapore's labor market from time to time.

The Korean government has also had a hand in repressing wages, though in more subtle fashion than in Singapore:

> Acting through the Bankers' Association of Korea, the government also tried to keep wage increases low by having banks restrict credit for firms which increased wages beyond government guidelines. This move in late 1980, however, faced strong resistance from the Federation of Korean Trade Unions. Whenever there was a more explicit confrontation over this issue, the government would say 'There is no official guideline. It is just a suggestion on the part of the government' (Nam, 1984, pp. 73–74).

But considering the heavy involvement of government in the Korean economy and in the society, "suggestions" carry a great deal of force (Bai, 1985). Scitovsky (1986, p. 154) attributes to Edward Mason the statement: "It does not take a Korean firm long to learn that it will 'get along' best by going along." Korean workers have recently taken to the streets by the tens of thousands to protest for strong labor rights. Wage repression is unlikely to be sustained in Korea for much longer.

At the risk of overgeneralizing, I would say that the East Asian economies neither pushed wages well above market-clearing levels nor forced them well below market-clearing levels. In general, these economies' wage policies may be characterized as ones of market wage determination.

Benefits of Market Wage Determination. Market wage determination, prevalent in much of East Asia thus far, has had several fundamentally important implications for the success of export-led growth in those economies. For one thing, it helped those countries avoid economic inefficiencies and misallocations of labor which might have arisen from distortions in wages; this in turn enabled them to avoid distortions in productivity between sectors. Market wage determination also naturally led employers to utilize the available labor force to the fullest extent possible, enabling those economies to pursue their inherent comparative advantages and produce goods intensive in labor.

Market wage determination discourages substitution of capital for labor in the production process which, when it takes place, lessens employment. Market processes also diminish the expected-income incentive in rural-urban migration. As I have shown in Fields (1984),

the wage differential between manufacturing and agriculture is quite narrow in East Asia, much in contrast to most Latin American countries. Finally, market wage determination avoids unnecessarily high production costs that might hamper a country's ability to sell its products profitably in world markets.

The wage policies adopted by East Asian nations quickly resulted in full employment, after which real wages rose rapidly (as shown by the figures in Table 1). The tight labor market, in turn, led to policies aimed at economizing on the use of increasingly scarce labor and enhancing labor productivity through investments in complementary physical and human capital. Thus, wage policy interacted with trade and industrialization strategies in these countries to contribute to successful, equitable development through export-led growth.

There is an important lesson here. Whether an export-oriented trade strategy is better or worse than an inward-oriented strategy may well depend on a country's choice of wage policy. Suppose an export-promoting country adopts a lenient wage policy which permits premature wage increases to be granted, and suppose further that because labor costs often constitute the largest share of total cost of a product, the country's exports become unprofitable in world markets. In such a case, if the revenues earned by private companies fail to equal the social costs of exporting, an export-oriented development strategy subsidized by the government may cause the country to lose money.

The interaction between trade policy and labor market policy has attracted considerable attention in the last year or two, both from policymakers and from researchers. The development agencies have called for increased labor market flexibility to accompany trade reforms (e.g., Rajapatirana, 1987). Policies of wage restraint and/or wage guidelines or wage-reform policies are part of many adjustment programs negotiated with the International Monetary Fund (IMF, 1986, Table 12). However, it is not generally the policy of the World Bank to impose labor market reforms as conditions for structural adjustment loans or other external support. For further information, see Lim (1986), Koo, Haggard, and Deyo (1986), Krueger (1986),

Addison and Demery (1986), and Fields and Wan (1986) and the earlier references cited therein.

Employment Adjustments. A final labor market issue, vital at the macroeconomic level though less important to trade policy per se, is that of wage and employment adjustment mechanisms. When wages are adjusted to prices and to other macroeconomic variables in an ad hoc way, wage levels are free to fulfill their standard equilibrating role. Likewise, when employers are free to take on and dismiss workers at will and workers are free to shift jobs, employment fulfills its standard equilibrating role. Labor markets adjust well in such circumstances. This is the case in the economies of East Asia, for example, in Korea, where wage tables and employment levels are adjusted annually based on prevailing supply and demand conditions in labor markets. In many other parts of the world, for example, in Argentina, Chile, and Uruguay, wages are formally indexed to prices, and hiring and firing decisions are restricted, despite other stabilization and liberalization policies. "Labor markets were changed little in the three countries. They continued to be controlled through penalties or prohibitions on labor dismissals, together with legislated wages and wage indexation. However, the weakening of trade union power in the early stages of the reforms amounted to some deregulation" (Corbo and de Melo, 1987, p. 127).

A position commanding a great deal of support in recent years is that wage indexation and employment rigidities have seriously impeded adjustment processes; but when "heterodox policies" combining fiscal correction and incomes policies were put into place in such countries as Argentina, Bolivia, Brazil, Chile, and Israel, inflation was brought under control and these economies were stabilized. Real wages fell sharply but, at least in some cases, temporarily.[7]

Interrelationships between wage policy and macroeconomic stabilization policy is another subject to which a great deal of attention is being directed.[8] But, as this is more a matter of macroeconomics than trade, I shall give it no more attention here.

Prospects and Policies for Export-led Growth: The Case of Costa Rica

The key to successful export-led growth in Costa Rica is the private sector.[9] This is partly because the private sector remains the primary employer, accounting for more than 80 percent of total employment, and partly because of the dynamism of local entrepreneurs and foreign investors. The most important task before the Costa Rican economic authorities is the upgrading of employment opportunities in the private sector as a means of achieving further economic development. Specific policies that might help achieve this objective are macroeconomic stabilization policy, sectoral policy with respect to export expansion, and labor market policy.

Macroeconomic Stabilization. A stable macroeconomic environment is essential to employment generation. In a mixed capitalistic system such as that of Costa Rica, the private sector must have confidence in the stability of the economic environment. Local entrepreneurs and foreign capitalists will invest in Costa Rica only if they are reasonably certain that they will receive at least a fair return on their money. They will believe just the opposite if external debts are not serviced, if real interest rates are negative, or if an overvalued currency is in imminent danger of devaluation—all of which were the case in Costa Rica in the economic crisis of the early 1980s. Under circumstances such as those, local investors will tend to place their money abroad and foreign investors will not enter Costa Rica at all. It is necessary that a stable macroeconomic environment be assured.

At the urging of the International Monetary Fund, the World Bank, and the U.S. Agency for International Development, and with their financial backing, the Costa Rican government brought about the necessary stability. Among the policy measures taken in late 1982 and early 1983 were

- tightening of monetary policy to control inflation
- reestablishment of positive real interest rates to stimulate investment
- cuts in government spending and subsidies, to try to narrow the budget deficit

- increases in taxes, among them the social security tax, also to try to narrow the budget deficit
- rescheduling of debt with ten creditor countries to permit payment to be made in a more manageable way
- attainment of an understanding with commercial bank creditors, also to prevent payments from getting out of hand

Macroeconomic stabilization policy has led to an economic recovery since 1983. Debt payments resumed, exports increased, inflation slowed, investment rose, and GNP grew. In fact, the World Bank's Vice President for Latin America and the Caribbean has held forth the Costa Rican experience as a model for successful adjustment (Knox, 1985). The policy reforms, and the consequent resumption of economic growth, have had favorable labor market effects. Since 1983, employment increased, unemployment and underemployment fell, real wages rose, and the composition of employment improved. The climate for future economic expansion is favorable. Macroeconomic policy can be the decisive factor in assuring economic stability, and in the case of Costa Rica indeed it has been. Other countries in the region would do well to learn this lesson.

Trade Policy. Costa Rica's economic growth has been export-led. The two main categories of Costa Rica's exports are agricultural commodities and manufactured goods. The agricultural products include coffee, bananas, sugar, beef, and cocoa. These are sold in highly competitive world markets. The other category is manufactured goods. Approximately 80 percent of exported manufactured goods and other "nontraditional exports" are sold within the protected Central American Common Market.

Costa Rica has adopted a protectionist trade policy with respect to "nontraditional exports," a policy which is partly responsible for the change in the classification of that country's trade orientation from "moderately outward-oriented" in 1963–73 to "moderately inward-oriented" in the period 1973–85 (*World Development Report 1987*, p. 53). One of the country's leading economists, Claudio Gonzalez-Vega (1984), has criticized these inward-oriented policies, calling instead for a more outward-looking trade strategy:

> Costa Rica requires a series of sharp, rapid adjustments induced by bold economic policy revisions, including a much lower and uniform rate of protection of import substitution manufacturing, a reduction in the level of implicit or explicit subsidies, a much smaller public sector, particularly in productive areas, and a drastic overhauling of the financial sector, in order to increase the share of domestic savings in financing investment.

Indeed, the Costa Rican economy now appears to be liberalizing. The licensing regulations and other controls established during the economic crisis of the early 1980s have since been dismantled. Costa Rica is now negotiating to join GATT. The economy is moving decidedly in the direction of more outward-looking trade policies.

Conditions in Costa Rica are conducive to export expansion. The labor force is well educated and productive. Political stability makes Costa Rica attractive for foreign and local investors alike. Incentives for export are offered under the Caribbean Basin Initiative. The government has undertaken major reforms as part of its structural adjustment program.

These efforts have borne fruit. In recent years, assembly industries have been developed particularly successfully. These exports have been made overwhelmingly by foreign firms or by firms with substantial foreign investment.

The equity effects of export expansion have been positive. More than 15,000 new jobs have been created, adding more than 10 percent to Costa Rica's manufacturing employment (Inter-American Development Bank, 1985). And there is no evidence that the size distribution of income has become any more dispersed with the expansion of international trade (Bourguignon, 1986, p. 51).

Looking ahead, two key policy decisions must be made in Costa Rica: (1) whether to expand traditional exports (coffee, bananas, etc.) or nontraditional exports (chiefly light manufactured products), and (2) how actively to promote exports through selective public expenditures, tax incentives to certain sectors, and the like ("export promotion") versus a more laissez-faire approach ("export substitution").

On the first of these, most of the attention in Costa Rican policy circles is directed toward expanding nontraditional exports. If Costa

Rica's comparative advantage in labor-intensive production is followed, exports of nontraditional exports could create a great many jobs. In the highly competitive dynamic world economy of today, Costa Rica should be able to penetrate new markets. However, the expansion of nontraditional exports does not preclude the expansion of traditional exports. Yes, it is true that the world prices of coffee and bananas are volatile and that the terms of trade have been moving against these products. But it is also true that for geographical and climatic reasons, Costa Rica has a comparative advantage in land-based products, the exports of which generate badly needed foreign exchange and rural employment. More attention should be given to the advantages of traditional exports as well as their disadvantages. Domestic circumstances and world market conditions do not obviously favor nontraditional exports in Costa Rica.

The other strategic decision is how actively to promote exports, to which I suggest the following working rule may apply. The only export activities that should be promoted by the expenditure of public resources are infant industries with excellent prospects of paying their own way in the very near term but which, for some good reason (e.g., lack of transport facilities), are not now under way. The best products are those that can be sold in the world market, but consideration should also be given to those that can be exported to what is left of the Central American Common Market. Otherwise, a hands-off policy is in order, and incentives should be structured so that they are neutral with respect to production for export vs. production for the national/regional market. Costa Rica should not spend scarce public resources just to generate foreign exchange, just to diversify into new areas, or just to generate jobs in the export sector. Before such resources are expended, it must be shown that the benefits to society of that particular type of export promotion outweigh the costs.

Labor Market Policy. Labor market policies in Costa Rica are on the whole quite reasonable. In general, a great deal of competition prevails within the private sector labor market in Costa Rica. Wages are set largely in accordance with supply and demand. Unions are present, but they cover only a small fraction of the private sector labor

force. Where unions are present, they do not raise wages much above the levels prevailing in the nonunionized sectors of their economies.[10] Minimum wages also exist in Costa Rica. The authorities seek to keep the minimum wage growing in line with productivity but not faster (Gregory, 1981; Pollack, 1985). In a comprehensive study of minimum wages throughout the world, Starr (1981, p. 50) says of minimum wages in Costa Rica, ". . . the impact on wages actually paid, while significant, is far less extensive and apparent . . ." than in Colombia and Mexico. We may conclude that neither union wage-setting nor minimum wages has an important influence on market wage levels in Costa Rica.

The most important nonmarket force influencing wages in Costa Rica is public sector labor market policy.[11] Wages in the public sector are about twice as high as those in the private sector. Large differentials remain even after standardizing for differences in the levels of education and experience of workers in the two sectors (Uthoff and Pollack, 1985; Gindling, 1987).

Because of the higher pay in the public sector, private sector workers throughout Costa Rica aspire to public sector jobs. In response to the pressure for government jobs both from private sector workers and from the unemployed, the government has expanded public sector employment. This has led to shortages in the private sector in certain occupations, especially those requiring the highest amounts of education.

The growth of public sector employment at above-market wage rates has diverted funds from other uses and is not obviously the best use of those resources. Serious thought should be given to two aspects of policy concerning public sector labor markets in Costa Rica: whether to freeze the amount of total employment in that sector, as was agreed upon but apparently not effectuated; and whether to gradually bring public sector wage levels more into line with those in the private sector.

All in all, market forces have a large role to play in determining wages in Costa Rica; other than in the public sector, employment and wage levels are determined largely in accordance with supply and demand and hence with labor productivity. The general adherence

to market wage determination in Costa Rica has favorable implications for that country's prospects for achieving economic development through export-led growth.

Looking Ahead

In much of Latin America, Africa, and South Asia, the prevailing attitude toward outward-looking trade policies is one of distrust. Critics of outward-looking trade policies say trade makes them vulnerable to the rest of the world. I insist those countries are vulnerable anyhow, and their vulnerability is reduced if the goods produced are in high demand in the world market. (Witness, for instance, the resilience of the East Asian economies in the face of external shocks.)

The critics say exports have only minimal effects on employment, citing such examples of capital-intensive export activities as copper mining in Chile and oil extraction and refining in Venezuela. I reply that nonmineral exports are very labor intensive, and point to industrial exports in the Far East and agricultural exports throughout Central America.

The critics say that a drive to export means that wages must be kept low. Yet the mix of job opportunities in the newly industrializing economies of East Asia has improved substantially and wages in those countries have increased many-fold.

The critics say that even if I were right about all these other points, things are different now, and that in today's stagnating world economy it is futile to try to export when world markets are not growing. But the "futility" argument assumes (almost always implicitly) that importers will maintain their traditional supply sources no matter what. This is an assumption I do not share. World markets are fickle, not loyal.

In general, consumers and firms will buy elsewhere if it pays them to do so. It is the ability of the developing countries to supply goods of high quality at low prices, rather than an increase in global demand for these products, which results in rapid, equitable export-led

growth. This is why Japanese products have gained markets throughout the world and why Korean products are competing so successfully today.

Take the example of Hyundai automobiles, one of the latest Korean success stories. Hyundai is the number one import in Canada and is growing rapidly in the United States. Why? Hyundai saw these markets as potentially profitable. They believed, rightly, that despite difficult world economic conditions, the North American markets were open to them. They were confident that consumers would choose Hyundais over Toyotas or Chevrolets if Hyundai's autos were better in quality and/or price.

Hyundai employs tens of thousands of workers who produce manufactured goods for export around the world. Similarly, entrepreneurs in the Asian countries are continually seeking new markets to penetrate and new ways to cut costs while maintaining quality. As they succeed, more jobs are created, competition for labor is heightened, real wages are pulled up, and workers' standards of living are raised. This occurs not only in the export industries but also in other industries which either must pay the higher wages or lose their workers to better paying sectors. Thus, the benefits of growth are widespread.

Another example of successful export diversification is the changing situation in the world market for baseballs and baseball equipment. A large proportion of the baseballs used in the United States are manufactured in Haiti, the reason being that American sporting goods companies have found it profitable to set up operations there. This example is important, because it shows that Haiti has started to follow a development strategy similar to that of Korea, and that Haiti has successfully penetrated a significant market, as Korea has done on a much larger scale. The fact that balls for America's national game are manufactured abroad (as are most of the fielders' mitts, batters' helmets, and other baseball equipment) says a great deal about the possibilities of world trade.

Let other countries consider similar possibilities for enhancing employment and achieving equitable growth by producing and selling in world markets. Every item you see might conceivably be produced in the developing world. If hundreds of Haitian workers

can be employed making baseballs, receiving higher wages than they could have earned elsewhere in that impoverished economy, why not expect a Latin American economy to produce and sell footballs to the U.S.? Or an African country to produce lightbulbs for Europe? Or an Asian country to produce luggage for Brazil? The possibilities are limitless: just look around and think whether it is possible to produce the item in question at a lower cost than it is now being made. In many cases, the answer will be no because the comparative advantage is to be found elsewhere: televisions will probably go on being made in Japan, aircraft in the United States, and wines in France. But sometimes the answer will be yes. I am sure there are ample opportunities for export diversification to lead to economic growth and improved standards of living throughout the developing world.

If the drive to achieve economic development through export-led growth is to succeed, public policy must be appropriate. Export diversification will not happen unless a cost advantage exists and is maintained. Labor cost is a major cost of production, often the most important one. An important component of public policy is therefore wage policy. Third World countries must be patient and allow wages to be pulled up by supply and demand. Premature increases in labor costs must be avoided. Not to be able to export profitably is bad; to export unprofitably, failing to cover the costs of export promotion, is worse.

Conclusions

1. Policy reform and equity mean many things to many people. This paper considers the effects of trade and industrialization strategies on poverty.

2. These strategies must be chosen in light of four new realities of today's international scene: a secular worsening of the terms of trade, the inability of some and the diminished ability of others to accumulate additional debt to finance growth, the reduced likelihood of sustaining previous standards of living without further adjustments, and prospects of continued sluggishness in the international economy.

3. After discarding those nonpolicies which are little more than wishful thinking, and in recognition of the limited availability of external resources, the most practicable way of resuming economic growth for the benefit of the poor is through renewed attention to the prospective gains from exports.

4. At the risk of overgeneralizing, it may be said that the economies of East Asia had certain features of export-led growth in common: they sought to earn profits by penetrating foreign markets; they had a warranted export optimism; they relied on products for which there was a preexisting demand; they allowed market prices to reflect comparative advantage; and they had flexible labor market policies. However, they differed in the degree to which they expended resources to actively promote exports.

5. Export-led growth has had favorable equity effects in East Asia. Not only have GNP's grown, but also full employment has been attained, the composition of employment has steadily improved, real wages have increased several-fold, absolute poverty has fallen rapidly, and income inequality is at low-to-moderate levels. By shifting the demand for labor and improving job opportunities, export-led growth has benefited the poor in that part of the world.

6. Some of the obvious impediments to widespread improvements in living standards are pervasive corruption, excessive regulation, and nonoperational bureaucracies. Other less obvious but important impediments are adherence to policies which deprive local workers of complementary inputs and reliance on mineral exports which use little labor.

7. Labor market policies may make the difference between successful export-led growth and inability to compete in world markets. Premature wage increases are to be avoided. Also to be avoided is wage repression.

8. Costa Rica is among those countries which offer the prospect of successful, broad-based export-led growth. Critical to their efforts are macroeconomic stabilization policy, trade policy, and labor market policy.

9. Looking ahead, other developing countries would do well to set aside their fears of involvement in the world economy by examining the records of those countries which have succeeded and studying what they did right. Producing for the world market remains a viable option for developing countries, not in all products, but in many. They have few options left.

Comment

Anne O. Krueger

There is a great deal I agree with in Gary's paper. I would like to allocate my time to two things: first, to focus a little on places where Gary and I have some disagreement of emphasis; and second, to examine the link to equity and what evidence there is about the relationship between trade policies and distributional considerations.

Turning first to differences in emphasis, I do not agree that in the 1980s the major change for developing countries is that they can no longer grow or access international capital markets. It is certainly true that it is a harsher world than the 1970s. The penalties for policy mistakes are significantly greater than they were in the past. In that sense, it is true that countries that muddled along 20 years ago with adequate growth despite questionable policy environments cannot grow as rapidly in the current environment; they may not be able to grow at all given their policies, but policies can be changed.

That much said, however, I think that the majority of countries had unsustainable policies even in the environment of the 1970s.

Had the international economy continued on its (unsustainable) course, we would have witnessed a continuation of what was happening anyway: one by one, countries found their policies unsustainable, and were faced with debt crises and rescheduling and attendant policy reforms.

So to say the entire phenomenon is brought about by the 1980s seems inappropriate. What really happened was that the deterioration of world conditions shook things out a lot faster than would otherwise have happened. But just as storm brings down trees that would have fallen anyway but does it all at once, the economic environment of the early 1980s was one in which those with unsustainable policies all confronted that uncomfortable fact in a very short space of time. To be sure, there were some countries in 1980 and 1981 that met some degree of difficulty and undertook policy reforms that would have been adequate to right the situation in the environment of the 1970s but were inadequate to the conditions of the 1980s.

I also do not share Gary's view that all developing countries must get along with no new money. We have quite a bit of evidence that the new money still goes into those countries which are creditworthy (and which face the same international conditions as those which are not creditworthy). East Asia is having no difficulty borrowing; in fact, the banks want to lend, and the East Asian countries are repaying their debt.

Lest I should be interpreted as complacent, there are important international problems surrounding the debt situation. For some countries which have undertaken policy reforms, there are abundant new investment opportunities, but domestic savings are too low to finance debt repayment and a rate of new investment high enough to permit a restoration of growth. The problem of the "debt overhang" is that the existence of debt obligations places an implicit tax on any new income streams. Lenders therefore stay away, new investment is not forthcoming, growth cannot resume, and the debtor country is caught in a vicious circle. To address that problem, it is urgent that the international community undertake a number of

policy measures. But those concerns are far removed from the concerns of Gary's paper, so I shall not focus on them here.

I would also change my emphasis from Gary somewhat with the degree to which reform has been undertaken. While countries have in most instances undertaken reforms, one can question whether they have gone far enough. It would be my judgment that there is a pressing need for further reforms in many of them. In some cases, countries' policies were so unrealistic that domestic producer prices were a small percentage of the international price. In some African countries, producer prices at 8–10 percent of the world price were the norm. In those circumstances, 50 percent price increases may sound large; they are not.

In part, what happened was that some countries adopted a variety of policies that were highly inconsistent with growth, and especially with rapid growth. But in the environment of the 1960s and to a lesser extent the 1970s, there was some moderate growth in any event. In those circumstances, economists came to believe that antigrowth policies were reflective of social objectives, and were the conscious choice of policymakers. With the harsher environment of the 1980s, the penalties for policy mistakes have become much larger and more visible.

In a similar vein, I do not share Gary's view that countries had to cut living standards. In the early 1980s, capital flows were abruptly reduced and that did require sharp macroeconomic adjustments, and would have even if those flows had been grants. The massive macroeconomic adjustment was to that cutoff, and it has been absorbed. Even without massive inflows, there is no need for further downward adjustment, and the real question is the rate at which growth can proceed.

Finally, I am dubious about the distinction between "export promotion" and "substitution." I do not believe there has been a case of successful, sustained, long-term growth based on an outer-oriented trade regime where the government has played a major role in the choice of export industries.

Governments have facilitated the expansion of successful exporters, and they have on occasion tried to identify industries, but they

have often been wrong in the latter, as in Korea in the late 1970s. To my knowledge, that was the only time the government attempted the systematic capital deepening to which Gary referred, and by the government's own admission, the result was not at all satisfactory; government had to back off.

Insofar as the government facilitates the expansion of any successful exporter, a market criterion is in fact used to "pick winners." In all unsuccessful outer-oriented regimes, what has happened has been that there has been a uniform incentive for the production and exportation of any commodity, sometimes with the exception of traditional commodities. Even then, the exchange rate has always had to be realistic, so that the degree of disincentive to the traditional exporters has been very small contrasted with that in the import-substitution regimes.

Even credit subsidies, which Gary mentioned, are the virtual equivalent of a uniform incentive insofar as all exporters are eligible and can use the funds. Citation of Japan as a case of omniscient government intervention is amusing, especially since it is well known that MITI fought tooth and nail to close down the Japanese automobile industry in the belief that they would never be successful.

MITI's record is much more mixed, and they intervened much less with uniform incentives, than most observers believe. Gary defies people to think of new products that have come in as Korean exports. I allowed myself five minutes and thought of three. The first was wigs, which was unanticipated but one of Korea's first major exports in the 1960s. The second was Reverend Moon who was a large foreign exchange earner for several years. Thirdly, the Koreans got into the construction business in the Middle East and developed that market.

From all this I conclude that there are market niches, and no economist or central planner can or should try to anticipate exactly which goods or services will be exportable and which will not. Indeed, the surest path to failure of an export would be to decree that a commodity must be exported, and then pour resources into the activity until quantitative targets are achieved. I can think of no worse formula for economic growth. The only one that is comparable is to

give automatic and unlimited protection to any commodity that is domestically produced.

For that reason, I found the discussion of product identification in Costa Rica disturbing. This is especially true of the agricultural-nonagricultural distinction. Brazil introduced reforms, including the exchange rate, a lowering of tariffs, and an increase in tax rebates on exports in 1968. The result was a huge and sustained increase in exports—both agricultural and nonagricultural. Within agriculture, soybeans (which were hardly exported prior to 1968) became a leading export within a short period of time. But poultry and orange juice also became leading agricultural exports. Simultaneously, nonagricultural and especially manufactured exports grew even faster.

There is comparative advantage within agriculture and within industry. Especially within industry, it takes the right entrepreneur, combined with a not-too-inappropriate set of factor prices and a ready availability of inputs from the international market, to determine what is the right export.

Let me now turn to the second item I wanted to discuss: evidence as to the distributional impact of trade policies. I believe that there is a lot more work than Gary cited. I did not make a systematic literature search, but simply came up with a quick list of things I recall. Paul Schultz estimated earnings functions for Colombian workers and employers as a function of the usual variables plus the rate of effective protection for the industry's output. According to his estimates, workers in protected industries received one percent more in wages for every ten percentage points additional effective protection to the industry. But employers received about three percent higher income for each ten percentage points of protection![1]

There is also evidence regarding the behavior of wages and employment in countries such as Korea that have shifted trade strategies and adopted outward oriented-trade regimes. Rates of growth of real wages and of employment have been much higher than in any country adopting an inner-oriented trade strategy.

It is in fact relatively straightforward to identify who are the winners from the inner-oriented import substitution strategy. They

are the politicians, the bureaucrats, the army, the policymakers, the industrialists in the new and protected industries, and the workers in those industries (whose wages are always higher and whose conditions of work are substantially better than those excluded from such activities). That alliance has driven up rewards to themselves at the cost of growth in real returns to other members of society in both agriculture and industry. When the economy is relatively closed, it is almost inevitable that there are the protected few who benefit at the cost of the unprotected many. In those circumstances, political interactions will dominate and will frustrate growth. It would appear that the real choice is either growth with equity or stagnation with inequality.

Gary himself has done a lot of work on the informal sector. As he knows, those in agriculture are clearly discriminated against by highly protectionist regimes (except for the occasional odd few in some exotic, protected, small part of agriculture).

To continue with respect to the evidence regarding distributional consequences, I was sorry Gary did not bring the real wage data he used up-to-date. There are more pronounced differences between countries with different trade regimes after 1980 than before; paradoxically, those countries most dependent on trade fared relatively better in the bleak years afterward than they did before.

Likewise, I think it would have been useful to distinguish somewhat more carefully between the distributional implication of reform programs while they are in progress and the implications of regimes once they are in place. I do not think anyone says there is more inequity in outer-oriented regimes. The real concern appears to be that there may be costs to the transition. There, I would cite the work of Corbo and de Melo on the Southern Cone; while the reforms failed for a variety of reasons, there is nonetheless a great deal of evidence that in terms of unemployment consequences and losses in protected industries, these were much, much smaller than anyone anticipated.[2] Many of the protected industries were able to attain large efficiency gains, and the problems of transition were much smaller than most analysts suggest. The Choksi, Michaely,

Papageorgiou project, which Gary cited, also contains a lot of findings suggesting that transition costs are far smaller than widely believed.

The important consideration in reform, it appears, is not its voluntary aspect, but rather whether trade liberalization is accompanied by a realignment of the exchange rate to a realistic (and then sustained) level. Exchange rate realignment makes exporting profitable and simultaneously offsets part of the negative impact of deprotection. Countries that instead have removed tariffs and quotas but left the exchange rate unaffected have had significant difficulties, for two reasons. First, import competing industries were less profitable. Second, export industries were no more profitable: wages, domestic costs, and output prices were all unaffected.

Probably the most important lesson from experience with alternative trade regimes is that a realistic exchange rate is the single most important policy there is. Without that policy, imports will mushroom and, one way or another, trade restrictions will be reintroduced.

My time is up. Let me just reiterate: I think there is a great deal more evidence with regard to the income distributional aspects of trade regimes than was brought forth in Gary's paper. Hopefully, future work will assemble the evidence and permit a more systematic presentation of results.

Discussion

MR. MORSS: I just wanted to suggest a different picture of the world than the one that has been put forth, make an argument for it and trace out its policy implications. I come out exactly the opposite of the prior two speakers. Let me try to summarize very briefly why I do.

First of all, I don't think the experience of the East Asian countries is relevant. Unlike the past two decades, we are now facing a threat of massive global unemployment. Kenneth Galbraith the other day said that the decade of the late 1980s and 1990s is going to be the decade in which nation states try to maximize employment, not income and not elimination of poverty. In such a world, governments will adopt interventionist policies to protect their existing employment bases and find new employment possibilities. This is what is happening in the U.S.; we, like other countries, are not going to let others freely export much longer.

What prices should an exporter look at in the international market? In agriculture, do you take a World Bank projection of what the price of sugar is going to be and do a benefit-cost analysis and decide whether to get into it? If you are in Ghana, do you say, "We want to get back into the cocoa market, let's take the World Bank projection and do a benefit-cost analysis for investment in that sector"? I would suggest that you have to go one step further and ask if Brazil is going to let you back into that market.

As soon as you ask that kind of question, you are into something I would characterize as strategic planning, and that is far different than the neoclassical prescription: to get prices right, take world market prices as a given and let everything else follow.

Korea just dropped two billion dollars to get into the microchip market. They missed on the 64K chip, but those are the sorts of gambles and big bucks that these countries are putting into international trade. India, right now, is a wonderful case. The U.S. is talking about getting prices right, but the Indians want a strategic plan. They see what Korea is doing. They want to know what the industries are in which they can gamble a hell of a lot of money so that five years from now they will be in a competitive position.

Strategic planning—an approach which involves active interventionism—is what these countries want. For the most part prices don't reflect opportunity costs. Just add up the things that are not freely traded: the counter trade arrangements, the agricultural glut, tariffs, et cetera. I don't see any real resemblance to free trade, and I don't see it coming back very shortly.

Now there are a whole lot of countries that cannot compete—cannot play this sort of sophisticated, strategic planning game. To them I say, "Don't try. Try to protect what you have now." If I were in Africa, I would say, "Close it down. Try to become food self-sufficient and think very, very hard about trying to promote an export product."

MR. BERG: I hope somebody is keeping you at home! Let me tell a story. When I was a graduate student many years ago, I sat in on a seminar given by a leading Japanese economist named Shigetu Tsuru. Tsuru presented a brilliant paper to this distinguished group

of Cambridge (Mass.) economists. He set out on the blackboard a highly persuasive argument that Japan had absolutely no possibility of penetrating world markets to a degree sufficient to provide a rate of growth that would raise living standards adequately.

That was 1955. There has been lots of export pessimism for lots of other countries since then. Yet many countries continue to confound the pessimists. In the 1960s the prevailing wisdom was that an agriculturally based economy like that of the Ivory Coast couldn't maintain its growth rate; it did so for another 15 years. By the mid-1970s prospects for continued rapid growth of LDC-manufactured exports were generally discounted. Yet no fewer than 24 countries had growth rates in manufacturing exports of 15 percent or more between 1975 and 1979, and this in an already declining world economy.

It's not surprising that export pessimism is perhaps more widespread now than ever. We're in the midst of a decade of slow growth in world trade and output, and there are worrying structural factors affecting LDC trade prospects. But the pessimists have been mostly wrong in the past, and if their policy prescription is to reduce export-raising efforts, then it is extremely questionable, to say the least; for the really poor, small economies it is scarcely conceivable.

MR. THORBECKE: The question of the extent to which the experience of the Gang of Four can be reproduced by other countries is, of course, an open question which I think we ought to discuss.

But I think there is one additional factor which Gary did not emphasize which certainly led to the success of at least two of these countries, Korea and Taiwan, and it is that they put their agricultural house in order before they embarked on the industrial export promotion process.

We can learn something from that experience. The major land reforms which took place in the two countries led essentially to a unimodal distribution of farm size. The Joint Commission on Rural Reconstruction provided the package of measures (extension, research, etc.) which led to both growth and equity. The export promotion process really started with some agricultural commodities, such as mushrooms in the case of Taiwan. The point is that

putting agriculture in order at the outset of this export promotion process makes it a lot easier to succeed than if you start with a highly dualistic agriculture sector consisting of large farms, using perhaps relatively capital-intensive techniques, side-by-side with traditional farms using very labor-intensive techniques, and where for one reason or another the package of measures discriminates against the small farmers. This is something which we ought not to overlook.

MS. KRUEGER: I just wanted to talk a bit more about trade policy. I am probably more optimistic than most about the world economy. I also think interdependence has gone too far among the industrial countries for them to be able to move too far toward protectionism. But that would not be my argument if I were talking to a policymaker about trade policy in a small African country. The argument I would make would be very simple, straightforward and different; this would go back to what Gary calls nonpolicies.

In the typical African country (leave aside Nigeria) your market for industrial products is incredibly small. There is no substitute for the world market. Most African countries are so small that even if there is protection, they are still going to be better off opening up and going around it. Even if you put many small countries together you could not get anything like a viable basis for much manufacturing.

When you try to do so, the political-economic interactions in that small market where you have one or two producers of commodity "A" and two or three producers of commodity "B" are all-pervasive, and where "B" needs some of "A" for an import, the import licensing gets highly personal. What happens to the political-economic process in that system is so detrimental to growth that the inefficiencies associated with it make the outer-oriented regime (in my sense of uniform incentives) preferable, regardless of prospects for the world economy.

And the point still remains: don't let the government decide what the price of sugar or whatever will be; let the individual producer or producer's association in the small country take a look at that and decide accordingly. Government, anyway, has enough to do and limited capabilities.

MR. KAUFFMAN. Well, I am worried. I am caught between the optimists and the revisionists. I like what I heard from Gary and from Anne which really reinforced and strengthened my biases; it is what we want to hear and is in line with what we like to believe we are doing.

But Elliot, while I find myself feeling as you do, that we should keep Elliott Morss at home, he raises in a very strong way some views that I think are widely held. One keeps hearing the questions, and I am not sure that we get answers that are quite satisfying. I am not sure I know how to explain it to an African policymaker or one in Latin America or wherever in a way that will be persuasive to him.

If the policymaker is told that regardless of what happens with the world economy, he should be outward-oriented for other reasons, then I can understand that he will be worried. The advocates of outward-lookingness are here this week and somewhere else next week. The Bank and the Fund and a lot of others go around preaching the same message: we are all supposed to look outward. Wonderful.

But I read U.S. newspapers and see what is happening in Congress and observe how many protectionist bills there are. So I would have to ask myself: what really are my chances, especially since all of us at the same time are trying to find these niches? How do we know which niches are ours and which somebody is already preempting? How do you deal with that kind of issue?

MR. BROCK: I am an optimistic revisionist, I guess. I do think that outward orientation has a lot going for it. I have seen some of the results in Chile which, despite its problems, looks pretty good in terms of the future of its outward-oriented trade strategies. But it is harder to be outward oriented if you are a primary product producer than if you are not.

Think of a country like Colombia that produces coffee and assume it is totally free-trade. There will be some naturally occurring import-competing industries, some nontraditional exports, and there will be coffee exports.

Now imagine if you can, a world with complete futures markets, let's say, even 20 years out, so that Colombia can contract the price

of coffee that it sells for the next 20 years. Everybody then knows with certainty exactly what coffee income will be. (Assume further there are no problems with crop failures or anything like that.) Then the price that Colombia will get for its coffee will fluctuate over time. However, producers in the import-competing sector and in the nontraditional export sector will all know that ahead of time, so when they are making their decisions to accumulate capital, they will think: since for the next seven years the price of coffee will be low, let's build up our noncoffee capital investments to produce a lot in these seven years. Since we would also know that the price of coffee is going up after seven years, we can plan in advance to shrink the size of that sector and everything will work out fine.

I hope that what I am trying to get at is clear. If there is a world of certainty, even a fluctuating price of coffee over time won't cause problems because people will know about it ahead of time. When they make their capital accumulation decisions, they won't be facing uncertainty as to how much capital to accumulate.

My point is that there is a lot of uncertainty in these kinds of economies, and if you have risk in the economy there will be a risk premium attached to setting up an industry. The question is what do you do about that.

One possibility is to have foreign equity participation. You would diversify away a lot of the risk even if you don't have complete futures markets. I think that is something that should be taken seriously; it is one possible solution. But if there are problems of getting foreign equity participation, you may see countries introducing other policies like subsidizing investment in nontraditional exports, or providing credit subsidies, or (as Miguel mentioned) imposing taxes on coffee during good times and subsidies in bad times because you are trying to smooth out the economy and make it less uncertain for producers.

When you are in an economy where there are no complete contingent contracts available, and you can't diversify away all of the uncertainties, you have to be careful about some of these generalizations about outward-orientation. I am not saying that they are wrong in their thrust; just that you have to be a little bit more careful. My

hunch is that the Gang of Four countries have less of a problem with highly variable terms of trade than do Latin America and Africa, for example.

MR. BATES: The African governments lack public sector instruments to handle these kinds of risks so that the societies, instead of going toward international markets, shy away from them because they don't have the mechanisms or institutions to cope with them.

MR. BERG: I'd like to comment on that and also on Phil Brock's point. In the array of factors causing uncertainty and risk that exists in most of the smaller and least developed countries, it would be hard to place external foreign exchange risk very high on the ladder. This is clear when we think about the kinds of uncertainties inherent in unstable political entities and uncongenial investment climates, in poorly structured administrative systems, and in a heavy regulatory environment over which they have limited control. All of that is much more important than uncertainty about what is going to happen to the price of coffee.

MR. BATES: That may be another interpretation of these kinds of mechanisms that the relatively stable European countries have. They are ways of controlling arbitrary interventions by governments as well.

MR. BERG: Maybe they are interconnected.

MR. BROCK: I agree with you. My earlier comment this morning was with regard to government interventions—capital levies, for example. I think that is a big problem for developing countries, and also that there is a strong incentive to have interventions like that.

But I don't think you want to discount the importance of changes in the terms of trade. I have spent a lot of time studying Chile. Copper prices have fluctuated enormously; the variances in prices on some of these commodities are as high as 20 or 30 percent per year, which is very high. So I would never say that external prices are the only uncertainty, but where that kind of uncertainty exists pursuit of an outward-oriented strategy may be more difficult than where that kind of uncertainty is absent.

MR. BERG: That's a reasonable position.

MR. WOLGIN: Can we accept the assumption that export orientation and more growth is the direction you want to go, and move to a different topic? Gary suggested that one of the important issues is labor policy. Does anybody know of any structural adjustment or stabilization programs that deal directly with labor policy? Does the Fund, the Bank or anybody else propose anything to directly affect real wages as opposed to indirectly affecting them through inflation?

MS. KRUEGER: There are a number of programs that have directly or indirectly done that. The big argument about the Brazilian program in 1984 hinged on what was going to be done about the indexation of wages. There have been a large number of programs in Africa where public sector wages have been one of the key components. There have been a number of others where wage indexation has been eliminated.

In the Chilean reforms, one of the critical pieces was that the provisions under which workers could be fired were greatly relaxed and that seems to have had an important impact on employment and the choice between capital and labor.

So there have been quite a few. Mexico is another county where the real wage is very much a hot subject.

MR. WOLGIN: There are a lot of countries in Africa where real wages had already declined as a result of inflation and devaluation, and the question was keeping them from shifting back up again.

MR. BERG: This relates to Charles's point this morning, where he cites the mid-1960s wage data. What we have had in the African case is something of a revolution in relative wages in the last 20 years. High-level wages have been severely cut in real terms, and the big skill differentials in public jobs have been completely eroded.

A major problem that the Bank and the Fund now are concerned with is how to raise real wages of highly paid people to provide them with adequate incentives. This is tied to reduced levels of employment of less skilled people who are almost always redundant. There is a parallel attempt to widen skill differentials.

There is not much conditionality on these wage/employment issues. Looking at the list of conditionalities in Bank SALs or SACs, until this year, at least, there are only two or three countries in which

wage/labor policy is mentioned as an explicit item of conditionality. But such conditionality is now becoming more common. In Senegal the Bank is reviewing labor legislation and regulations in preparation for the next structural adjustment program. So labor issues are getting more and more on the agenda. The IMF, it should be mentioned, does include provisions on wage and labor policy in a number of its programs, but not of course as formal conditionalities.

MR. VERNON: I am sorry to introduce this point late in the discussion; it really should have been introduced earlier. But I have a suspicion that we are dealing with both necessary and sufficient conditions for effectively getting the benefits of a generally liberal trade policy: low import barriers and fewer barriers to exports.

But one of the necessary conditions is institutional in character. If you look at the successful exporters of the world, there is no case among the developing countries in which the success in exports is not accompanied by some rather explicit institutional structures, which deal with the export problem independent of the trade policy. Characteristically, it is some form of conglomerate. It is the Jibord in Korea, the Zaibatsu in Japan, usually the Grupo in Brazil. Even when it is not a private Grupo, you tend to find the real exporters among the structures that are relatively large in character.

The reasons are rather obvious. If you picture the small African country that is seeking to export, the interesting question is: who will engage in the transaction costs, fulfill the search function, overcome that institutional set of barriers which consists of identifying markets, defining the nature of the product required for export markets, and so forth? There are a few markets in the world in which that is not necessary, in which the intervening structures are already in place and would take the product away. They are relatively few, however, and they tend to disappear as the product develops complexity to any degree.

If potential exporters are required to set up some sort of facility; if, for example, they are foreigners, and must make some sort of small investment in the country of export, then they come up against the institutional problem which Elliot described: the insecurity of private property in the countries concerned.

So as we pursue these very important policies that deal with exchange rate and factor cost differences, it seems to me we tend characteristically to construct only part of the structure. Without the full structure one doesn't get exports. When Korea finally became an important exporting country, I suspect that an objective study of Korea versus Tanzania wouldn't have given Korea any particular advantage in terms of any price it could find at the time. If there were any differences, the differences were institutional in character, and I am afraid that can't be forgotten in any policy setting.

MR. URRUTIA: I was going to mention the issue of wage policy. I would like to connect it with what Ray Vernon has just said. There has been more conditionality with respect to wage policy than you stated. The most dramatic example was the case of Panama, where insistence on changes in wage policy had rather varied political impact. Yet it probably involved looking at the wrong thing. I think Gary and many others have looked at wages and so-called "dualism" in many countries. It is increasingly hard to find this dualism; again I am not talking about Africa here but the rest of the developing world. Even in Latin America, the wage differentials, corrected for education and training and so on, are almost nonexistent.

Yet, in policy discussions the international organizations emphasize wage policy, and push changing of labor legislation. This is completely marginal. It probably has zero impact on exports. The really crucial things, as Ray Vernon said, are institutional. In many countries the large enterprises, or the groups that are effective in exporting, succeed because they can afford the search costs and not because they are terribly competitive internally. Frequently, the small enterprises compete rather successfully with the large enterprises in local markets since they have somewhat lower wages and other costs. But they cannot compete in export markets.

So the emphasis on trying to change labor legislation and to bring down wages in the formal sector, which includes trade unions, is a very peculiar policy stance. The unions have very important institutional impacts and political roles in these countries. Their survival is important from the point of view of maintaining democracy. To risk destroying them in order to get this very small increase in competi-

tiveness, when the really important barriers to greater exports are those that Ray Vernon mentioned, is a very peculiar policy.

MR. THORBECKE: My point follows directly on those of Ray Vernon and Miguel. Even if one were able to come up with the right recipe with regard to the set of measures which would be conducive to more labor-intensive exports, we still have to face the problem of what it is that creates a good entrepreneur (or an entrepreneurial function). Who is going to lead the way in taking advantage of whatever opportunities exist?

Thirty years ago in economics, you couldn't take a course without something being said about the role of the entrepreneur. Today it is somewhat passe. But it seems to me that there's a real issue of whether the success of countries like Korea, Taiwan, the Gang of Four generally, which rely on really first-rate small-scale or larger-scale entrepreneurs, can be duplicated. This question can only be answered if we know a little bit more about how we can create an environment that is more conducive to the role of the entrepreneur.

In this connection, it seems to me that we should also not forgot this concept that Liebenstein introduced but was never really able to define very well, namely, the concept of X-efficiency. It seems that these are questions that we ought to touch upon.

MS. KRUEGER: I agree completely on the importance of institutions, but I would have put my emphasis on some other institutions. I would have put the emphasis on things like having a phone system and a postal system and transport that worked. These are part of the necessary starting points, things which governments are supposed to do.

In the Korean case it happens that the early Korean exports were mostly handled by Japanese trading houses even though diplomatic relations were not restored. Traders were in there looking for products. Most of you probably know people whose jobs are to go everywhere around the world every year to find out what there is.

Sears Roebuck has or had whole departments of people whose job it was to do nothing but that. I was in India when Sears Roebuck discovered Kashmiri tables and went in and said to the Indian government, we would like to buy 50,000 of these a year and the

Indian government said they didn't know how to make 50,000 tables. "Where can we get that many workers?" There is no absence of demand when the situation and the focus is right. Now I agree that as things start, then institutions have to be supported and developed, but I don't think that is the critical point.

I agree with Erik about entrepreneurship, but my own implicit model would be that everywhere that people have found rewards and been able to create things, and when the basic infrastructure is in place, entrepreneurship has sprung up.

As to Miguel's point, I would agree that if the only object were export competitiveness I wouldn't worry too much about labor legislation, but that is not what I thought the object was. I thought the object was some degree of growth with equity, which means bringing people into productive employment and, for that purpose, the evidence I know says that even if it is not the wage alone, the conditions of employment, including the fact that you may not lay off workers, create strong disincentives to employment in many Latin American countries.

Again, I will cite deMelo and Corbo and the change in Chile which happened not in 1973–1974 but in 1978. Provisions which made it costly to fire workers were greatly reduced and employment increased. These things do matter, not necessarily just for getting the exports but for the quality of growth.

It would be there that I would put the emphasis, and for that matter, I would put that same emphasis there even if I thought you wouldn't get any more exports. I still think that you would bring more people into productive earning streams and that that is what is important.

MR. McCORRY: Anne, did I understand you to suggest just now that in the African context the situation is such that they need to start at a different place, that there are problems at a somewhat more basic level that need to be addressed before we can realistically talk about African countries taking advantage of these ideas about trade and export.

MS. KRUEGER: No. I would have said that those things have to go hand-in-hand. If these are strongly protectionist walls then there

will be problems with economic growth no matter what. They are a disincentive and, therefore, at the moment, they are a barrier to growth, and they have to come down. But even with those disincentives coming down, you are not going to get the very big burst for very long unless some of these other things are done, too.

MR. McCORRY: All right. I would like to follow up on that. I am just not sure what the experience of the Gang of Four has to say to Burundi. We are talking about using the East Asian experience as some kind of universal model for economic development.

MR. FIELDS: I would just answer that by saying that there is one dominant question they are asking in East Asia: what can we produce and sell profitably in world markets?

MR. McCORRY: That is part of my problem. The minister in Burundi or other places is not even worrying about that question. He is back trying to cope with the kinds of infrastructure needs that Anne mentioned.

MR. BERG: He is also probably busy trying to control every trader in sight, so he is preoccupied.

MR. McCORRY: We are back to institutional arrangements and political questions.

MR. FIELDS: But in East Asia they are asking other questions.

MS. KRUEGER: Elliot is saying that what capacity exists is being used on the wrong things, and I agree with that. If the minister would start worrying about the infrastructure and so on and stop trying to set tariffs and run the marketing boards and otherwise control prices, distribution, et cetera, then maybe he would get somewhere. Let me make one more point: if you took U.N. estimates, and there were some for 1955, I think you would find that Zambia's per capita income was above Korea's in 1955.

MR. BERG: Let me quickly say that it is not the minister in Burundi or Zambia or wherever who should be worrying so much about what to produce but a lot of individual traders and producers. That is a different stage, maybe, than the trading house in Korea or Thailand, but it is not any less important.

It's worth recalling the Niger story. In that country the major export crop (groundnuts) disappeared almost overnight in the 1970s

because of disease, low relative prices, poorly designed marketing controls. In none of the documents analyzing future prospects was any mention made of so-called cow peas as an alternative crop.

Yet in three years, the 300,000 tons of groundnut production that had disappeared (which is a lot for a country of six million people) had been replaced by about 300,000-odd tons of cow peas. The agents for this structural change were the smallholder-producers and an illicit network of traders who exported the output to Nigeria. All of this happened without positive encouragement by government; in fact, the government was busy trying to prevent it from happening.

MR. WEINSTEIN: Yes, on Burundi, it is interesting because it so happens that there is a case in point. They had been looking for what they could do to diversify out of coffee and turned to cotton. Now they have a factory that was put up with Chinese help. They have started to produce very high quality cloth, and found a niche for it in East Africa; the industry has taken off and is doing quite well.

So, in fact, Burundi is going after a regional market. You find the ministries there asking export-oriented kinds of questions, and trying to see whether there is some way they can start to capture some part of that niche. So it is even possible in Burundi.

MR. URRUTIA: I wish to return to the labor market issue. It is peculiar that there should suddenly be this pressure from the developed world against any sort of institutional development in the labor market, while there isn't any pressure for or against anti-monopoly legislation. I think most of us would agree that labor markets are pretty competitive all over the world, certainly much more than product markets. Yet suddenly we are finding that some of the conditionality is going towards making some extremely costly political reforms in the area of labor markets, which will have minimal impact since I believe those are pretty competitive markets anyway. This is why I think it is a somewhat dangerous trend.

Now with respect to the impact on employment, once again I am talking about the countries that I know about. If the impact of labor legislation on labor costs isn't all that large, the effect on employment of such labor legislation is not large either. Some recent studies such

as that by Chenery and the Colombia Employment Mission come to precisely that conclusion, contrary to the widespread belief in the country and among employers that labor legislation did have these negative employment effects.

So once again it surprises me that there is a concentration on the imperfections in labor markets and not in product markets where imperfections are much clearer.

MR. BERG: Miguel, I want to clarify a point. I have said that conditionality concerning labor-market behavior is not a major focus in Fund/Bank agreements, but when you look for labor-market conditionalities in Bank policy loans, there are virtually none.

MR. URRUTIA: Yes, because no country has accepted them.

MS. KRUEGER: I think the Bank as a matter of policy was not getting into labor markets until about two years ago.

MR. URRUTIA: Correct. But in Panama, one of your advisers suffered directly from that particular problem. He tried to put in a major labor market conditionality.

MR. MORSS: I haven't heard anyone else mention the trade policy implication of new technologies. Technologies are changing fast. A robot that can substitute for roughly 50 percent of the labor force in a nonautomated auto plant now costs under two dollars an hour fully amortized. This compares with the U.S. and Japan labor price of about $22 an hour. If we were to eliminate textile restrictions today, China would be the only textile producer. However, within ten years, China will no longer be competitive unless it invests in automation.

MR. FIELDS: I just wanted to follow up on a few things that have been said. First of all, on this issue of labor markets, I think that country experiences are different. I have worked on the Colombian labor markets as has Miguel, and I have seen that in the distribution of wages within sectors, there is a great deal of overlap. If you plot the frequency distributions, they lie almost on top of one another. They are not spread way out. That is consistent with Miguel's argument. I have also seen evidence from Costa Rica, for instance, which indicates that after standardizing for education, experience,

and other things, public sector wages are about twice as high for comparable workers as private sector wages.

So it clearly varies from country-to-country, and we shouldn't overgeneralize in either direction. My point was simply that what goes on in the labor market may prove to be important.

I wanted to back up to Anne's comments and discussion. If I was guilty of rhetorical excesses like saying that there can be no accumulation of debt for countries into the future, I was going too far. I think, however, that the point remains valid: most LDCs can't go on accumulating debt at anything like the rate at which they accumulated it in the past. In the 1970s, debt-financed growth was indeed a way by which those countries avoided adjusting and facing the painful realities of the first OPEC oil price shock. But in the early 1980s one country after another could no longer go on postponing the time of adjustment.

Again, in the case of Costa Rica, Claudio Gonzalez Vega has a very interesting analysis. He calls it "fear of adjustment." He says that because they didn't adjust earlier when they might have, and then suddenly were forced to do so all at once, things were actually much worse.

A few points emerged in the discussion that I think are important and that I would just like to point out. One is that in the case of the Gang of Four, they not only got into certain markets, but it was apparent to me and to others who have been there that they also anticipate that they are going to have to get *out of* certain markets. Japan anticipates it is going to lose some markets to Korea, and Korea anticipates it is going to lose some markets to Malaysia or the Philippines or whomever comes along next. Comparative advantage is not something static and there forever. You have it temporarily. You can take advantage of it and when somebody else comes in, you have to get out.

This is something that touches on a point that Ken Kauffman raised: what if everybody does it? Well, if you are there first you benefit from being there first, and if everybody gets into orange juice concentrate, or whatever, then maybe the time comes for you to get

out of orange juice concentrate and get into something else, maybe grapefruit concentrate. Such possibilities for new products exist.

On the issues of commodities, there are really two separate points. Phil was alluding to some of these. One is the question: does a country have a comparative advantage on the basis of the average price that might reasonably be projected, say, over the next five years? The other is the question and the problem of price variability. It's true that it would be better for risk-averse countries and risk-averse farmers if that average price were to be constant rather than moving up and down. It nonetheless remains true that on average the commodities in question are products whose prices are variable but which nonetheless are worth producing. It's not appropriate to keep your oil in the ground because the price of oil goes up and down, nor should farmers pave over the coffee plantations or banana plantations for the same reason.

One last point: I feel that there is a very important question to be asked, which determines one's view about being an export optimist or an export pessimist. I will illustrate it with two specific products that were under discussion during a recent visit I made to a typical, small African country. People have been asking what Burundi could do. Well, I wasn't in Burundi, I was in the Gambia which is even smaller, I think, and there were two things that struck me there about things they could do.

I was told that 90 percent of their export earnings came from peanuts, one single crop. Peanut prices were variable, they said. They also said, we can't export anything else. So I asked them about two specific products. One was mangos. As we all know, we go to the store and pay one dollar or more apiece for mangos. They cost nearly a pound in Britain. Yet mangos fall off the trees and rot in the Gambia. I also asked them about cashews, which also are very expensive in the U.S. I asked them why they couldn't export mangos or cashews at lower prices. Nobody had ever thought about that. This is the basis of export pessimism: the idea that you can't sell your products abroad.

MR. BERG: Gary, without wanting to diminish the value of those insights, I'd be willing to bet that if you looked around in Banjul, you

would find ten studies about cashews and fifteen studies about mangos. Not only that, but every foreigner who comes to every one of these countries looks around and has the same reactions. "Look at these lovely grapefruits, why can't you export grapefruits?"

MR. McCORRY: What is the answer?

MR. BERG: The answer is that there are usually damned good reasons why they can't export those things.

MR. VERNON: They are institutional in nature.

MR. BERG: They are institutional or economic. The grapefruits are not sufficiently homogeneous, or they mature at the wrong time, or costs of production are too high, or ships and planes aren't available when needed or cost too much, or a dozen other reasons.

MR. URRUTIA: The mangos are exported by Israel. It is incredibly institutional.

MR. BERG: The main point is that somebody close to local realities has to decide what they are going to export, not people like us who come in for three weeks or three months.

MR. STOCK: Whether export optimism is justified or not is related to rates of technological change. How rapidly the cost of robotics decreases, for example, says a great deal about where dynamic comparative advantage lies for the LDCs. The idea of dynamic comparative advantage applies to a world in which the nature of the industries doesn't change. That kind of export optimism may not work if technology changes as rapidly as it is likely to over the next 20 years, and I don't think that is addressed by these traditional distinctions about export optimism versus pessimism.

MR. FIELDS: But if technology is changing so fast, that is an opportunity for everybody.

MR. WOLGIN: In a sense, I think the question is irrelevant. It may be that technology and Prebischism and other things foreclose export possibilities. LDCs, and in particular, African LDCs, are going to have to do the best they can. And it may be that the best they can get from export-orientation, when the world economy is so negative, will be to slow down the rate of immiseration. It may be, in fact, that you should be pessimistic and export-oriented at the same time.

MR. BERG: The distinction between manufactures and primary commodities is important in thinking about pessimism and optimism. The skepticism that Ken reflected is primarily focused on primary product exports. If everybody is growing coffee and everybody is growing cotton, we know that somewhere along the line there is a problem.

MR. KAUFFMAN: I think it extends to a lot of other products that are mass-manufactures that are supposedly the things that a new industrializing country is most likely to be able to do successfully like textiles.

MR. BERG: The problem there is one of relative comparative advantage. A country can jump in and out of baseball gloves. If Haitian wages rise relative to those in the Dominican Republic, the footloose manufactures run to the Dominican Republic or Puerto Rico, and I don't know what you can do about that. But with the coffee producers or even with producers of annual crops like cotton, it is a little less clear. The alternative use of their labor and land is so much less productive, that many producers have to stay in those commodities even at extremely low prices.

That means they will continue to produce and take market share from the Colombias and the Brazils and the Malaysias which will go into more productive lines. It is hard to see what else can happen in a world in which all the coffee producers are expanding output in the face of low price and income elasticities of demand.

MR. MORSS: That is the neoclassical dream, that they will go on to do productive new things.

MR. BERG: Well, the more developed LDCs certainly have more options than the African producers do, and they are richer.

MR. MORSS: That is true. I will give you that. But in a world of significant unemployment, comparative advantage does not provide useful policy direction.

MR. BERG: Once again, I must draw this discussion to a close and allow author to have the last word.

Response

Gary Fields

My comment is in two parts: first, a response to the assigned discussant, and then some points bearing on the general discussion.

Anne Krueger is always an incisive and provocative commentator. She has made many good points with which I agree. But in a few places, her comments run the risk of being misread. Let me briefly take up some points of agreement with Anne and raise a few quibbles.

Anne's first set of points raise matters of emphasis. She sees in my work the suggestion that the "new realities" of the 1980s—worsening terms of trade, debt crises, structural adjustment, policy reforms, falling standards of living for the poor, and the like—are the results of phenomena of the 1980s alone. This is not so, and I didn't say they were. What I said was that events of the 1970s were responsible: oil price shocks, falling commodity prices, failures to adjust earlier, and so on. However, the immediate problem in the 1980s is that debt-financed growth is no longer a realistic option for the developing

countries as a whole. For most, adjustments and policy reforms are inevitable.

Anne is right in observing that while many developing countries must adjust to these new realities, it would be wrong to say that all of them have to adjust in this way. Some are in the fortunate position of being able to sustain growth out of their own domestic resources or by borrowing. The problem, though, is that most cannot. It was misleading of me not to have included qualifiers such as "most but not all developing countries" in the earlier draft. But while it would be wrong to conclude that "*all* developing countries must get along with no new money," it would be warranted, I think, to anticipate that many, perhaps most, developing countries in Africa and Latin America would fall into that category.

What I argued was that in today's environment, many countries are poorer than they had been. I didn't say, as Anne suggests, that further downward adjustment is required. What I did say was that many countries will probably remain poorer than they were before. This is precisely *because* they have already made the required downward adjustment and settled at a new, lower level of economic activity.

Anne raises several curious points about export promotion. She rightly points to MITI's mixed record of success in picking winners. But I am not who it is she takes to task for citing Japan as a case of "omniscient government intervention." It was not I, and I was surprised to see that comment in her discussion. I was surprised too by her dismissal of the distinction between "export promotion" and "export substitution." It seems to me that export-oriented countries differ qualitatively in the extent to which they expend resources to promote exports and that these differences are worth recognizing. And who could fault her for arguing that a path to failure is to decree that a product must be exported at whatever cost? But nowhere did I call for "automatic and unlimited protection," nor indeed did I call for *any* amount of protection. I tend to think that protection is economically inefficient most of the time. I'm sure Anne and I would agree fully on the need for efficiency in export-promotion activities.

Anne's second set of points concerns the relevance of other literature. Which citations are relevant to include in a wide-ranging paper such as this i a matter of judgment on which she and I are entitled to disagree. I cannot let pass, though, her comment about the existence of evidence on wages and employment in outward-looking countries such as Korea. One does not have to look very far to find that evidence: it is in Table 1 of the paper and in the accompanying text.

Let me turn now to the general discussion and respond with a few words of emphasis. First, I believe strongly that producing for the world market is not going to work for every product, or even most. It is not going to work in sugar. It is not going to work in shoes. There are a lot of things it won't work in. But in those parts of the world where export-oriented growth succeeded, economic planners and entrepreneurs were undaunted by the failures. They kept looking for successes. What they did was to ask, product by product, "Can we produce this?" If they asked about producing sugar and were wise about it, they would probably have concluded: "No, in today's market conditions, we shouldn't." Likewise, if they asked about producing wine and competing with France, the right answer in most cases would have been: "Probably not." There are many things that a given country cannot produce profitably; those things should just be ruled out. What should be investigated, though, are those products which might be profitably produced. For instance, when I buy a package of light bulbs, I don't know where they are made, nor do I care. What I do care about is how much I have to pay for a package of four, and if those light bulbs can be made more cheaply in Mexico or in the Dominican Republic or someplace else, that's fine with me. Many such products can be made in the developing countries and sold in markets in the industrialized countries. All too often, the developing countries lack the confidence to believe that they can penetrate markets where someone else is already selling. The NICs have succeeded and are succeeding by producing existing products, not new ones, and replacing traditional suppliers. The LDCs can do likewise.

Second, I should distinguish between three classes of export products: minerals, agricultural products, and industrial products. As I read the record, the mineral types of exports have not had beneficial effects on either poverty or inequality. This is in the very nature of the technology appropriate to mining copper or bauxite or pumping oil. Agricultural products are in a different category. When Miguel Urrutia said earlier that Colombia needs to consider getting out of coffee, I thought: the only thing worse for Colombia than selling coffee is not selling coffee. If Colombia were not to export coffee, conditions would probably be even worse for all of the peasants there who are now producing it. But that does not in any way diminish the importance of pursuing industrial exports and diversifying out of agricultural products. Labor-intensive industrial development has helped spread the benefits of growth in the Far East; there is no reason that this might not also happen in Colombia. Indeed, the most important lessons to learn from studies by Anne Krueger and others are that many developing countries have a natural comparative advantage in labor-intensive industrial production, and if their policies do not distort that comparative advantage, they may well succeed with export-led growth if they adopt an outward-looking orientation.

Finally, I would emphasize that labor-market policy can make a critical difference between successful export-led growth and a country's inability to compete in world markets. If a country gives primacy to its labor-market policy, and many countries do, the effect on exports may be profound. Panamanian planners instituted very strong protective labor legislation in the belief that it was right. A serious recession ensued. Which is the better way of protecting workers?

In Jamaica, two competing trade union federations each curry the favor of respective political parties. In that country, the wage paid in the unionized sector is more than double the going market wage. Ask a very simple question: how can Jamaica possibly compete with Japan or Hong Kong or Sri Lanka in U.S. markets when their wages are twice as high as they need to be? What else do they have going for them? The unhappy answer seems to be that Jamaica has no basis for competing successfully when its wages are artificially high, which

means they probably won't be very successful in the world market if they try to compete.

In arguing against wages being set prematurely above market-clearing levels, I must repeat that it is equally important that wages not be set too low. Singapore tried wage repression and ended up with serious labor shortages which impeded growth. Simple neoclassical analysis shows that the market-clearing wage is also the employment-maximizing wage. Simple neoclassical analysis isn't always right, but I think it is right this time.

To conclude, there can be no doubt that these are difficult times. Developing countries should carefully consider the costs and benefits of producing for the world market. In many product areas, exporting remains a viable option. Especially for the smaller countries, not to export may be a sure route to economic stagnation and persistent inequity.

5

Elliot Berg

Privatization and Equity

Introduction

Thanks largely to Mrs. Thatcher, "privatization" is usually equated with the selling of state-owned companies to private buyers, whether by sales of shares or by disposal of whole enterprises. While this has been the most glamorous and most debated aspect of the privatization question in industrial countries, it is only one form of it: the privatization of ownership. And for less developed countries (LDCs) it is not the most significant aspect of privatization.

There are many ways to privatize an economy—i.e., to give the private sector a larger role—without directly changing ownership rights to public sector assets. Management contracts can be arranged with private sector specialists, or state-owned assets leased to private operators. More production of goods and delivery of services can be assumed by the private sector: by government contracting out to private agents while retaining responsibility for financing (e.g., fire

protection, garbage disposal); by removing regulations that restrict private competition with public agencies (e.g., mail delivery, public transit); by providing vouchers or other forms of payment that allow consumers to choose between public and private providers of goods and services (e.g., health care, education). The financing of publicly provided goods and services can be shifted to consumers/users and away from taxpayers by reduction of subsidies and wider application of user fees.

Privatization can occur in various forms. In all of these forms, moreover, pure "publicness" or "privateness" is extremely rare. Thus the concept of private financing is blurred when private firms enjoy subsidized credit, tax holidays, tax rebates on imports, and other privileges; it becomes even more so when private loans to public entities are guaranteed by the state. A firm that is wholly private in ownership, management and financing may depend on government allocation of foreign exchange for vital inputs, on government protection of its market and its earnings by tariffs or quotas, and on government price and wage policies for its output and input pricing guidelines.

The concept of privatization, then, is a lot more complicated than the selling off of some state-owned enterprises (SOEs). There is no clear dichotomy between public and private sectors, no nicely homogenous areas of economic activity separated by a clear frontier. Rather, every economic activity is a blend of public and private elements, each of which is itself more or less "impure." Privatization means transferring to private agents more dimensions of more activities, and increasing the degree of "privateness" within each dimension.

The concept of "equity" is also complicated, but in a different way. Equity, like beauty, is in the eye of the beholder. At best, economists and other experts can only clarify alternatives, illuminate conditions, and focus passions. Some observers believe equity is achieved when economic advances raise the incomes of individuals above a specified level of absolute poverty. Others insist that equitable progress results only when a nation's income distribution becomes less unequal. For purposes of this discussion, the essential achievement of equitable development is a reduction of poverty.

In this paper we consider, from the point of view of their impact on income distribution, three of the privatization dimensions mentioned above: ownership (via divestiture), private provision of services, and financing. Management contracts and leases are not discussed, in part for reasons of space and knowledge, in part because in most cases the equity implications of privatization of management do not seem different from those of ownership privatization.

Privatization of Ownership: Divestiture

For shorthand, we will call privatization of ownership "divestiture," though strictly speaking it's not correct to do so, since divestiture includes liquidation and closure as well as sale. The World Bank, the International Monetary Fund (IMF) and the U.S. Agency for International Development (A.I.D.) frequently recommend the sale or liquidation of SOEs that are not viable or not central to government's political or economic objectives. This part of the policy reform agenda, however, has thus far had little impact.

The Record to 1985. Divestitures have been rare in LDCs and privatization properly speaking (sale of full or partial ownership to private parties) rarer still. Annex Table I summarizes some results of a recent survey, undertaken for the World Bank, of worldwide experience with divestiture.[1] The Table numbers are underestimates. Some divestitures occurring before 1985 were missed, and new divestitures have since taken place. Mexico, for example, is reported to have divested over 100 SOEs as of early 1987, and significant new sales (foreclosures) are also said to have taken place in Sri Lanka, the Philippines, Guinea, and Cameroon, among others. Moreover, plans to privatize are much more extensive now, and numerous negotiations are underway. But the picture remains basically unchanged, and can be summarized as follows:

- Substantial sale of assets or equity has occurred only in Bangladesh and Chile. Elsewhere there are only scattered cases: around 100 incidents of SOE equity sales, and only a handful of sales of partial ownership.

- Such privatization as has occurred has involved mainly small SOEs which employ few workers. The 18 firms being considered for sale in Costa Rica employ less than one-half of one percent of the labor force. Only one of the 17 firms privatized in Brazil by the end of 1984 employed more than 1,000 people.
- The sectoral distribution of privatizations (not shown in the table) indicates that most have been in the manufacturing and service sectors. There has been little in farming, utilities, mining. Divestitures of telecommunications corporations, which occurred in Malaysia, are being considered in a number of other countries.
- Most of the privatizations have really been "reprivatization"; new privatizations (i.e., sales of SOEs that were never under private ownership in the past) are unusual. Almost all of the divestitures in Bangladesh involved enterprises that were abandoned by owners fleeing civil strife in 1965 and 1971. In Chile, between 1974 and 1979, nearly all the sales involved firms that had been taken over by the Allende regime. In Brazil, 14 of the 17 privatized firms formerly had been in private hands.
- The most common form of divestiture is closure, or informal liquidation. This is a situation where enterprises remain in legal existence, but have partially or completely shut down their operations. Of the 143 cases of liquidation and closure that are identified in the table, 70 percent are informal. These numbers underscore another striking fact: legal or formal liquidations are extremely few.

The main factors that explain this sparse record of divestiture are well known: the desire of most LDC governments to sell only money losers, few of which anybody wants to buy; the political embarrassment and risks of selling public assets at prices far below book value; the political opposition from workers, bureaucrats, intellectuals, and often the army. Since none of this is likely to change much in the near future, the impact of this form of privatization will remain minor in most countries.

Types of SOEs to be Divested. In order to look at income distribution effects of divestiture, it's important to distinguish among three types of SOEs: those that are profitable, those that are unprofitable but salvageable, and those that are both unprofitable and nonsalvageable.

In the case of the firms that are relatively efficient and generally profitable, the principal reason for sales of shares is to improve the firm's competitive position: to facilitate access to private capital (as in some Brazilian privatizations and Singapore Airlines' recent sale of some of its stock) or to dynamize management in a highly competitive industry (as in Malaysia's privatization of the container facilities at Port Klang). One of the objectives of partial privatization of Singapore Airlines was to head off criticisms by other airlines that it was an unfair competitor because it was state owned.

There are other objectives for the sale of shares in these profitable SOEs: for example, to raise government revenues (Pakistan and Thailand), and to increase popular participation (recent privatizations in Chile, Britain, France, and Brazil).

The second category of ownership privatization concerns sales of ailing SOEs—those that are unprofitable. Into this category fall the great majority of SOEs that LDC governments put up for sale when they adopt a privatization program. They seek in this case to rid themselves of budget burdens, sinkholes of indebtedness, claims for credit and absorbers of management energies. The starting point of analysis here has to be the question, Why are these firms persistent money losers? One or all of three factors seem to be at work:

- The institutional environment is uncongenial: management can't hire and fire autonomously; can't raise prices when costs go up; can't pay enough to keep good workers; can't get quick decisions through supervising ministries; and can't avoid similar disabilities deriving from the legal, political, or regulatory environment.
- Management is deficient because it is politically appointed, or has a civil service mentality, or is badly paid, or operates under a system of incentives that is inadequate.

- The firms have structural disabilities, largely irreversible. Many should never have been born. They represent the legacy of flawed investment decisions: tomato canneries without supplies of tomatoes, sawmills without logs, feedmills without poultry industries, oversized match factories, high-cost cement plants, unneeded sugar plantations and refineries, overequipped airlines, etc. In some cases adverse changes in market conditions or changes in technology have made a once viable firm nonviable. In others, careless handling and lack of maintenance have rendered physical equipment unusable.

Within this category of unprofitable firms it is useful, for understanding the effects of privatization, to distinguish between "salvageable" and "nonsalvageable" money losers. Salvageable SOEs are those that, given existing or projected market conditions, can cover variable costs (excluding interest on existing indebtedness). The main sources of their difficulties lie in the institutional environment and/or in management deficiencies. If these difficulties can be significantly reduced, financial viability can be attained. Nonsalvageable firms, obviously, are primarily victims of structural factors. The prospects of their becoming financially viable are extremely slim, even with a zero price on assets; assumption of debt obligations by the government; and with optimistic projections on input prices, market prospects, and productivity gain. The only realistic hope for most of these firms is to be granted some special privileges: a monopoly on imports or an exclusive contract of some kind. This might assure their financial viability, but it would not be economically efficient.

Income-Distribution Effects of SOE Sales. Given the small quantitative significance of SOE privatizations, direct distributional effects have been minor and are likely to remain so in most countries. As noted above, if Chile and Bangladesh are set aside, the importance of ownership privatizations is derisory. Nonetheless, whether small in scale or not, sales of SOEs can have some effects on income distribution. What can be said about them?

Sale of Profitable SOEs. In this category of ownership privatization, income distribution is likely to be made slightly more skewed

in the short run. Domestic owners of capital are marginally better off as a result of privatization, as are foreign investors, if they are allowed to buy shares. (In most countries their participation is excluded or sharply limited.) Employment and average wage earnings might be higher because of new infusions of capital, better market position, and/or energized management.

Income-gap-widening effects of this type of privatization can be softened by making special efforts to sell shares to employees or users, selling to pension funds and similar institutions, or even to special trusts or holding companies in which disfavored groups are given shares; this is what is being done in Malaysia for the Malay population (the "Bumiputra").

In any event, except in cases of massive privatization or reprivatization, as in Chile and Bangladesh, the short-term and static income-distribution impacts are likely to be modest. What really matters are the longer-term dynamic effects, notably on levels of absolute poverty. These longer-term effects will depend on how privatization changes the fortunes of privatized firms and the overall rate of economic growth. These effects are indirect (impact on the surrounding policy environment) and direct (impact on the privatized firms' productivity, profits and investment rates), and are too complex for analysis here. The presumption, however, is that performance of the firm (and the economy) will improve because of better and more responsive management, easier access to capital, greater transparency of operations, reduced exposure to political decisions, and—should profitability decline—an increased likelihood of going out of business.

Sales of Unprofitable Firms. For both equity and efficiency reasons, nonsalvageable firms should not be candidates for privatization. They should be liquidated. This is what will happen to most of them anyway. Indeed, many are already in informal closure when governments announce that they are for sale. In Niger, for example, about half of the 24 SOEs on the government's "to privatize" list were in this condition at the beginning of 1985. In Argentina, 12 of the 29 SOEs up for sale in 1985 had already closed their doors.

Sale of these economically nonviable enterprises by attaching to them some income- or rent-earning privilege is bad for growth and

probably bad for equity in income distribution. Income is transferred to employees and the private owners from consumers and taxpayers. Since modern-sector wage earners are a relatively well-paid group in most LDCs, the transfer is likely to widen income differentials.

Privatization of the salvageable firms will have mixed short-run distributional effects. The effect on wage employment and the wage bill will be positive. The privatized firm will employ fewer workers than were formally listed on the firm's preprivatization payroll, but more workers than would have actually been receiving wages had there been no privatization. The share of aggregate income going to management and to capital will be larger than before.

To the extent that the privatized firm is free of the institutional constraints that prevented price increases, prices of outputs may rise, with consequent reductions in real incomes of consumers of those outputs. Many outcomes are possible—too many to be predicted except in a much more complex analysis. In any event, these static and short-term distributional effects are almost certainly less significant than the effects on income and growth.

The privatized firm will presumably be more alive to possibilities for profitmaking that were previously unknown or unexploited. It may seek out new markets, discover new products, seize new opportunities for cost cutting. It will be more likely to shut down if it cannot become competitive. And, directly and indirectly, a new private presence can lead to positive changes in the institutional environment.

Disemployment Effects. One special point needs to be made relative to redundancy of workers. The analysis up to now has skirted that issue, in part because the implicit model of the SOEs to be privatized consists of small manufacturing or service enterprises, and in part because we assumed that many of the firms in question are already crippled and limping along with reduced payrolls. Both these assumptions are in tune with actual privatization experience up to now. For example, no case seems to exist where larger enterprises in mining or transport or power have been privatized. In Chile, substantial parts of the national railway system have been shut down, and assets sold. But the redundant railway lines were not privatized.

Should such cases arise, significant unemployment would result as redundant workers were laid off. In these instances, the main distributional issue concerns fiscal incidence. Since redundant workers in SOEs are in essence transfer recipients, the equity effect depends mainly on who pays taxes. If, as in many non-mineral-exporting, low-income countries, the bulk of taxes are paid directly or indirectly by smallholder farmers, the first-round effect of privatization-induced unemployment is to make income distribution less unequal.

Distributional impact also depends on the structure of the economy; it would be different in the typical African economy, where modern-sector wage earners are relatively high on the income ladder, than in Latin America, where they are lower down. (This of course is on the assumption that the public sector resources no longer needed for subsidies to the privatized SOE are not spent so as to benefit groups as well off or better off than modern-sector wage earners; also, issues of costs associated with the sale such as debt repayment, including government guaranteed debt, are ignored.)

Where public sector resources are mainly generated by taxes on profits, export duties on minerals or crops grown by bigger, richer farmers, and/or by foreign aid, distributional outcomes are less clear. In any event, this is for the most part speculative, and in reality little privatization-induced unemployment has occurred beyond that which would have taken place anyway, without privatization.

Program Design and Equity: The Case of Chile. The equity effects of privatization of ownership are very much shaped by the policies and procedures that privatizing governments adopt. Not much is yet known about these matters. Casual observation of evolving experience in the smaller and poorer countries, such as many of those in Africa, suggests that sale of state assets is sometimes accompanied by abuses: under-the-table payments, fixing of asset prices that are too low, granting of special privileges.

In countries where larger-scale privatizations have taken place, such as Bangladesh and Chile, the process has been more orderly and transparent. There have nonetheless been departures from sound policy in these cases, too. The case of Chile is particularly illuminating in this respect. Not only is Chile one of the champion divesters

among less developed countries (Bangladesh is the only competitor), but it has gone through two discrete episodes of privatization, in which the equity problem was approached differently. The Chile story illustrates the importance of program design and implementation in determining the consequences of privatization for equity.

The post-Allende experience (1974–1979) shows that poorly designed divestiture programs can have strongly negative effects on the distribution of assets and hence income. The program, which was hastily executed during a period of recession, had the following characteristics that bear on equity issues.

- The prices at which the sales took place were too low, resulting in subsidies to buyers that have been variously estimated at between 23 percent and 40 percent of the book value of the privatized firms.[2]
- Government sold the nationalized banks early in the process, and was unable to prevent concentration of ownership of these banks by a small number of conglomerates, called grupos. An effort was made. New legislation stipulated that individuals could not buy more than 3 percent of a bank's stock, nor corporations more than 5 percent. But these rules were violated, mainly by linked holding companies acquiring large numbers of shares.[3]
- For the sale of nonfinancial enterprises, some 80 percent of whose assets were privatized between 1975 and 1978, government no longer even pretended to worry about concentration of ownership; all of government's holdings were sold in single packages. Most of the buyers were grupos. These conglomerates were in fact organized around financial enterprises with interests in diverse sectors.

  Drawing on credit from their own banks, the grupo managements were able to buy up additional firms for privatization. The result was a significant increase in concentration of ownership. In the 1960s, there were some 20 grupos prominent in finance and industry. But in 1979, five grupos controlled 53 percent of the total assets of Chile's largest enterprises; these

five, and four others, controlled over 80 percent of the assets of the banking system.

Concentration also increased within individual companies; in 1970, the largest shareholders in the Banco de Chile held 4.5 percent of outstanding shares. By 1979, one group held 31 percent of the bank shares and two others had 10 percent each. Overall, it appears that the assets of the top five grupos almost doubled between 1969 and 1978; assets of all other firms grew by a mere 14 percent. Also, the degree of market concentration in manufacturing was much higher in 1979 than in 1967, and had increased more than in other countries. Foreign competition, resulting from liberalization of the trade regime, however, prevented profit rates from rising.[4]

Between 1981 and 1983 Chile sank into recession; the financial sector in particular experienced deep crisis. The grupos, whose banks had excessive exposure in their own nonfinancial enterprises, were highly vulnerable. By late 1982 the share of credit that the banks had lent to firms directly connected to controlling grupos was extremely high: more than half for some banks. In early 1983 government took over the main grupos, nationalized a number of banks and liquidated others. The privatization process was put on hold.

In 1985 the privatization process began again, and was greatly facilitated by the major economic recovery that started in 1985 and continued through 1986. The new reprivatization program is giving careful attention to the concentration question. It is seeking to distribute equity widely. Terms of sale are favorable, and generous credit is available for individual share purchases. For purchase of stocks of the two major banks, low limits are put on the amounts individuals can buy. For other financial institutions, limits on shares obtainable are even lower. Also, buyers have to be members of pension schemes. Shares of nonfinancial public enterprises are being sold first to employees (on credit), then on the Stock Exchange, and thirdly to financial intermediaries.

The errors of the earlier decade seem to have been avoided in this new reprivatization. About 60 percent of the equity of the two major "internal" banks had been sold by mid-1986 to 23,000 shareholders.

Several other important financial institutions sold minority shares to foreign banks and insurance companies, with minority holdings widely dispersed; and in another case, 98 percent of the shares were sold to a multinational insurance company. Shares of nonfinancial public enterprises worth 22 bn. pesos had been sold by mid-1986; (about 60 percent of the total equity in those companies to be privatized). Some 35 percent was bought by financial intermediaries, 14 percent by employees, 28 percent by stock exchange purchase and 23 percent by users and others.

Those who have purchased shares in this second Chilean privatization episode have enjoyed substantial appreciation in their portfolios; sales prices to initial buyers were below book values, and soared on the Stock Exchange after the original placements. Better-off groups and foreign investors have probably benefitted disproportionately from those events, but it is hard to see how widespread distribution could have been achieved without it—as the British and French governments have recognized in some of their recent privatizations.

The broader capital ownership that has resulted should help create an environment more congenial to growth-oriented economic policies and institutions. The greater decentralization of wealth holding also could sustain tendencies toward more democratic political institutions.

Privatization of Service Provision

"Public" services can be delivered by private or public agents in various combinations. Municipal services like garbage collection can be done by city workers or by private contractors. Transport can be provided by urban bus parastatals or private minivans and jitneys. Roads can be built and/or maintained by public works departments with their own men and machines or by private contractors. Veterinary medicine distribution can be restricted to state animal health officers or some medicines can be privately sold. In some countries only the state is allowed to provide educational and/or modern health services; others allow private schools and clinics to operate as profit-making institutions.

Most policy reform proposals favor a bigger private role in the delivery of these kinds of services. In general, liberalizing reform agendas call for open and competitive markets, and the elimination of regulations that prevent entry into transport, trade, education, and other sectors.[5] The impetus for privatization in service delivery comes from efficiency considerations: greater private participation allows the delivery of more and better services, probably at lower average cost.

But this kind of privatization also has positive equity effects of two kinds. On the "production" side, privatization in at least several sectors involves employment-intensive methods of delivery. And on the consumption or "user" side, privatization via deregulation reduces rents and inequalities of access commonly present in controlled economies.

Production-side Equity Effects. In distribution and transport—two large and strategic sectors—public and private marketing and delivery systems in many LDCs utilize different production structures. Private "producers" tend to rely on methods that are more labor-intensive than those common in public sector operations, and they use relatively more uneducated labor. The result is a distribution of factor payments that is more favorable to lower-income groups.

Agricultural Marketing. Agricultural trade offers the prime example of privatization's equity advantages. Agricultural marketing services are in many countries highly regulated. Government monopolies in export-crop marketing are common, and private trade in food crops, fertilizer, and other agricultural inputs is frequently restricted. In some parts of the world, private traders are not allowed to buy food crops directly from farmers, or can do so only at official prices that may be very different from prices prevailing in unofficial markets.

Agricultural marketing is extremely demanding for large-scale bureaucratic organizations. It entails numerous transactions dispersed in space under diverse market conditions and in circumstances of rapid change. The difficulties of control over agents imposes simplistic pricing rules and severely limits flexibility of decision

making in general. For these and other reasons state trading systems operate with relatively heavy inputs of skill per unit of sales (i.e., accountants, administrators, supervisors, controllers, etc.). They also use capital resources relatively heavily. As compared to private systems, they hold bigger inventories in more central locations, and for longer periods. They therefore require relatively large and good quality warehousing facilities, access to sizeable capital for financing crop purchase and storage, elaborate transport, communication, accounting and record keeping equipment.

The private trading structures in low-income LDCs differ on all these counts. Independent, often part-time, traders abound. Wholesalers and larger traders use labor intensively, relying on networks of small agents and subagents. The main control problem—how to keep agents from cheating—is minimized by the decentralized nature of private and small-scale trading organizations, and by the vigilant supervision that is a condition for commercial success. Traders rely on informally acquired skills, on raw ability, and on energy generated by the search for profit.

Inventory policies in the privately organized system tend to be labor-using and capital-saving. They are based on small, dispersed stocks, controlled by large numbers of individual traders. Coordination and control requirements are reduced, as are needs for capital and skilled labor. These differences are more pronounced in the poorer regions, such as Africa and South Asia, but are widely prevalent.

Urban Transport. A similar dualism in production structure exists in urban transport systems. In most cities, two common-carrier systems coexist. One is the modern bus and subway network, which is capital-intensive, highly structured, and usually organized in the form of parastatals or franchised monopolies. The other is a privately owned and organized fleet, diverse and unstructured; it includes such vehicles as taxis, minibuses, vans, reconstructed trucks, jitneys, pedicabs, and rickshaws. In many cases, the government controls the privately owned system, preventing it from fully competing with the public network or the franchised bus monopolies.

Numerous examples exist of the efficiency advantages of urban transport privatization.[6] And here, as in agricultural marketing, the

privately organized transport sector combines greater efficiency with favorable income-distribution effects. Privatization involves the substitution of labor-intensive, decentralized modes of transport for the heavily capital-using "modern" systems, and leads to a pattern of factor payments favoring unskilled workers and small entrepreneurs. Bus drivers and similar public sector employees are affected negatively, but they are relatively few in number and in any case are relatively well paid.

User-side Equity Effects. In addition to the "production-side" consequences of privatization in the services sectors, another, much more significant, set of equity-enhancing effects comes on the consumption or "user side." These arise from the reduction of inequalities that are endemic in the regulatory arrangements found in many LDC economies.

Four features are typical of these regulatory systems:

- the prevalence of excess demand, due to price controls, subsidies, foreign exchange, and budget constraints;
- official reluctance to use prices as a major allocation device in many "strategic" markets: for example, foreign exchange, food, social services, agricultural inputs;
- generalized perception of private merchants as parasitic, exploitative and conspiratorial, and a parallel skepticism about the efficacy and beneficence of competitive markets;
- widespread belief that it is inappropriate for private profit seekers to supply basic services, especially education and health care.

These common features of the regulated LDC economy breed various types of inequities. We consider three here.

Administrative Rationing. The administrative rationing that is inevitable when excess demand exists almost always favors the rich and well placed. When demand for school places exceeds supply, children of higher-income, better-educated parents tend to occupy a highly disproportionate share of the places. This will happen even without the exertion of influence or bribery, since performance on

exams is highly correlated with family income and/or education levels.[7]

When fertilizers are distributed by single-channel public sector agencies, larger shares tend to go to bigger farmers, males, farmers located near depots and main roads, or those willing to bribe distributing agents or cooperative officials.[8] Poor and powerless people rarely have access to scarce medicines, trained doctors, limited hospital beds, or the best medical facilities. Subsidized food tends to go disproportionately to urban dwellers, usually civil servants or wage earners in modern-sector employment, who are all relatively highly paid compared to rural majorities. Poorer people have to buy in parallel markets, at much higher prices. It is notorious that many fortunes have been made by shadowy transactions involving access to rationed foreign exchange.

Food Policies. A second kind of inequity, somewhat less general, arises from food procurement and price policies in many countries. Official procurement prices for foodgrains in zones of surplus production are set below levels that market (supply and demand) conditions call for; very often at the same time, the official distribution system can't deliver to cities and other deficit areas enough grain to meet demand at those low official prices. Parallel markets develop, and officials try to prevent farmers from going around the official procurement system by placing movement controls on grain: roadblocks, special transport permits, licenses to buy, etc. Every requirement for approvals to buy, sell, or transport, gives rise to rent seeking and hence corruption—the payment of bribes for the right to pass, buy, or sell. The result is higher prices in deficit areas (often containing poorer people), and siphoning off of income from farmer-producers, traders, and transporters to policemen and other officials. Consumers as a whole suffer to the extent that the real cost of delivering food is higher, and because of negative output effects of lower producer prices in the longer run.

Monopolies. Finally, there are the inequities caused by the legal imposition of what are often inefficient and ineffective monopolies. These are perhaps most pervasive in agriculture, and are related to the procurement and price policies mentioned above. In numerous countries, especially in Africa, various restrictions on free entry

prevail in marketing of inputs and crops. Single-channel input marketing, combined with subsidy policies, gives rise to various forms of inequality in input distribution. These are discussed below.

With respect to crop purchase, marketing parastatals are often given exclusive responsibility, operating through so-called cooperatives (usually artificially created bodies, acting as administrative arms of government) or "licensed" private traders. This approach entails the systematic creation of monopoly power, in the name of efficiency and protection of peasant farmers against exploitation by unrestrained traders. To the extent that monopoly control is maintained, conditions become ripe for favoritism, corruption, and genuine exploitation, in the sense of payments below market prices for outputs, as well as neglect and inefficiency in provision of ancillary services such as transport and grading.

These arrangements usually do not work, particularly in the poorest countries. Prices of food crops tend to be fixed too high in good harvest years and too low in bad years. Grain agencies lack financing money and storage capacity sufficient to buy quantities offered at official prices in good years. And they can only buy low-quality grain or acquire some by coercion in bad harvest years. Farmers are thus disappointed in good years and coerced or harassed in bad ones when the parallel market offers more for their grain than the official market. Perverse equity effects abound in such systems. In good years, well-placed farmers sell at the (higher-than-market) official prices, or traders appropriate the rents. In bad years, the most vulnerable farmers deliver grain at low official prices while bigger and more aggressive ones sell in parallel markets.

Deregulation Problems and Potentials. The greatest single source of equity enhancement in regulated economies, then, is deregulation: the removal of legal barriers to entry. Creating more open, competitive markets will reduce the inequalities associated with administrative rationing, monopoly, movement controls, etc.

Some improvements may be possible without privatization via deregulation. Well-run auctions, for example, and the replacement of direct controls by indirect ones would eliminate at least some of the problems due to rationing. This is most obviously the case in

foreign exchange and grain markets. But effective auctions and functioning indirect controls require appropriate institutions, and a substantial and vital private sector.

Deregulation is likely to be a long and complex process. It invariably involves a great deal more than sweeping away a few laws. Markets may not work to reduce inequalities unless there is a broader dismantling of controls. It will not change things much to allow private traders to have access to farmers, but then stipulate that they can only buy and sell at official prices, during specified months or in specified locations, or only if they are licensed. Nor can an open marketing system function properly if governments insist on fixing single prices throughout the country or over the course of the year.

An uncongenial macroeconomic policy environment reduces prospects for success. Adequate, or at least evenhanded, allocation of foreign exchange is especially important in the more open economies. It is difficult to sustain a liberalization program, involving greater freedom for private actors, if the policy environment creates incentives to break the law or engage in what is felt to be antisocial behavior: to smuggle, to hoard, to speculate, to "cream markets." Truckers will not carry freight at official rates on routes that fail to cover costs, nor will importers fail to hoard if they do not believe that an import liberalization reform will stick.

These caveats notwithstanding, there is little reason to doubt that privatization-liberalization in the service sectors will tend to be equity-enhancing in the circumstances of the typical, controlled LDC economy.

The benefits of privatization in service delivery in these sectors are of course much more extensive than the creation of a more even income distribution and a more equitable access to services. They lead to the mobilization of new resources, better use of existing capital and skilled labor, improved services, reduced production costs in goods-producing sectors and hence increased competitiveness of the economy. They provide training grounds for entrepreneurship. All of this should lead to increased growth, and a corresponding reduction in absolute poverty. The positive effects on income distribution are a bonus.

Privatization of Finance

This third type of privatization involves reduction of subsidies and wider resort to user charges for the financing of public services. Subsidized provision of goods and services normally arises from laudable economic and/or social objectives. Fertilizers are subsidized to encourage farmers to adopt more modern technology. Education and health subsidies are intended to give low-income families access to schools and clinics. Food subsidies are usually part of an incomes policy designed to protect the poor or key groups such as government employees.

Equity-reducing Effects of Subsidies. However laudable or understandable the original objectives, most subsidies end up benefitting better-off people more than the poor. They thus have the unintended effect of widening social and economic inequalities. The phenomenon is well known and is discussed in other papers in this volume. So only a few examples are given here.

Subsidies for Credit. Agricultural loan programs, for example, are notorious for their tendency to benefit bigger farmers.[9] Forced to lend at below-market-level interest rates, banks lend less money to a more limited clientele, almost invariably to big farmers whose default risks are lower and whose connections and ability to meet transaction costs (fees, bribes) are greater. The same dynamic has been widely noted for lending in industry; artificially cheap loans end up going to large, well-connected enterprises at the expense of small-scale firms.[10] Another of the effects of subsidized credit is to make the costs of unsubsidized credit higher.

Subsidies for Basic Foods. Food subsidies are sometimes direct (below-cost sales through fair-price shops, food coupons, etc.), and sometimes indirect (by imports priced cheaply because of overvalued exchange rates or by below-market procurement prices paid to farmers).[11] In either case, poorer groups usually benefit less than the relatively well off.

In one country cited in a recent IMF study, 10 percent of food subsidy benefits accrued to the poorest 20 percent of the population, while the richest 27 percent of urban people received 46 percent of

benefits. Only 15 percent of the total budget cost of the subsidy was transferred to the seriously undernourished in rural areas and 25 percent in urban areas.

In another country, food is sold in ration shops at below-market prices. Rural people—90 percent of the population—only receive 20 percent of the rationed food, and less during shortages. More than 60 percent of the recipients were government workers.[12]

Subsidies for Health and Education. Despite the fact that most developing country governments charge their citizens little or nothing for these services, provision and access are not equitable. Many recent studies have highlighted the fact that the distribution of government subsidies for education in LDCs is strongly biased in favor of richer groups. While much less regressive, a similar bias is observable for health subsidies. The subsidies flow disproportionately to urban white-collar and manual workers at the expense of people in rural areas. In addition, the public services most likely to be consumed by richer groups—such as higher education and private rooms in hospitals—are the most heavily subsidized.[13]

The case of education is especially remarkable. For all developing countries, the 6 percent of the population with access to higher education receive 39 percent of public educational resources, while the 70 percent who receive primary schooling receive only 22 percent. In some West African countries, government-dispensed scholarships for higher education are eight times higher than GNP per capita (1980 figures).[14] Scholarships to secondary and university students, who come mostly from better-off families, comprise a substantial share of government spending on education. This spending pattern is not only inequitable, it is also inefficient. At least until recently, the social rate of return has been far higher for spending on primary and secondary education in LDCs than for spending on higher education.[15] The sort of education for which wealthy people are willing to pay (because private benefits are relatively high) is paid for by governments, while the cost of education yielding relatively greater social benefits is borne, disproportionately, by poor families.

Subsidies for Fertilizer (and other inputs). These subsidies can have more positive distributional effects than product price increases if bigger farmers account for most of the marketed surplus, but do

not use most of the fertilizers, and if the rationing systems that often accompany subsidized input distribution are reasonably effective and equitable. Experience suggests that these conditions are not common.

In one country (Senegal), a study of fertilizer usage revealed that the benefits of subsidization went heavily to better-off farmers: those in better-watered areas.[16] This may be general: those farmers benefitting most from irrigation also benefit most from fertilizer subsidies, and they tend to be better-off farmers. Also, distribution of inputs under input-subsidized systems is frequently characterized by scarcity, inappropriate nutrient mixes and late delivery.[17]

More to the point here, and as already noted above, the administrative rationing that so often accompanies these subsidies opens the door to arbitrary or dishonest allocations by the actors involved: agriculture ministry staff, extension agents, cooperative officials, among others.

Those who live closest to agricultural posts or other depots have easier access to the fertilizers than those who live further away. Bigger farmers may get more than smaller ones because many governments try to allocate inputs according to output volumes marketed through official channels, or because bigger farmers often buy the output of smaller farmers, for bulking and transport to points of sale. In many countries, women are discriminated against, since they grow food crops which are not eligible for subsidized fertilizer.

Subsidies for Public Services, Energy, and Housing. The perverse distributional effects from subsidies are even more apparent in the case of certain public service, energy, and housing subsidies. The main beneficiaries of heavily subsidized telephone systems, electric power and water companies, gasoline, and urban housing projects are obviously not the poorer segments of society, yet such subsidies are common throughout the developing world.[18]

The rental system on houses in Abuja, the new federal capital city in Nigeria, provides a striking example. A recent report notes:

The better off citizens are favored at the expense of the poorer because the majority of the subsidy is paid on the bigger dwellings. The four to six bedroom dwellings will absorb 29 percent of the estimated housing cost while rents for them will only provide 15 percent of the rental income. At the other end of the scale, the single

compound rooms will absorb 4 percent of the estimated cost but will raise 24 percent of the rental income.[19]

These anomalous results spring from two sources: a government policy decision that nobody should pay more than 20 percent of his income for rent; and official desire to provide "suitable" housing for civil servants and other urban dwellers.

User Charges: Areas of Consensus and Disagreement. Subsidy patterns that reinforce inequalities in income and access are universally recognized to be undesirable. For many of them, there is a broad consensus on appropriate policy responses. Thus, there is increasing agreement upon the need for interest rate/credit policy reforms that will channel more credit to small borrowers, especially in rural areas and in informal nonagricultural sectors.

Almost everybody agrees that it would be desirable to charge higher user fees to the urban, largely middle-class consumers of secondary and university education, curative medical services, electricity, piped water, fuel, urban transport, upscale public housing. The most contentious issues revolve around user charges. Yet even here there is a growing unity of opinion.

Technical consensus now also prevails with respect to fertilizer subsidies: while there exist some theoretical arguments for them, they justify only small and temporary subsidies at most. Moreover, the adverse effects of subsidies on use of nonchemical fertilizers, and their negative impact on institutional development, equity of access, and income distribution, tend to outweigh their advantages.

Disagreement persists with respect to user charges (reduced subsidies) in food, primary education, primary health care, clean water, and other services consumed by the poorest and most vulnerable groups. The main argument in favor of shifting a greater portion of cost to users/consumers runs as follows: (a) budgets are constrained, so that demand can't be met at existing prices; (b) the people who are excluded tend to be primarily the poor; (c) the poor, like others, are willing to pay more for such services, but in most cases can't buy them, even at higher prices because of lack of supply; (d) higher user fees and reduced subsidies will allow expansion of supply.[20]

The principal argument against higher user charges (or cost-based consumer prices for food) is that it adversely affects vulnerable groups.[21]. It may lead to cutbacks in demand, as is said to have occurred in Nigeria, for example, when school fees were reintroduced recently in one Nigerian state.[22] This is asserted to be the case for preventive health care services as well. Finally, insofar as the poor maintain demand in the face of higher user fees, they may be unable to meet other basic needs.

An assessment of these arguments has to be done on a case-by-case basis, and judgments would depend on levels of fees, sector, levels of income, expected elasticities of demand and supply. On balance the evidence to date seems stronger for the pro-user charge position: that low-income people are willing and able to pay for more and better services, that the proportion of income likely to be tapped will still be small in most cases, and that relatively small increases in fees can lead to substantial supply increases.

Summary and Conclusions

The main rationale for privatization in all its dimensions is that it leads to mobilization of more resources and to more efficient use of resources, and hence to faster economic growth. This is the right emphasis because growth alone makes possible the sustained reductions in absolute poverty which is such a major concern in all development strategies.

But privatization, as defined here, has other equity-enhancing effects. Many of the specific private-sector-oriented policies tend to make income distribution less unequal; almost all of them reduce inequalities in access to goods and services by limiting the opportunities for favoritism, corruption, and differential attribution of rents that permeate economies characterized by extensive state controls, subsidies, and restrictions on private economic activity. And, in the longer run, broader ownership of assets and greater opportunity for entrepreneurship encourages institutional conditions favorable to the development of competitive economies and democratic political systems.

Privatization, then, will in general bring about both more growth and more equity. This will not automatically happen. Deregulation and liberalization programs can be and often are stymied by inadequate implementation, such as foot dragging by local officials, or by unfavorable changes in the environment: failed rains, for example, or an unanticipated foreign exchange crisis.

In many cases, partial reforms are frustrated by continued regulations in the unreformed sectors of the economy. Structural obstacles also can reduce the effectiveness of these policy changes. Institutions that facilitate the smooth functioning of markets are often rudimentary: appropriate credit systems, for example, or organized generation and transmission of market information, or regulations aimed at assuring transparency of market behavior. Entrepreneurial classes are thin and sometimes dominated by feared minorities. Habits of competitive behavior can be shallow and capacities to enforce it from outside weak. Poor transport facilities can be inhibiting.

All of this suggests that privatization, whatever its form, is no panacea, that in many situations it can only be introduced at a measured pace, and that prudent regard for facilitating measures—transport investment, creation of special credit facilities, entrepreneur-nurturing affirmative action, etc.—is essential.

It should be recognized also that while privatization will generally increase equity in the sense of narrowing gaps in income and access, some privatizing measures will hurt the poor in an absolute sense. If Indian Railways reduces the subsidy it has so long provided for third-class passenger services, there's little doubt that the resulting real-income loss would be concentrated on lower-income groups and would be sorely felt. The same is true of food subsidies, which in most cases benefit the poor in absolute terms, whatever their distributional effects.

Here the first question to ask is whether the poor can be protected in a more cost effective way, i.e., by better targeting? In most cases they can. The Sri Lankan experience with food stamps is indicative. In some instances, voucher systems might be devised that would soften the impact of reform on the poor; such an arrangement is conceivable in the Indian Railways situation. A reformed rail tariff

structure could lead to more productive use of capital, more efficient and more balanced industrial location decisions, and speedier growth of more efficient transport modes. Gains to low-income groups generally might then outweigh losses to the lower-income riders who benefited from tariff subsidies.

Even with better targeting, negative effects of a subsidy on fiscal balance, on production, on growth may be so significant, and overall fiscal pressures so great, that subsidy reduction may be justified. Reduction of fertilizer and food subsidies allowed the Bangladesh government to finance new investment in irrigation facilities in the late 1970s, which in turn spurned rapid growth in output.[24]

Despite the difficulties, the possible slips, the occasional errors, privatization-oriented policy reforms are almost certain to be equity-enhancing on balance, given the deep inequities that usually pervade the pre-reform economy. This simple proposition, so obvious and yet so muted in most discussion of structural adjustment policies and income distribution, should be at the center of the debate on policy reform and equity.

Annex
Table 1
Recent Divestitures of State-Owned Enterprises [1]

	Dimensions of SOE Sector		Sales		Formal Liquidations	Closures
	Total Number	Number Employed (000s)	Target[2]	Actual[3]		
REGION/Country						
AFRICA						
Cameroon	80	12				5
Ghana	130	40				
Guinea	65[a]	30	43			16[b]
Ivory Coast	113	86	20	4	5	
Kenya	180		5			10[c]
Liberia	23	12	7			
Madagascar	130		15			5
Mali	54	14	11	2	9	
Mauritania	108	30[a]	10	1		4[b]
Niger	54	13	24		3	
Senegal	104	34	10	5[a]		25
Sierra Leone	26	13	10[b]			1[a]
Somalia						
Sudan	136	600[a]	NA	7		10
Togo	73	5-7[a]	40[c]			9
Uganda	130		67[a]			
Zaire	138	48	37[b]	11	3	
LAC						
Argentina	29		27		9	
Brazil	547	1500	155	17		
Chile	421			133		
Jamaica			30	2		
Mexico	378[a]			8[c]	10[b]	
Panama	45		5[a]	1[b]		
Peru	142		60[a]	3[b]		
OTHER						
Bangladesh	778[a]		217[b]			
Malaysia			4[a]			
Pakistan	75[a]		6[b]			
Sri Lanka	43	66	6			
Turkey	65		11			
Thailand	70		3[a]			2

Source: Elliot Berg. *Divestiture of State-Owned Enterprises in LDCs*, report prepared for the World Bank, November 1985.

Notes

1. "State-owned enterprise" means wholly or majority-owned, unless information on ownership shares is unavailable. In several cases, we have counted as "state-owned enterprises" with slightly less than 50% public ownership.
2. The "target" number of enterprises to be divested is derived mainly from decisions made by the government in question, as reflected in an official statement, or a combination of government statements and agreements with donor agencies.
3. Excludes sales or transfers of shares in SOEs held by state development finance corporations.

Footnotes to Table 1

Bangladesh
(a) There were approximately 50 SOEs prior to the massive nationalizations that followed "liberalization" in 1971. The total number of "abandoned" units was about 725, all of which were vested in the government. Most of these were small. Later, 239 larger units were nationalized, leaving 484 still vested in the government. Therefore, the total number of enterprises is 392 or 778 depending on whether only the larger nationalized units are included. (See S.H. Chrishty, "Privatization in Developing Countries: The Experience of Bangladesh," *Conference on Privatization*, Asian Development Bank, January 31-February 1, 1985, Manila, Philippines.)
(b) These are entities divested up to 1983 and include units in the process of being divested, i.e., either on the auction block or advertised for buyers. The figure comes from R. Sobhan and A. Ahsan, *Divestment and Denationalization: Profile and Performance*, draft paper, Dhaka, October, 1983. Other estimates put the number at around 700. these differences probably evolve around treatment of "vested" smaller units.

Brazil
The data came mainly from Walter Lee Ness, Jr., "Destatization Program of the Brazilian Government" n.d. (December, 1984?)

Chile
Estimates for SOEs privatized after 1973 vary widely for reasons that are not clear. In his 1981 *Journal of Development Economics* article ("Towards a Free Market Economy"), Foxley gives 507 SOEs in 1973 and 70 in 1977. But CORFO figures (in Mary Shirley, *Managing State-Owned Enterprises*, p. 57) list only 133 enterprises sold from 1974 to 1982. The difference may be due mainly to whether "intervened" enterprises are counted or not; 259 firms were taken over this way in 1970–1973. More recent informal estimates are that 350 requisitioned or intervened enterprises were returned between 1973 and 1979, 92 sold between 1974 and 1983, and 49 liquidated in the same period. Fourteen SOEs including power, telecommunication, and mining companies, were fully or partially privatized between 1984 and 1986.

Guinea
(a) The total number of enterprises is 139 if individual gas stations and retail outlets are separately counted rather than included under one umbrella enterprise.
(b) The 16 industrial enterprises no longer in operation included five that are closed but with some employees on payroll and 11 others that are in the process of being "renovated."

Ivory Coast
(a) Sales include IVOIROUTIL (a tool company), SUCATCI (a rubber company), SUNAGECI (a construction company) and BNEC (a housing bank).

Malaysia
(a) The two partial privatizations are the AVIONICS Repair Facility and the Port Klang container operation.

Mauritania
(a) The four liquidated or partially liquidated enterprises are: MAFCO (fishing); SMTH (hotel) which is closed with liquidation action underway; SOMIR (refinery) and Project Sucre, whose refining unit is closed and whose processing plants are to be privatized.
(b) The identification of the enterprises to be privatized was the result of a government study. The ten targeted enterprises are based on a World Bank sector study covering 30 enterprises.

Mexico
(a) These are "empresas" (state enterprises) as of December 31, 1984, of which over 80% are majority owned. The state sector more broadly defined has 845 entities. In addition to the "empresas," there are 211 "Fidelcomisas" and 176 "decentralized organisms." This information comes from *Revista de Administracion Publica* #5960, July/December 1984, published by Instituto Nacional de Administracion Publica.
(b) In 1983 and 1984. An additional 32 enterprises are to be liquidated in 1985. (Ibid., p. 164.)

Pakistan
(a) The number of public enterprises shown does not include the 2,000 cotton, rice and flour mills nationalized under the Nationalization Act of 1974; since these were denationalized less than a year later.
(b) The six divested enterprises are two engineering firms, one sugar mill and three textile mills. In addition, 2,000 cotton ginning, rice husking and flour mills nationalized in 1977 under the Nationalization Act were returned to their previous owners in the same year.

Peru
(a) Estimated value of the 60–70 enterprises to be sold ranged from US $400-600 million. This is the equivalent to about 3% of Peru's GNP. ("Privatization of Public Enterprises in Peru: The Situation as of December, 1981," April, 1982.)

Senegal
(a) The five privatized companies were previously societes d'economie mixte (corporations with public and private shareholders). They are SIV (textiles), SISCOMA (farm implements), IRANSENCO (petroleum distribution), SNCDS (tuna canning), SNTI (tomato canning) and SONAFOR (drilling of water holes).

Thailand
(a) The three privatized firms are The Paper Factories of Industrial Workshop, Central Thai Industry Shop, Esarir Gunnybag Company, Ltd.

Source: *Business Review* (Bangkok), March 1985 and P. Pakkasem, "Thailand," in Manila papers. There is ambiguity in these sources as to what has been sold and what liquidated.

Comment

Raymond Vernon

It is a bit difficult to comment on Elliot's paper because he has taken a sort of eclectic approach to privatization as a phenomenon. I intend to cling to a view of privatization that is a bit more conventional, consisting of a shift in ownership or management to the private sector.

Let me begin with the privatization which consists of the sale of equity to the public in the developing countries. Elliot did one of the pioneering studies on this subject a year and a half ago. By now, however, that study is beginning to show the inevitable signs of being dated. We will have discovered some years from now that the actual sale of equity had been rather more extensive than present impressions suggest.

Thus both Turkey and the Philippines are likely to have relatively large sale programs of various kinds over the next year. Mexico makes claims of having sold off a lot of those dribs and drabs of equity shares that the government absent-mindedly acquired when it took over

the banks in 1982. Jamaica is boasting about the sale of a majority interest in a profitable bank. I suppose it was one of the few profitable state-owned banks, but the sale was made to a relatively poor public, the Jamaican public.

There is a certain momentum behind the privatization movement. One has to speculate about what the source of the momentum may be. But it is not implausible to conclude that there has been a certain learning process going on.

For example, take the aspirations of the developing countries in the 1970s to seize the monopoly rents that foreign firms were earning in raw materials. Few developing countries now entertain the illusion that having a state-owned enterprise in oil or copper or aluminum or in other raw materials is likely to get them much in the way of rent. Some rent remains in aluminum and some even remains in oil. But, for the most part, there is a readiness on the part of governments to allow the private sector to come into the picture here and there in ways that were not visible ten years ago. Argentina, for example, while it has not sold off shares of YPF and probably won't, allows foreign oil companies to do some of the oil production in Argentina which previously it had prohibited.

Moreover, there is a recognition in some countries that the state's takeover of private failures does not exactly produce a booming business. While hard data on this subject are obviously not available, one has the impression that takeovers of private failures are less common than used to be the case.

I rather doubt, however, that this learning effect runs so deep as to affect the ideological balance in many developing countries. Except for a very few countries such as Chile, the ideological shift is not immediately visible to the eye. Therefore, I assume that once the developing countries feel that the conditions that require them to privatize no longer are appropriate—once they feel that they have developed a good control system or acquired enough managers or developed some new sources of capital—there will be no ideological block to a return of the state-owned enterprise as an instrument of the state.

One reason why I think it has been easy for many developing countries to announce a program of privatization has been that the announcement alone has quite ambiguous ideological implications. Different ministers with different perceptions of how the country should move in the future can readily agree on launching a privatization program without being agreed in the slightest as to what they hope to achieve through the program.

A variety of ministers of quite different ideologies can agree on the first step because the one factor to which all ministers will be responding is the existence of a money crunch on the public sector. It is an irony that the first step in a privatization process consists of taking liquid capital out of the private sector and putting it in the public sector. The follow-up after that transfer need not be determined when the privatization program is launched. The Minister for Defense may assume that the increment in resources in the public sector is going to be used to buy a new family of MIGs while the Minister of Finance is thinking of retiring some debt and the Minister for State Holdings is thinking that the money will be circulated right back into the state-owned enterprises for the purposes of expanding those enterprises.

In those instances in which developing countries have sold shares in state-owned enterprises, a substantial proportion have entailed no shift in control or in the management of the firms involved, suggesting that the motive for the sale has not been to shrink the state-owned sector. In the case of Italy, where the state-owned IRI group has sold over $5 billion in equity, the clear intent of the sales is to strengthen the financial position of the state-owned sector, not to weaken it.

Projecting oneself into the boots of a Brazilian or an Argentine or even a Chilean minister, one can readily guess that many of them harbor the same motivations.

Because we don't know what is going to happen to the funds once the funds are acquired, the effect of the privatization on income distribution is obviously indeterminate.

If Elliot sounds a little bit uncertain about income effects, that is exactly where I think he should be. Indeed, I think he may be even a bit more certain than the facts justify.

One contention bearing on income distribution that I believe is totally unwarranted is that privatization will bring the people in developing countries one step closer to a people's capitalism. The Jamaicans have used this theme rather widely in the sale of their bank shares, parroting the Thatcher campaign in the United Kingdom. The persons who bought these shares in Jamaica surely were not the poor of the country.

In instances in which we know what happened to the shares after they were acquired—we only have the facts for the United Kingdom—considerable numbers of smallholders very sensibly sold out as soon as the shares recorded a profit in the open market. If persons positioned like the smallholders in the Jamaican bank don't sell out rather quickly, they will have to accept some considerable risks. The opaqueness of financial statements in the developing world is notorious, and the perception of the management as to what obligations it owes the outside stockholder bears no relation to SEC standards.

In income distribution terms, sales of shares usually generate a windfall for a group you might roughly call middle-income savers. If they are sensible, they will take their windfall and run. That is what I expect them to do to the extent that these transactions take place in the future. The full income effects of selling state-owned enterprises, of course, depend on whether prices or payrolls change in connection with the sale. That subject is much too tangled for a summary judgment. But by and large the short-term effects are bound to be adverse to labor and favorable to investors. The longer-term effects are so complex as to defy analysis.

Now let me turn to Elliot's comments on contracting out services. On the whole, I rather suspect that the short-run effect of the government's contracting out some of its services such as garbage and busses and the marketing of exports will probably be a good thing.

One reason that I expect this to be a good thing is that with respect to many of these services, such as busses and garbage collection, the only way in which you can get a change in technology and in work patterns is, in fact, by an alteration of ownership: by some discontinuity which has the effect of displacing the stake holders, the

principal stake holders in this case often being the labor unions. The introduction of new technology and new work habits, such as a shift to minibuses from big seaters, probably does give you a one-time increase in productivity.

Beyond that first discontinuity, however, I am doubtful about the consequences of the change. We have to remember that the characteristic arrangement of the private entrepreneur in service industries of this type is commonly the creation of a cartel, or a monopoly, or the capture of the local municipality. In some ways, U.S. municipalities can be thought of as developing areas, with cozy relations often prevailing between the private service providers and the local politicians. Although here and there you can point to cases in which the private sector has managed not to slip into the business of fixing prices or using strong-arm men or buying out the local legislators, those cases are matched very readily by cases of an opposite kind.

My formula in this case was first suggested by Thomas Jefferson. You liquidate whatever you have every 20 years and shift to another arrangement. Make no assumptions about the inherent superiority of any arrangement, because few of them will actually perform in a manner that will deliver the theoretical advantages of the market economy.

Now in the case of several services of this kind, notably in the case of health and education, I would be altogether hesitant to assume that a movement from the public sector to the private sector would represent a clear improvement. In these cases, the distribution issues are so important that efficiency considerations should be made to take second place. Like Elliot, I believe that the pricing and the terms of delivery of such services should be looked at very hard with a view toward making them more efficient; but I would never lose sight of some paramount questions of distribution.

Discussion

MR. BERG: I will say a few words and then open it up for general discussion. First of all, with respect to the privatization of ownership, an interesting and important question is whether or not experience from 1980 to 1985 reflects fundamental factors which are not likely to change much in the future. If it does, we can't anticipate much more extensive resort to this type of privatization.

My own view is that it does. There are so many obstacles to privatizing ownership that it is hard to see it happening on a large scale in many LDCs. The main obstacle is political: the fact that there is an array of forces virtually everywhere aligned against sale of these state assets, and it is hard to see much of a constituency in favor of it. The main constituency consists of external players, the Bank and Fund and U.S. A.I.D. people, especially in places where the United States has particular influence. But the opposition is formidable. Most bureaucrats are against it, as are most powerful ministers. Workers fear disemployment effects. Intellectuals see it as a transfer

of state assets to rich or middle-class people. It's not clear to me that this array of forces is likely to change in the future. This means that emphasis on divestiture of SOEs by privatization of ownership as a major component of structural adjustment— for example in the Baker Plan—is misplaced. There will be some increase in partial sales of equity, sales of some smaller operating units, and formal liquidation of mostly already-closed enterprises, but I don't expect dramatic changes in the structure of ownership, except perhaps in a few middle-income countries.

We should be thinking less of ownership problems and more of the other kinds of privatizations.

MR. VERNON: They are not against selling off shares to strengthen the enterprises.

MR. BERG: No, but that is all right. Nobody is against that.

MR. VERNON: Well, that is called privatization and, in the expansion of privatization programs, that is what I anticipate will be happening to a great extent.

MR. BERG: Well, then if we are going from 90 percent state ownership to 70 percent or 60 percent—

MR. VERNON: Look at the new Chilean plan. That is just what they are proposing for the big enterprises.

MR. BERG: Perhaps. But I have a table on Chile that shows a lot of them are being sold 100 percent. And Chile is in any case exceptional.

MR. VERNON: They are by and large the smaller enterprises.

MR. BERG: Now on the second point on privatization of services, I think you are too pessimistic about the possibilities of maintaining competition in these markets. When you change the structure of a market in the direction of more competitiveness, it seems to me that you create a different set of forces than when you have a monopoly provider.

It may be that garbage collectors tend to conspire and create cartels so as to extract rents from consumers, but that is hard to do when you have many suppliers and policies congenial to competition, such as franchising by competitive bidding or auctions, and you generally encourage free entry. Markets in services are likely to

remain competitive if public policy doesn't encourage cartel formation.

MR. VERNON: That is an empirical question. And my suspicion is that the weight of the evidence is against you.

MR. BERG: Where would you find evidence?

MR. VERNON: Well, the only pieces of evidence you can find at the present stage are largely in industrialized countries such as the United States. Wherever you find garbage collection in private hands, the arrangements have few elements of competitiveness in them.

MR. BERG: I disagree with that. There are many U.S. cities where contracting-out arrangements for garbage collection have led to lower cost and more responsive services, presumably competitive. In fact, it is said to be one of the success areas of privatization.

MR. VERNON: We will have to examine the evidence. I read it differently.

MR. BERG: Let's not restrict ourselves to Philadelphia or Seattle, nor to efficiency considerations alone. Think about Calcutta or Kinshasa or about rural markets in those parts of the world. It's hard to believe that market structure and organization is not a basic determinant of both efficiency and equity in market performance. If you have free entry, say, in agricultural markets or transport services, costs are likely to be lower, prices also lower, service better, and consumer access more even than in a market that is controlled by an official monopoly.

MR. VERNON: Well, it is an empirical issue that we can't debate here.

MR. BERG: Yes, but it would be hard to think of a situation more amenable to exploitation and abuse than a single channel marketing arrangement.

MR. VERNON: If owned by the state?

MR. BERG: Yes, where the power of the state stands behind the monopoly.

MR. STOCK: On this matter of market structures I think there is a third variable that intervenes: the degree of preceding equality. The fact that the governments of Taiwan and South Korea did not

abuse their agricultural sectors was due to the high degree of equality in the countryside. Those political markets were not as distorted as they are in many other places. This leads me to think that the degree of equality is an important determinant of competitive behavior, whether you are talking about political markets or traditional markets of private exchange.

In environments characterized by severe inequality, markets, whether publicly or privately organized, tend to exhibit the same degree of monopoly. When forces to bend the rules of the game are strong, they will be bent. There's no body of law out there that will protect small, private traders from powerful people who attempt to change the rules of the game in their favor. So if you somehow managed to talk a government into privatizing markets under these conditions, isn't it likely that in practice the privatization would be only nominal, with a new group of privileged traders in the market?

MR. BERG: That's an interesting point, but I don't think it is what Ray is arguing.

MR. VERNON: No, I am not arguing that. It goes too far. In the case of India, for example, government originally sought to take over crop collection and crop financing. The results were pretty disastrous. In such a situation, I prefer the local small monopoly to the big national monopoly, because the small private monopoly will probably be more efficient in crop collection and crop financing. There are times when private monopolies are superior to state monopolies; but I think that is a question to be judged by the local situation.

MR. THORBECKE: In the provision of certain services such as health, extension and perhaps education, I think we have to be very careful that we don't push privatization too far. Those who use these services benefit over time. Extension services help small farmers to become more productive. People who can go to a dispensary and get low-cost medical care will be healthier and, therefore, more productive. But it is only in the future that the benefits of these expenses will be reaped. Now if they could borrow, you could say, "Fine, they borrow now, they pay for these services and they repay at the end of the process at which time their productivity has increased." But in the presence of very fragmented capital markets, it just doesn't work this

way. So I think that we ought to be very careful in pushing some of these services too much into the private sector.

MR. BERG: We should be equally careful to not let imperfections in capital markets lead us to overlook the realities of most of what happens with these services in existing situations. Extension services, for example, work poorly in many, probably most, countries. Maybe they do work in Indonesia. But in most of the world, the extension agents are poorly trained, equipped, motivated. They know little more than most farmers, and have no transport to get out and visit farmers anyway. This is the pattern in the least developed countries, where there is the greatest need for information flow to farmers. So in searching for ways to make extension-type services more private, we are trying to overcome fundamental delivery problems, more basic I think than capital market problems. We're trying to encourage private input suppliers, for example, whose salesmen are in fact extension agents.

In education, also, capital-market imperfections do impose some constraints. However, privatization of finance in education is aimed at situations that are clearly inequitable and inefficient, where access is limited and students from relatively rich families receive 20 or 30 percent of the spending on education for scholarships in universities, for example; or where budget constraints limit places, and private entry is prohibited.

MR. THORBECKE: It should, of course, be targeted better. You are talking about something else. You make the assumption that public services will not be targeted, yet if they get into the private sector, you will get targeting. My point is that if you are able, at least to some extent, to target these services better to the people who simply cannot afford to pay for them in the short run, given the absence of capital markets, then we shouldn't push the privatization idea too far. I would vote with Ray on this issue.

MR. BERG: Everybody is in favor of better targeting. The question is whether you are ready to make people pay more for services for which there is an indicated willingness to pay, for which budget constraints prevent expansion of supply, and for which entry

is prevented by public policy. Those are the conditions under which the privatization alternative has to be considered.

MR. WOLGIN: Moving to privatization and competition doesn't mean eliminating the public sector. This is clear in agricultural marketing. One of the things A.I.D. has been talking about, at least in some of the countries in Africa, is opening up marketing to private competition but leaving the marketing board in place as a possible buyer or seller of last resort. This supposedly eliminates the risk of monopoly practices. In education, it is similar. The more you open it up to competition, the better the opportunities.

There is one question about targeting in education and health that came up in the discussion on subsidies: are there really effective and efficient ways of targeting subsidies of these kinds? It would be useful if there were, but I don't know of any.

MS. KRUEGER: I am a little uneasy with the way the argument is going. We know about market failures, i.e., imperfect capital markets and all that. We also know that there are some government failures which Elliot has pointed out: for example, that the subsidies are going to the rich. I guess I am not yet to the point where I have a good enough model in my head that works and tells me, "I can correct that government failure." If the political process leads to subsidies going to the wealthy, we can agree here that this is a slip, and say, "Well, of course, they just shouldn't do that." But I don't know if that corrects the failure any more than to say that there is no good capital market and, therefore, privatization shouldn't be pushed.

There is a pragmatic issue here of who delivers what. In cases where there is a strong presumption that what the government is doing does not deliver the equity and certainly doesn't deliver the growth, it seems to me that there may be some presumption for a change.

Even if nice targeting arrangements existed, I would open up to competition on the production side. This raises a question in Elliot's paper, Is there evidence anywhere, in services or otherwise, about how much of the problem with provision is due to inefficiency in production and how much to bad allocation and distribution?

This is an empirical question. How it is answered would make some difference in determining the weight you give to increasing competition versus what you do about redistribution. In any case, I find it very difficult to argue that universities, for example, should be so heavily subsidized and supported at the expense of primary education. And I certainly can see no basis on which to maintain a monopoly on many of these services. I think the issue is best treated pragmatically.

MR. BERG: It is unfortunate that the area of disagreement has gotten wider than it should be. I tried in my paper to suggest that there is a wide area of agreement. Most studies show, for example, that subsidies to higher education are a big share of total subsidies to education. We know that social rates of return are higher in primary education than in university education, so we have an anomalous situation where services for which private benefits can be captured are being subsidized by the state, and primary education, which probably has a higher rate of return and greater externalities, is starved for resources. Everybody agrees that there's something wrong there. Shifting user charges to university people is one part of the remedy on which there is wide agreement.

MS. KRUEGER: The children of the civil servants and the politicians do not agree because they want their children to get their education.

MR. BERG: The agreement is on the technical level, not the political level. There are indeed a lot of questions on which there is general technical agreement. For example, in the new UNICEF book about structural adjustment, the authors observe that under a food stamp plan much lauded by free marketers, Sri Lanka's government has reduced its large food subsidies by one-third. But, they say, there are signs of increasing malnutrition in the country and in any case the poor are being hurt by this policy. They condemn the subsidy reduction, pointing out that the national airline continues to receive its subsidy of one billion rupees annually, the amount saved by food subsidy reduction. It would be better economics and far better social policy to cut the subsidy to the national airline rather than to food.

Now, everybody except the flight crews and perhaps a few others would probably be in agreement that food subsidies are more worthwhile than airline subsidies. But if you look at any budget of any government in the world, all sorts of issues arise about priorities in allocation. After all, every budget contains the debris of past decisions that were questionable, as well as general over-manning in many departments, or new capital projects of dubious merit. Why shouldn't all of those be cut, before turning to food subsidies? Moreover, there also exist issues about the role of foreign financing in all of this.

MR. VERNON: What is the foreign issue, Elliot?

MR. BERG: The UNICEF people argue, for example, that foreign donors should provide resources for health care to children. But the question can be raised, Why aren't local governments providing those resources when they are spending money so wastefully on subsidies such as those for the national airline? If it is true that governments can save the lives of thousands or millions of their children by allocating a few dollars a year per child to vaccination or oral rehydration campaigns, and they don't do it, while they continue to spend on low priority or wasteful activities, what does it say about those governments?

MR. FIELDS: I was going to bring up the Sri Lanka food stamp program in answer to Jerry Wolgin's question about targeting. It is an example that Erik mentioned in his paper this morning and has written about previously. It seems that that was a well-targeted program. Erik's criticisms in his paper were that the number of people covered had diminished and that the food stamp program was not indexed to the rate of inflation which was very high, so there was an erosion of the real value of the subsidies. But this is not a question about its technical side, right?

MR. THORBECKE: No, that is correct.

MR. FIELDS: I think it raises the following possibility. There is a distinction in my mind between, on the one hand, working through existing markets by changing purchasing power and on the other relying on more direct controls: for example, trying to put in floor prices or ceilings. Food stamp programs work through existing

markets. This is precisely the kind of example that may answer Jerry Wolgin's question about targeting. Targeting can work if you can identify poor people.

MR. THORBECKE: There is the beginning of a good literature on improving the degree of targeting, particularly with regard to food subsidies. Targeting is never going to be perfect because it is extremely difficult to identify the poor. The poor come from many different socioeconomic groups. Even if you knew exactly where they were, you might not have the instruments, the administrative capacity to get the benefits directly to them. So, in fact, you have to operate with socioeconomic groups and any poverty measure inevitably has an element of arbitrariness. But ideas for improvement are coming along.

Now I would like to come back to a point that is important from a political economy standpoint. I am not convinced that it is desirable to go too far in the direction of perfect targeting. The political costs of improving program coverage beyond a certain point—i.e., reducing coverage to those people not in need—can lead to the rejection of the subsidy program. We ought to consider, therefore, the possibility of having some leakages simply to get the subsidy accepted politically.

MR. MORSS: In discussions of privatization, I can't resist mentioning the Baker Plan and the emphasis on privatization there. Three American private firms, Citibank, Chase Manhattan, and Bank of America, made some very foolish loans in Latin America in the 1970s and that has led to what we call the world debt crisis. When I see the sorts of mistakes that these so-called private firms have been making around the world, I cannot bring myself to be an ideologue for privatization.

MR. SAWYER: I would like to go back to some of the comments about the lack of a constituency for privatization. I think that there are some political and social factors in these societies that one has to recognize. Parastatals, for example, are a basis of privilege. They are seen as sowers of prestige, profit or plunder, for officials and political authorities. So there is a tendency to want to guard very closely those opportunities.

At other levels of the society, there is the perception that privatizing transfers privilege to people who already have political power because those are the ones who in most cases have the opportunity to go into the kinds of business activities that are being privatized. So most ordinary people see a no-win situation whether things are privately or publicly organized.

I wonder whether there is not a middle course between strictly private situations and government ones; for example, letting people at local levels define and run their own irrigation or other projects with payment systems that they work out themselves.

MR. BROCK: I was at the University of Chile in 1985–1986 during their second privatization episode. They called it popular capitalism instead of people's capitalism, but it had the same sort of ring to it. My colleagues at the university all rushed to take part because they could buy up to 2,000 UFs (a UF was about $15 at that point) worth of stocks in one of the two big banks, and they only had to put down 5 percent of their own money; 95 percent was put up by CORFO, the Chilean development agency. Furthermore, at the end of 1985, the government said, "We are going to give you a one-time dividend of 100 UFs on your ownership of these enterprises." So basically it was free for everybody. And if during the coming year, purchasers defaulted on buying the next installment, the bond reverted back to CORFO and the buyer lost nothing in the process. In the meantime the value of these stocks had gone up so it became a transfer to the upper-middle-class of Chile. That is how it was widely perceived at the time.

A second point is that in these privatizations where the government doesn't relinquish control of the firm, no real effect should be expected. According to the Modigliani-Miller theory, the method of financing of a firm doesn't affect the value of the firm, which is the value of the machines and what it produces. It is much the same for a state enterprise. If the enterprise sells off some stocks to the private sector, it still has the machines. They are still being run by the state. There is no change in what is going to be produced by those machines over time and so there should be no real effects from privatizing in that way. If the state really gets rid of these enterprises,

gives them to the private sector and a profit-maximizing-type agent takes charge, then you might expect to see real effects.

MR. BERG: In general I agree with that: if the majority ownership of a SOE is sold, there are likely to be more changes on the institutional and managerial side than with partial sales of equity. But majority ownership may not be necessary. In Peru, it has been found that a transfer of as little as 30 percent of the equity into the private sector has led to observable changes in corporate behavior. This problem differs a lot from country to country or from sector to sector.

MR. VERNON: You can generalize about it, however. There are cases at the margin in which the minister will use the existence of the minority stockholders as a device for dealing with some of the stake holders like labor and say, in effect, "What can I do? We now have these minority stockholders, so I have simply got to hold down the workforce." Or he will say to the consumer, "What can I do?" and will permit an increase in prices. So you do have marginal effects associated with sales of noncontrolling shares.

But to return to this question of the constituents for privatization. We have already identified some of the constituents. Ministers may in some instances find it mildly useful to have some public stockholders in order to get some things done that otherwise would be more difficult politically, such as a price increase. Managers, who are constantly trying to wiggle out from under the ministers, may find it useful to have a private stockholder who can run interference for him. And remember that the private sector in some circumstances would like a portion of its stocks to remain in the state's hands so it can be sure of preferences with respect to credit and protection and so on.

So there are constituencies for the minority sales. That is why I anticipate that the pattern will be fairly common.

MR. McLURE: I would like to make just a quick comment on Elliott Morss' antiprivatization comment that the private sector hasn't done so well either, even in the United States.

To some extent, that is right. But a lot of the reason the private sector hasn't done very well in its decision making is that there has

been so much dumb public policy that creates the environment in which they have operated. With respect to the debt crisis, Ron MacKinnon observed a few years ago that if we distinguished banks that engage in commercial operations in this country from those that do much riskier things like make big loans to developing countries, and we protected the first group, where failure would really affect the banking system in this country, and allowed those who want to do riskier things to sink or swim as they wish, there might be a lot less vulnerability. Also, if those bank managers knew that the federal government wasn't likely to bail them out of their dumb decisions, they would act differently. After all, they may not be dumb decisions if they realize that heads they win, and tails they don't have to pay, since the government will bail them out.

Another problem is the overutilization of debt rather than equity finance. In a lot of countries, including the one we are sitting in, of course, tax policy encourages the use of too much debt and not enough equity. Such policies drove real estate development in Houston and Denver. The private investors and developers knew that those were dumb tax policies and eventually the door would close. They wanted to get in and get the money while they could. Now, of course, you have a big overhang of empty buildings.

MR. MORSS: We haven't had any debate, as we did about Chrysler, about whether the recent replenishments of the World Bank and particularly the IMF should or should not have been done. Quite clearly these are bail-outs of private firms—banks that made some bad decisions.

MS. KRUEGER: There was a big debate about that. But I'd like to make another point. While I agree with Charlie on some things, I would have made a very different response to Elliott. There is one great presumption in favor of the private sector (assuming equal incompetence): namely, that when the private sector makes a mistake, he who made it is more likely to pay, and there is bankruptcy. So you on occasion get rid of the stupid decision makers. In the public sector, it is very likely you won't; there is a presumption against making taxpayers pay for these stupid mistakes.

MR. MORSS: Part of the privatization issue is really one of approach. In a number of A.I.D. missions I visited there's too much of an ideological push being given and too little meaningful dialogue. Mission people say, "You know, we are not getting anywhere with our colleagues over in the ministry of such-and-such. We have these cables from Washington that say promote this and promote that, and we go over to ministries and try to promote it and all they do is get angry, and they don't want to talk to us any more."

MR. WOLGIN: Privatization isn't going to go away any more than policy reform is going to go away. The basic impetus is financial and the basic problem is shutting off drains on the public purse. That is going to continue to happen as stabilization takes place and whether it means divesting or closing down or making public firms play to the tune of the marketplace, I am not sure. However, in small countries, privatization raises the question of monopoly. I don't know how you transfer ownership of the one textile factory in the country.

MS. KRUEGER: Take off your tariff.

MR. BERG: Right. Though governments are very rarely willing to do it.

MR. WOLGIN: In fact, in one country where government was talking about selling the state's partial interest to the private sector company which manages the firm, there was no question about lowering the tariff. More than that, they wanted to ban importation of used clothing.

Fiscal pressures and donor pressures lead governments to get rid of parastatals because they need the funds. Yet they compromise the equity and the efficiency advantages by giving them a monopoly position in the markets.

MR. BERG: That's a general and serious problem in privatization policies; private parties will often not buy SOEs unless special privileges are attached to the firm. This is especially so with manufacturing enterprises. But, except in Latin America and a few NICs elsewhere, these are perhaps not terribly significant from the privatization policy perspective. The service enterprises are usually much more important— marketing agencies, bus companies, railroads, for

example. Those are the big money losers, and economically important. So discussions which focus almost exclusively on manufacturing SOEs are a bit distorted.

MR. VERNON: But when you turn to infrastructural enterprises, then you must recall an important point made in your paper, that the privatization issue is a lot less important than the regulatory environment in which all of this takes place.

MR. BERG: Yes, I would agree with you.

Response

Elliot Berg

Ray Vernon says that there will be more ownership privatization in coming years than in the recent past; that it will mainly take the form of sales of minority equity shares in SOEs; that middle-income savers will be the main beneficiaries; and that the present turn toward privatization represents no ideological revolution, so that it will be reversed when governments have enough money, management and control systems.

I have little quarrel with most of this. The record will certainly show more incidents of ownership privatization in 1986–1990 than in 1980–1985. But given the exceedingly modest results up to the mid-1980s, this would hardly be surprising. In many middle-income countries there should indeed be more sales of government-owned shares, especially those acquired by development finance institutions when adversity led to conversion to equity of nonoperational loans made to private firms or SOEs. But the question remains one of scale. The vision of a large-scale selling off of whole companies or of

majority ownership in key enterprises—a vision implicit in some of the debate about the Baker Plan—is improbable. The array of forces opposed to such extensive ownership privatization is much stronger than the group in favor.

Does it matter anyway? Is reduction of state ownership important for improved efficiency and faster growth? It has become conventional to observe that unless the economic policy and institutional environment changes, enterprise performance will not be much better, whatever the ownership arrangements. Reduced controls and a more open, competitive system are what is needed to make firms perform better, whether they are publicly or privately owned.

This position too can be exaggerated. Even a little injection of private participation in ownership of an SOE can change corporate behavior by creating new client groups, new channels for dialogue and, as Ray noted, by providing management and oversight ministries with a possible new shield against unfavorable government action.

More important, no matter what the environment, there are many activities that are almost certain to be better managed under private ownership than public. Small-scale operations such as retail trade or bus transport show this most dramatically, as we will argue below in commenting on efficiency in service provision. But it is true in larger corporate organizations as well. The more private an enterprise is, the more it is likely to be able to resist policy intrusions by the state, and the more likely it is that internal incentive systems will be conducive to efficient performance.

Privatization of ownership will not bring faster economic growth if sales of economically nonviable firms or activities are affected by "tying" arrangements—i.e., by attaching to the physical assets of the enterprise some special rent-generating privilege—or high protection against imports, for example, or a contract granting monopoly rights to provide given goods or services to the state. This conversion of economically and financially unprofitable enterprises into financially profitable ones by grants of rent-generating rights is the greatest potential danger of ownership privatization. Unfortunately, it seems to occur widely, especially in low-income countries with

weak administrative structures. The story, cited in the discussion, of the privatized textile mill that requested a ban on used clothing imports is typical.

Ray agreed in principle to the proposition that deregulation or demonopolization of markets for services would augment efficiency. But he is skeptical that competition could be maintained in such markets, and he sees the efficiency effect only in the one-time introduction of new technology and work habits.

The first question—whether service markets tend more or less inevitably to cartelization—is, we agreed, an empirical question that warrants investigation. On public-private differences in performance, however, there is already considerable evidence. The Calcutta story is one of the most illuminating.[1] The Calcutta State Transport Corporation (CSTC) competes, since 1960, with some 1500 full-sized, privately owned buses and 500 minibuses. The private buses, unsubsidized, carry two-thirds of the passenger trips in the city and are profitable at the same fares, and plying similar routes, as the CSTC, which suffers persistent and substantial deficits.

Three basic factors account for the greater efficiency of the private operations. Their vehicles have much less down time for repairs. Repairs are quickly made, often by going into the black market for spare parts. The CSTC has to go through laborious formal procedures to obtain spares, with the result that half the CSTC buses are down at any one time. Secondly, private bus crews receive a percentage of revenues, and hence work harder to collect fares than do CSTC employees. Probably 25 percent of CSTC passengers evade fare payment, which is rare on private buses. Finally, private buses operate with many fewer workers; the CSTC has 50 employees per bus, the private buses many fewer.

The efficiency impact of private entry in this case was not, as Ray Vernon suggests, due to changes in work rules. Nor is it a one-time change. The institutional environment is such that private operators respond faster and more flexibly to operating needs. And incentive systems are more conducive to good performance in the private bus sector.

A certain amount of skepticism prevailed in the discussion about the desirability of privatization in the health and education sectors and resort to more user charges in those sectors. The basic analytic case for such policies is so straightforward that this skepticism is somewhat surprising. Where supply is constrained by budget pressures, where better-off people receive the biggest share of the subsidies and individually capture most of the benefits (as in higher education and urban curative medical services), there are strong reasons to raise fees. Special efforts to overcome capital market imperfections would help: e.g., loans for needy students in secondary and higher education. But in any case it is clear that restricted access, especially to education, breeds pervasive inequities, in addition to its negative longer-term effects on growth. Any measures that increase access to education (and health) services therefore should have broad appeal. What is truly inequitable is to restrict free entry and/or refuse to raise fees in those cases where people want more schooling for their children but cannot get it because of supply constraints.

6

Elliot Berg

Conclusion

The seminar papers and discussions make clear that policy reform/equity issues can be approached from at least three different perspectives. First, they can be considered in the context of general development strategies, with focus on what kind of income distribution is likely to be associated with different development strategies. While the question was touched upon in numerous discussions at the seminar, Gary Fields' paper most concentrates on this aspect.

A second approach is to place the problem in the context of economic stabilization and structural adjustment programs. This focuses on how the poor are affected by structural adjustment, and how the most vulnerable social groups can be protected when economic stabilization and adjustment programs are necessary. The "adjustment with a human face" theme of recent UNICEF-sponsored writing is typical of this approach.[1] The World Bank has also produced papers on the same theme.[2] This perspective was well

represented in our seminar discussions, notably in the many references to targeting of subsidies.

A third approach is to start from the typical pre-reform situation and analyze the equity effects that are likely to follow the adoption of a standard set of liberalizing reforms.

Where There is Consensus

Each of these approaches views equity problems from a different angle, and focuses on somewhat different questions, but they are closely related. And although the points of departure of seminar participants varied widely, a considerable area of consensus is evident from the papers and discussions. It mirrors a consensus that exists in the larger community of development practitioners and students.

There is no longer much disagreement with the assertion that economic growth will reduce absolute poverty. So, to the extent that liberalizing policy reforms raise growth rates they are a major instrument in the attack on poverty.

The seminar papers did not address (nor did participants evoke) a related issue: whether a development strategy that gives priority to poverty reduction and utilizes direct intervention on behalf of the poor might reduce absolute poverty faster than a strategy that gives higher priority to growth. There would undoubtedly be less consensus in answers to that question. Poverty-focused projects and human-needs-based strategies retain wide appeal, and for good reasons. But while some leaning in that direction can be defended in terms of both growth and equity, experience suggests that there are clear limits to such orientations.

Most of the world's poor live in rural areas. Their poverty is affected by two major (and sometimes) overlapping factors: landlessness and the fact of living in disfavored regions. Neither of these critical target problems is easily addressed.[3] Growers of millet and sorghum in semi-arid Africa, for example, have been given little new technology to raise output and income. In its absence, possibilities for durable, income-raising project interventions are limited.

Projects that aim at regional balance, in the absence of suitable technology and/or projects that are not based on sound economics, will require continuing subsidization which often proves unsustainable, politically and fiscally. A classic example is the Ivory Coast's massive investment in sugar complexes, aimed at helping the people in the poor, dry, northern regions of that country. These proved to be costly mistakes; much of the sugar refining capacity that resulted has had to be abandoned. The continued financing of poverty-oriented programs demands a policy regime and investment patterns conducive to economic growth.

Not only individual projects but also human-needs-oriented strategies are hard to sustain without robust rates of economic growth to generate fiscal receipts necessary for their support. Sri Lanka seems to provide an example. During the 1960s and 1970s, it spent heavily on social welfare programs aimed at the poor; transfers absorbed almost half the budget by the mid-1970s. These programs could not be sustained.[4] In the event, the number of Sri Lankans below the poverty level actually increased between 1960 and 1975, and over this period Malaysia, the Philippines, Thailand and Korea outpaced Sri Lanka in terms of increasing school enrollment and reducing infant mortality.[5]

The point needs no belaboring: without adequate growth, poverty-focused programs and basic-needs strategies inevitably falter.

There is also very broad agreement in principle that the costs of the policy reform programs should not bear heavily on the poor. There is even considerable consensus on the kinds of protective measures that should be taken. High on everybody's list is the maintenance of public expenditure in education and health, and their reallocation to better serve the poor. Such expenditures have in fact been relatively protected, during the economic difficulties of the 1980s, in most LDCs.

Reallocation of expenditures within each sector has been on reform agendas since well before the 1980s, and major reform recommendations are familiar to sectoral specialists: relatively less in subsidies to university students; less spending on universities in general; more and better primary education; more nonsalary education

spending (books, maintenance); relatively more rural and more preventive health services; and higher priority to primary outreach services and less on modern high-tech services.

Direct programs to protect the poor also attract wide support, though consensus is less firm on specific measures. Various types of direct employment schemes have been adopted, and could be used more widely. Most common are projects involving direct employment on public works construction, especially food-for-work schemes. These are widely used in South Asia and Latin America. Bangladesh, the leader in food-for-work programs, has in recent years provided 100 million days of work annually, involving distribution of 400,000 tons of food for rural infrastructure construction.

Other targeted employment programs involve direct hiring for cash; Chile has employed a quarter of a million workers under such a program. Special cooperation schemes are also being tried in many places: payments for discharged employees of state enterprises, retraining and relocation efforts, and so on.

Food subsidies and nutrition programs are, finally, perhaps the most widely used form of protection for the poor. Many countries distribute food at low (or no) cost to vulnerable groups such as pregnant and lactating women, and children. General subsidies on food, food stamp plans, fair-price shops, and a variety of more-targeted programs can be found in many countries.

The principal problem with all these efforts to protect the poor is that of targeting itself. Unless they are well targeted, budgetary and economic costs can become burdensome, and cost-effectiveness low. A number of participants in the seminar, and especially Erik Thorbecke, emphasized that much has been learned about targeting, and experiences around the world support that view. Targeting by season, by neighborhood, by type of food, by well-specified groups (underweight children, pregnant women, etc.) all have promise.

Targeting is the main but not the only obstacle to effective antipoverty programs. Food-for-work employment (and food distribution) programs tend to be difficult to design, costly in use of supplementary skilled-labor inputs and demanding administratively. Even in Bangladesh, only about one-third of the food-for-work projects function properly.[6]

A final important area of consensus concerns deregulation or "demonopolization." The seminar discussion, like the general debate on these matters, reflects a greater awareness of the advantages of competitive markets than was common a decade ago. The inefficiencies and inequities associated with monopoly, whether in marketing of agricultural inputs and outputs, provision of urban transport, or in production of goods and services more generally, are widely recognized.

Some participants expressed skepticism about the possibility of maintaining competition in privatized markets, but policies that prohibit free entry and maintain legally protected monopolies have few advocates. This is related to a more general point: that we are all more sensitive now to the reality of "public sector failures." No longer do we point out private market failures and blithely conclude that the public sector has to step in. We want to know now whether the public sector can do the job, or make things worse.

Where There is Disagreement

While seminar participants agreed on many issues, there remained significant differences. Some of these reflected the diversity of regional conditions and perspectives, more than basic disagreement on principles; Miguel Urrutia insisted, for example, on the point that Latin American governments still spend relatively little on education and health, so that what might be good tax policy for Africa is not applicable in Latin America. His objection to labor market conditionalities by the IMF and World Bank appears to be based in part on the view that labor market distortions are slight.

Gary Fields pointed out that this was not so in Costa Rica, and it is not true in most of Africa. He and other participants also rejected blanket condemnation of export taxes and stressed that subsidies, such as those on food, may often be the only way to reach the poor. So preoccupation with refined targeting may be exaggerated.

Erik Thorbecke noted that if targeting is too effective it can destroy the political basis of the overall reform program by excluding

from benefits groups whose influence may be needed to sustain the program.

The most fundamental difference arose over issues of feasibility. Many participants seemed unconvinced that liberalizing policy reforms can work. In this, their attitudes mirror those that are widely held in the general development community, and particularly by academics.

The skepticism about the feasibility of liberalizing policy reforms and the development strategy implicit in them rests on at least three arguments.

- It is thought that few governments believe in and hence will truly accept liberalizing reforms; they run counter to social objectives or belief systems in many LDCs.
- Important preconditions for effective functioning of markets and constructive private sector growth are said to be lacking: for example, infrastructure, entrepreneurship, integrated and fully monetized economies, and reasonably competitive markets for land, labor, capital.
- Some argue that trade liberalization will not or cannot produce desirable results in the developing world. Generalized export-led strategies will, the argument goes, at best yield slow increases in exports, because of industrial country protectionism and because demand for most LDC commodity exports is highly price inelastic. Import liberalization can ruin infant industries. In the seminar discussions, this issue of export-led growth or outward-lookingness received particular attention. A number of participants expressed doubts that exports can provide an adequate engine of growth under present and projected conditions in the international economy.

Acceptance of Liberalizing Policy Reforms

It is true that many officials and others in LDCs find liberalization and market-oriented growth strategies technically unconvincing and/or ideologically distasteful. Nonetheless, many of the reform

prescriptions are now being accepted in economies representing the whole political spectrum.

The recent changes in the centrally planned economies are well known. Even the Soviet Union, long resistant to market-oriented reform, is now liberalizing in various directions, and giving price incentives a greater place.

LDCs with *etatiste* traditions are privatizing some of their SOEs (Mali, Tanzania, Ghana, Grenada, Jamaica). Many are opening agricultural input supply to private competition (Bangladesh, Kenya, Togo). Exchange rate systems have been made more flexible in numerous countries: Chile, Zaire, Uganda, Kenya, Jamaica, Somalia, among others. In many African countries, since 1984, real effective exchange rates have depreciated decisively. Each of these instances of market-oriented reforms went against the ideological grain, but were nonetheless adopted.

Nor does a scarcity of infrastructure, entrepreneurs and operative markets preclude market-oriented reforms. As Hla Myint observed, "The incomplete development of the market economy may be interpreted as prima facie evidence for further strengthening the market mechanism."[7] Poor infrastructure and poorly functioning markets indicate priority areas for public sector attention; better roads, easier access to information, easier access to credit, removal of legal and other obstacles to entry will make market-oriented policies work better. The creation of an environment congenial to the development of entrepreneurship will certainly induce new supply, though in some of the least developed areas it will take time and good policy to nurture entrepreneurial/managerial skills needed for modern industrial development.

And it should be noted that there are cases in low-income and little-developed countries where absence of infrastructure and the supposed absence of entrepreneurs has not impeded rapid growth. Cocoa production in Ghana grew from almost nothing in the 1880s to about 200,000 tons twenty years later, almost all of it hand carried or rolled in barrels through forest paths.[8] More recently, in the Shebelli Valley in Somalia, a burst of production took place before roads were in place. Trucks made it through the available tracks, and some farmers even paid to have roads built.

Trade Regime Liberalization

The liberalization of trade regimes and adoption of outward-looking policies does present many serious obstacles. It may be true that the industrial sectors of many LDCs would be severely shaken by the competitive shocks that import liberalization would bring.

In the agricultural sector, domestic producers of foodgrains might also be challenged by competitive imports—a problem that is complicated by the fact that many of the commodities in question are priced artificially low because of subsidies in exporting countries. But few reformers would deny the need for some protection for agricultural commodities; variable import levies at moderate levels are common features of structural reform programs. Moderate, uniform tariff protection for industrial goods is also standard.

The feasibility of export-led growth raises a multitude of issues too complex for adequate treatment here. Gary Fields and Anne Krueger addressed many of these. Given the central importance of the question, however, it may be useful to restate, in somewhat more detail, some elements of the argument that outward-looking reforms are feasible.

First, while it is true that industrial-country protectionism imposes limits on the rate of expansion of LDC exports, these limits have proved flexible in the past and in any case should allow significant growth. It is of course unlikely that rates of increase of 30 percent a year, typical of the Korean and Taiwanese experiences, can be repeated. But substantial export growth (perhaps 10–15 percent a year) should be possible for many countries, even with the world economy growing at rates below those of the mid-1970s.[9] As was noted in the conference discussion, the experience of 24 countries was as good or better than this in the late 1970s despite recession and growing protectionism.[10]

Second, LDC export growth is *not* tightly constrained by the overall growth of developed country (DC) economies. That such a constraint exists was one of the pillars of the export pessimism of the 1950s, and has been revived recently.[11] According to the argument, if LDC exports can grow only at some constant rate determined by

GNP growth in DCs, and if the developed countries are experiencing slower growth and frequent recessions, then trade will be a feeble, ineffective "engine of growth."

This view, however, goes against recent experience. In the 1960s, LDC-manufactured exports grew almost twice as fast as the real GDP of the developed countries. In the 1970s, LDC manufactures maintained this rapid export growth; they grew roughly four times faster than DC real GDP in this period.[12]

The notion that the expansion of LDC exports depends almost entirely on the growth of developed country markets is wrong on a number of counts. It tends to assume a static composition of developing country exports; trade in primary commodities is equated with LDC exports in general. But manufactures rose from 10 percent to 40 percent of the value of LDC exports between 1955 and 1978. This view also ignores substitutability in DC markets; much growth in LDC exports has been due to LDC exporters out-competing DC producers for larger market shares.

Overcoming Export Pessimism

Until very recently, one could conclude from these experiences that it is not demand but rather supply factors that have been the main determinants of LDC export performance in manufactures.[13] LDC exporters appear better able to discover market opportunities in developed (or, for that matter, developing) countries than outside observers. In countries that have remained open and not penalized exports, substantial diversification out of primary products towards agro-industrial and manufactured products has taken place. Until the early 1980s, in any case, the export pessimists' vision of constricted trading possibilities turned out to be too narrow, too static.

The export pessimists have been most insistent with respect to agricultural commodities. Here, they say, a "fallacy of composition" renders inapplicable the prescription to rely on export-led growth: if all countries expanded exports of coffee, cocoa, tea, sisal, tobacco, oilseeds, etc., export earnings would decline, not increase. The issue

has been debated most insistently with respect to African development strategies.[14]

The export pessimists may underestimate true potential. For example, we can ask by how much export proceeds would have increased if African countries had maintained their export share at its highest level during the 1960–1983 period. Using pessimistic assumptions on price elasticities for African exports, and no contraction of supply by Africa's competitors as prices fell due to higher African output, the additional annual export proceeds would only be $0.6 billion, or 8 percent higher in the mid-1980s. But there would surely have been some displacement of non-African production.

Because non-African producers are more diversified and developed for the most part, their Africa-competitive exports have higher opportunity costs, and their relevant supply curves would therefore be more elastic than those in Africa. If commodity prices fall, production in these countries will tend to fall relatively more than in Africa. A reasonable estimate for the mid-1980s under these conditions yields $2–2.5 billion in additional export earnings. This would be an increase of one-third over present actuals, not at all insignificant by itself. Taking account of accumulated totals it becomes very substantial.[15]

Pessimism about the benefits of export-led growth for the least developed primary producers may thus be a costly delusion. Its end result, moreover, may cause producing countries that take the pessimists seriously to be displaced by those who fight to maintain market share. It neither helps reduce African poverty nor contributes to equity on a world scale if Brazil, Malaysia, and Indonesia continue to win larger shares of world markets for beverages, oilseeds, or other commodities.

Whatever the inherent merits of the arguments for outward-lookingness, they have to be assessed not simply in the abstract, but in the light of available options. Few economists would recommend to small states with limited domestic markets that they turn decisively inward. But many do urge much greater priority to import substitution, which seems to be the policy orientation that follows from export pessimism. However, a lukewarm embrace of international markets is not likely to yield acceptable results.

There do not seem to be viable alternatives to energetic outward-looking policies if export sectors are to have a chance to achieve respectable growth. It requires suitable exchange rates arrangements, flexible export marketing organizations, incentive pricing for export producers, continuing research on export commodities, among other things.

Prospects for Market-oriented Policy Reforms

We have perhaps dwelt too much on feasibility, which after all is determined by national authorities on the basis of specific policy options available to individual countries. It is evident that many countries of widely different ideological complexion have adopted, or are seriously considering adopting, reform programs that involve greater export orientation. This suggests at the least that realistic alternatives are few.

The absence of better alternatives is a powerful argument in support of market-oriented policy reforms. But there is more than this to command such reforms. Under conditions that are found in many poor countries, economic liberalization will bring both more growth and more equity. Better targeting of subsidies can reduce negative impacts of adjustment programs on the poor. And as experience in Chile (and in other countries) shows, privatization programs can be designed to encourage widespread distribution of privatized state assets. Schemes can be introduced to facilitate redeployment of workers released because of SOE restructuring. Voucher systems could conceivably be designed to soften the impact of reform in the social sectors, in transport and in other areas.

Such efforts would reduce the short-term costs of policy reform to the poor. They may not eliminate them, especially since expenditure-reducing stabilization programs are usually associated with reform programs. It is this perhaps that explains the reluctance of many at this seminar, and more outside, to accept the proposition that, in general, liberalizing reforms will reduce absolute poverty and lead to a more even distribution of income. Empirical evidence to support this proposition remains sparse because market-oriented policy

reform programs are recent and thus require a few years before results are visible, and because many reform programs are unskillfully or halfheartedly implemented.

For the moment, the Chinese agricultural reforms are probably the most brilliant illustration of what is possible. Better incentives, greater freedom to organize production, and removal of constraining regulations such as those preventing free movement of goods led to amazing increases in production. Rural income per capita on average doubled between 1978 and 1983; these gains probably exceeded those of the previous 30 years. All this was done with very little in the way of increased inputs, and without any technological breakthrough.[16] And it appears to have been done with generally equalizing effects on income distribution.[17]

Chile also has introduced dramatic experiments, with some striking successes, as in export growth. More modest successes can be pointed to elsewhere, in Bangladesh and Sri Lanka, in Somalia and Ghana, among others. In the 1990s results should be more widespread, and the policy transformations of the 1980s will bear more visible fruit.

Market-oriented policy reforms tend to increase equity by raising economic growth rates and, thereby, reduce absolute poverty. This, in turn, will reduce differentials in income distribution, especially where education and asset ownership are relatively widely distributed or in agricultural economies where smallholder farmers are dominant. Properly implemented, these reforms avoid the shortcomings of classical state interventions that tend to benefit the rich more than the poor.

Given the extreme inequalities that are often characteristic of prereform economies, the equity-enhancing attributes of market-oriented measures provide a compelling justification for including such measures in policy reforms designed to increase equity and opportunity in developing nations.

Notes and References

1. Elliot Berg, Introduction

1. World Bank, *World Development Report 1987*; B. Belassa, "Outward Orientation," World Bank Discussion Paper (Washington, D.C.: World Bank, 1985).
2. IMF, Fiscal Affairs Department, *Fund Supported Programs, Fiscal Policy and Income Distribution*, Occasional Paper #46 (Washington, D.C.: International Monetary Fund, September 1986); and World Bank, *Protecting the Poor During Periods of Adjustment*, Paper presented to the Development Committee (Washington, D.C.: World Bank, April 1987).
3. Hollis Chenery et al., *Redistribution With Growth* (London: Oxford University Press, 1974), p. xiii.
4. I. Adelman and C.J. Morris, *Economic Growth and Social Equity in Developing Countries* (Stanford: Stanford University Press, 1973), p. 189.
5. See Deepak Lal, "Distribution and Development: A Review Article," in *World Development*, no. 9 (1976), p. 729.
6. Cf. Michael J. Crosswell, "Growth, Poverty Alleviation, and Foreign Assistance," in D. Leipziger, ed., *Basic Needs and*

Development (Cambridge: Oelschlager, 1981); Montek S. Ahluwalia, "Inequality, Poverty and Development," *Journal of Development Economics*, no. 3 (1976), pp. 307–342.

7. G. Pfefferman, "Latin America and the Caribbean: Economic Performance and Policies," *The Southwestern Review of Management and Economics*, Vol. 2, no. 1 (Winter 1982), p. 142; also published in World Bank Reprint Series, no. 228. See also M. Urrutia, *Winners and Losers in Columbia's Economic Growth of the 1970s* (World Bank/Oxford University Press, 1986).
8. M. Louise Fox, "Income Distribution in Post-1964 Brazil: New Results," *Journal of Economic History*, Vol. 43, no. 1 (March 1983), p. 271.
9. Gary S. Fields, *Poverty, Inequality, and Development* (Cambridge: Cambridge University Press, 1980), pp. 88-93; Montek Ahluwalia and Hollis Chenery, "The Economic Framework," in Chenery et al., ibid. See also David Felix, "Income Distribution and the Quality of Life in Latin America: Patterns, Trends, and Policy Implications," *Latin America Research Review*, Vol. 18, no. 2 (1983), pp. 3–34.
10. Guy Pfefferman, former World Bank Chief Economist for Latin America, has written: "The empirical basis for statements about income distribution trends is so weak even in the most advanced countries in the [Latin American] Region that comparisons in time lack statistical validity," ibid.
11. Cf. Hla Myint, "Growth Policies and Income Distribution," World Bank Development Policy Issues Service, VPERS1 (Washington, D.C.: World Bank, March 1985).

2. Charles E. McLure, Jr., Fiscal Policy and Equity in the Developing World

1. For a statement of this proposition, as well as a survey of studies of tax incidence, see Bird and DeWulf (1973). For a more recent statement of these themes, see Bird (1980).

2. For a survey of studies, see DeWulf (1975). See the references to the present paper for further discussion of alternative means to allocate benefits of general expenditures.
3. Strictly speaking, of course, it is not possible to determine whether expenditures should be increased or reduced, without knowing how taxes might be increased or reduced.
4. For a recent negative assessment of the possibility of using higher taxes to generate a budgetary surplus and make funds available for investment, see Bird (1987).
5. That confiscatory taxation of income above a certain level implies 100 percent marginal tax rates should be fairly clear. That a guaranteed minimum level of income also implies 100 percent marginal tax rates may require further explanation. The point is that if a minimum level of income is guaranteed, private efforts to increase incomes which are below the minimum level will have no effect on total income actually realized. So, individuals would have little incentive to exert themselves until the minimum level is exceeded. Of course, in actuality, administrative problems and the cheating they make possible may generally mean that marginal tax rates fall below 100 percent in practice, even if not in theory.
6. This reference to policy-relevant similarities opens the door to something of a "catch 22," since any particular difference can be said not to be policy-relevant. This is especially true when we come to benefits of public spending. See also note 8 below.
7. It may be worthwhile to clarify that this discussion of horizontal equity does not pertain to expenditures financed by user charges or by benefit taxation—a relatively small fraction of expenditures in most countries. Expenditures financed in this way should be analyzed in the same way as other goods and services for which prices are paid, not in the same way as expenditures financed from general revenues. There is no more reason to apply the concept of horizontal equity to expenditures for which user charges and benefit taxation can be and are applied than to do so for the purchase of such goods and services as hamburgers and postage stamps.

8. As suggested by note 6, this raises an interesting conceptual issue. We do not expect families with different numbers of children to pay the same amount of income tax. So should we think it a sign of horizontal inequity that they also receive different amounts of benefits of public education?
9. For compelling evidence supporting this proposition, see Rosenberg and Birdzell (1986).
10. See Olson (1987) for a provocative argument that failures of incentive systems in large bureaucracies help to explain the failure of economic planning and other policies of intervention.
11. It may be appropriate to note the close connection between the four topics for this conference. Important aspects of each of the other three topics are closely related to the central concerns of the present paper.
12. This quotation and the previously stated facts are from Duignan (1986), p. 18. Duignan notes further that differences between entry-level salaries and those of senior civil servants are commonly so great (30 to 40 times higher) that much time is spent trying to move up the bureaucratic ladder, rather than doing productive work. Olson (1987) suggests that (and why) bureaucracies will inevitably be inept, corrupt, and inefficient in societies that have little experience with large-scale organizations. Discussion at the seminar suggested that the differences cited here have since narrowed because of massive cuts in real wages in the public sector.
13. The methodological appendix provides further discussion of how this might be done—or, more accurately, it describes some pitfalls.
14. The seminar comment by Ray Vernon that in China the very poor have virtually disappeared and that in Cuba various social indices show substantial improvement deserves comment. These phenomena may be one outward manifestation of a policy that "levels up" by placing the poor on the public payroll. The possibility that much of this improvement may have resulted from wage employment seems largely irrelevant. The key empirical question is whether this employment

constitutes a major increase in output or only results in substantial "leveling down" because those who would otherwise have been poor are not productively employed.

15. The term "rent seeking" may deserve brief explanation. "Rents" to the economist are payments in excess of what would be required to elicit supply. In the case of remuneration for employment it is the excess over what could be earned in the next most attractive alternative employment (after allowing for nonwage differences in occupations) or the reservation wage, below which leisure would be preferred. Expanded public employment at artificially high wages bestows rents on public employees.
16. In too many countries there is a tendency to decentralize responsibility for expenditures but not for their finance. The results may include lack of responsible decision making at the lower level, reluctance to trust the central government to live up to its financial obligations, and lack of central government concern for lower-level activities which bring it little credit.
17. See also the paper presented by Berg at this seminar.
18. The concept of excess burden can be traced at least to Alfred Marshall's *Principles*. See any good undergraduate textbook in public finance for an exposition of the concept.
19. See Ballard, Shoven, and Whalley (1985).
20. For a more complete statement of this view, see McLure and Thirsk (1978).
21. This is argued in greater detail in McLure (1971a) and (1984). Administrative difficulties of implementing regional tax incentives are discussed in McLure (1980).
22. Consumption-based taxes allow immediate expensing (complete write-off in the year of acquisition) for capital goods (those that would be depreciated over their useful lives under an income tax). Suppose that an investment of 1,000 is made by a taxpayer in the 40 percent bracket and that a year later the asset yields an income stream of 1,100 and is completely depreciated; thus the before-tax rate of return is 10 percent. If the investment is 100 percent financed with the equity funds

of the taxpayer, the immediate expensing implies a tax benefit in the first year of 400 (40 percent of 1,000), so that only 600 of the taxpayer's own funds need be invested. The government takes 440 of the income in the second year, leaving the investor 660. Since this represents a 10 percent rate of return on the initial private investment of 600, the marginal effective tax rate is zero. A similar demonstration can be provided in the more complicated case in which investments are financed in part by debt. Under one proposal for a consumption-based tax, interest income is not subject to tax and no deduction is allowed for interest expense. Demonstration of these propositions can be found in Zodrow and McLure (1987).

23. See Zodrow and McLure (1987).
24. This point is explained in greater detail in McLure (1987b). See also Zodrow and McLure (1987).

Appendix/Endnotes

A1. What I say here will have a ring of familiarity to those conversant with my unpublished 1974 paper "On the Theory and Methodology of Estimating Benefit and Expenditure Incidence" (McLure, 1974). Precisely because that paper was never published, it may be appropriate to repeat some of the themes developed there.

A2. For surveys of studies of tax incidence, see Bird and DeWulf (1973) or Wasylenko (1986).

A3. See DeWulf (1975) for a survey of studies of the expenditure side of the budget. Colombia has been the subject of several such studies, including Urrutia and de Sandoval (1971) and Selowsky (1979).

A4. For further discussion of some of the issues suggested in this paragraph, see McLure (1987a).

A5. See Harberger (1983) and, for a similar discussion in a somewhat different context, McLure (1979) and (1981).

A6. See also Bird and DeWulf (1973) and McLure (1974).

A7. For such evidence for the United States, see Blinder (1980).

A8. For evidence of this, see, for example, Philpotts (1986) and Hewitt (1987).

A9. See Bird and DeWulf (1973), McLure (1974), DeWulf (1975), and Reynolds and Smolenski (1977), chapter 2, and references therein.

A10. For a more extended discussion see Reynolds and Smolenski (1977), chapter 2, and references therein.

A11. This distinction is drawn from Musgrave (1959), chapter 9. It is developed more fully in McLure (1974).

A12. For a more rigorous and analytical discussion of expenditure incidence and its determinants, see McLure (1971).

A13. This is, of course, an overstatement. For example, the children of the elderly may benefit indirectly from social security pensions if they are thereby relieved of the need to care for their parents. We ignore such qualifications in what follows.

A14. For an example of this error, see Gillespie (1965).

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3. Erik Thorbecke, Impact of Stabilization and Structural Adjustment Measures and Reforms on Agriculture and Equity

1. M. Guitian (1982).
2. Addison and Demery (1985) provide a comprehensive analysis of the impact of adjustment on income distribution and poverty.

3. Lecaillon, Morrisson, Schneider and Thorbecke (1987). The other side of the medal is that subsistence farmers will often be badly hurt by subsidized prices for imported food crops (under food aid programs). In particular, urban consumers seem to prefer the more palatable but less nutritious imported food, with serious consequences for the subsistence farmers.
4. This is one of the issues which should be addressed in the second seminar of the Sequoia series titled, "The Informal Sector and Growth in LDCs."
5. Stewart (1983), pp. 45.
6. Most of these changes would appear in Figure 1 under arrows 2.3 (transfer to subsidies). In some instances any changes in direct or corporate taxes would also affect the household distribution as shown by arrow 3.2.
7. See among others, Thorbecke (1986) and Kanbur (1986).
8. An even simpler model is that of A. Braverman, J. Hammer and A. Gron, "Multi-market Analysis of Agricultural Price Policies in an Operational Context: The Case of Cyprus," *The World Bank Economic Review*, January 1987.
9. This list of five categories is taken from Addison-Demery (1986 I), see pp. 23–25.
10. See Greer-Thorbecke (1986), pp. 125–126.

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4. Gary S. Fields, Trade Strategies and the Poor: Adjusting to New Realitites

1. For more on the distinction between relative and absolute approaches to income distribution and economic growth, see Fields (1980).
2. As Edgren and Muqtada (1986, p. 112) put it: "It is premature to predict likely outcomes of [trade liberalising policies], especially in the context of sectoral imbalances in employment and incomes. Concern has already been expressed over the fast decline in the small rural industries in Sri Lanka as a result of its liberalisation policies. *One has to weigh the loss of employment/income in this and other sectors against possible gains elsewhere before pronouncing on the merits of such liberalisation.*" [Emphasis added in the final sentence.]
3. I would suggest that perhaps the absence of a pattern is attributable to different underlying causality: that unemployment would be expected to increase if the country was experiencing such pronounced economic difficulties that it was forced to liberalize (e.g., Chile in 1974), but that unemployment would decrease if the country chose to liberalize in order to seize an opportunity (e.g., Korea in the early 1960s). This, of course, is just speculation.
4. See, for instance, the International Monetary Fund's *World Economic Outlook*, April, 1986 or the Inter-American Development Bank's *Economic and Social Progress in Latin America*, 1985.
5. On this, see the papers by Hong, Schive, Chen, and Wong in Bradford and Branson (1987).
6. Singapore's policies have been the least consistent on this score. This is discussed further in the text below.

7. In Israel, real wages fell by 18% in the first six months of the stabilization plan, but within a year, they had recovered all but 3% of their average value. In Argentina, a short-term real wage decline of 5% was soon followed by a real wage increase.
8. See, for instance, Bruno (1986) and Dornbusch and Simonsen (1987).
9. The following discussion is taken from Fields (1986).
10. Says Gregory (1981, p. 400): "The omission of trade unions from considerations as a significant force stems from the wide consensus I found in Costa Rica that they are not particularly powerful and do not represent a significant independent influence on wage levels except perhaps in some of the semiautonomous public corporations."
11. See, for instance, PREALC (1979).

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Comment, Anne O. Krueger

1. Paul T. Schultz, "Effectiveness Protection and the Distribution of Personal Income by Sector in Columbia," in Anne O. Krueger, ed. *Trade and Employment in Developing Countries* (Chicago: University of Chicago Press, 1982).

2. Vittorio Corbo and Jaime de Melo, eds. "Liberalization with Stabilization in the Southern Cone of Latin America," special issue of *World Development*, Vol. 13, no. 8 (August 1985).

5. Elliot Berg, Privatization and Equity

1. Elliot Berg. *Divestiture of State-Owned Enterprises in LDCs*, report prepared for the World Bank, November 1985.
2. P. Vergara. "Las Transformaciones de las Funciones Económicas del Estado en Chile bajo el Régimen Militar," Colección Estudios CIEPLAN 5 (July 1981), pp. 117–154; F. Dahse, *Mapa de la Extrema Riqueza (S*antiago, Editorial Aconcagua, 1979), cited in S. and A.C. Edwards, *Monetarism and Liberalization: The Chilean Experiment* (Cambridge, MA: Ballinger Publishing Co., 1987), p. 96.

3. The Edwards note: "What is in a way astonishing is that this was not a mystery to regulators, who in fact knew that their measures to avoid ownership concentration were consistently and systematically being violated," ibid.
4. These data are drawn from: A. Foxley, "Toward a Free Market Economy: Chile, 1974-1979," *Journal of Development Economies*, Vol. 10 (1982), p. 24; S. and A.C. Edwards, ibid., Ch. 4; M. Shirley, *Managing State Enterprises*, World Bank Staff Working Paper, 1983.
5. However, specific actions aimed at changing the public-private mix in service delivery seem to be common only in agricultural markets; policy-based loans in many countries are conditioned on liberalizing marketing of agricultural output and encouraging a freer role for private merchants in distribution of inputs.
6. Cf. Gabriel Roth, *Private Provision of Public Services in Developing Countries* (Washington, D.C.: World Bank, 1986), Ch. 6.
7. Richer and/or better-educated parents can spend more for private tutoring, are more likely to encourage studying, and provide all the general advantages of an educated household. Cf. S. Heyneman and W. Loxley, "Effects of Primary School Quality on Academic Achievement Across Twenty-Nine High- and Low-Income Countries," *American Sociological Review*, May 1983, pp. 1162-94.
8. Cf. Elliot Berg Associates, *Inputs Supply in the Cameroons*, a study prepared for the World Bank, 1983.
9. See World Bank, *World Development Report 1986*, pp. 95-97; and D.W. Adams, D.H. Graham, and J.D. Von Pischke, eds., *Undermining Rural Development with Cheap Credit* (Boulder, CO: Westview Press, 1984).
10. Cf. John M. Page and William F. Steel, "Small Enterprise Development: Economic Issues from African Experience," World Bank Technical Paper Number 26, 1984, p. 28.
11. This section and the following rely heavily on E. Berg, "The Challenge of the Private Sector," a paper prepared for the Agency for International Development, April 1986.

12. International Monetary Fund. *Fund-Supported Programs, Fiscal Policy and Income Distribution*, Occasional Paper #46, September 1986, pp. 39ff.
13. Emmanuel Jimenez. "The Public Subsidization of Education and Health in Developing Countries: A Review of Equity and Efficiency," *The World Bank Research Observer*, Vol. 1, no. 1 (January 1986), pp. 111-129. In the Philippines, annual subsidies to five specialized medical facilities that cater mainly to the upper classes totalled 229 mn. Pesos in recent years, while primary health care received 45 mn. Pesos. G.A. Cornia, R. Jolly and F. Stewart. *Adjustment with a Human Face: Protecting the Vulnerable and Promoting Growth* (Oxford University Press (draft), 1987), p. 226.
14. Jimenez, ibid.
15. Ibid.
16. World Bank. *Draft Report on Fertilizer and Millet and Groundnuts in Senegal*, 1980.
17. Elliot Berg Associates. *Inputs Supply in the Cameroons*, Vol.I, 1983.
18. For examples, see Leroy P. Jones, "Public Enterprise for Whom? Perverse Distributional Consequences of Public Operational Decisions," *Economic Development and Cultural Change*, Vol. 33, no. 2 (January 1985), pp. 333-347.
19. *West Africa*, 3 March 1986, p. 464.
20. Cf. David de Ferranti, "Paying for Health Services in Developing Countries, An Overview," World Bank Staff Working Paper #721, 1985, pp. 37ff.; and Jimenez, ibid., pp. 36–70. See also M. Thobani, "Charging User Fees for Social Services: The Case of Education in Malawi," World Bank Staff Working Paper #572, 1983.
21. See G.A. Cornia, R. Jolly, and F. Stewart (eds.), ibid., pp. 218ff.
22. Ibid.
23. Cf. E. Jimenez, *Pricing Policy in the Social Sectors: Cost Recovery for Education and Health in Developing Countries*, Johns Hopkins Press, 1987; and D. de Ferranti, ibid.
24. Cf. World Bank, *World Development Report 1986*, pp. 106–107.

Response, Elliot Berg

1. This account comes from Gabriel Roth, *The Private Provision of Public Services in Developing Countries* (Washington, D.C.: World Bank, 1986), pp. 204–205.

6. Elliot Berg, Conclusion

1. G. Cornia, R. Jolly and F. Steward, eds. *Adjustment with a Human Face: Protecting the Vulnerable and Promoting Growth* (London: Oxford University Press, 1987).
2. World Bank, "Protecting the Poor During Periods of Adjustment," April 1987, p. 17.
3. Cf. J. Mosley, "Aid for the Poorest: Some Early Lessons of U.K. Experiences," *Journal of Development Studies*, Vol. 17, no. 2 (January 1981).
4. Cf. H. Myint, "Growth Policies and Income Distribution," World Bank Development Policy Issue Series, 1985; and B.S. Bhalla, "Is Sri Lanka an Exception? A Comparative Study of Living Standards," in T. Srinivasan and P. Bardhan, eds., *Rural Poverty in South Asia* (Columbia University Press, 1986).
5. Bhalla, ibid.
6. World Bank, "Protecting the Poor," ibid.
7. Hla Myint. *Economic Theory and the Underdeveloped Countries* (New York: Oxford University Press, 1971), p. 303.
8. R. Szereszewski. *Structural Change in the Economy of Ghana, 1891–1911* (London: Wiedenfield and Nicholson, 1965). P.T. Bauer, *Reality and Rhetoric* (Cambridge: Harvard University Press, 1984). Bauer notes that in South East Asia and West Africa, "The facilities known as infrastructure were developed in the course of the expansion of the economy. It is unhistorical to envisage an elaborate and expensive infrastructure as a necessary groundwork for economic advance." Ibid., p. 4.

9. See W. Cline, *Exports of Manufactures from Developing Countries: Performance and Prospects for Market Access* (Washington, D.C.: Brookings Institution, 1984).
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