CENTER FOR GLOBAL DEVELOPMENT

Presents

When Capital Earns a 20% Real Return, What is Left for Labor?
A Glimpse into Latin American Reality

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[TRANSCRIPT PREPARED FROM AUDIO RECORDING]

Dennis de Tray: Let me tell you how today is going to go, but before I do that, let me thank my colleagues from the U.S. Agency for International Development for being the impetus behind this meeting, helping us – allowing us to bring Al here. They are actually sponsoring Al's visit to Washington as part of his ongoing consulting – or advisory work for the USAID, but thank you for allowing us to include Al in this event. For those of you who have been to Center for Global Development events before, you will know the format. We will begin with a talk by Al on a subject of his choice and we will then regroup here, myself, Al, and two eminently qualified discussants to talk a bit about what Al has to say. Bit of a conversation among that group and then open it up for conversation and comments from all of you.

As I began to prepare for this event, there was a sort of epiphany. I realized that had this discussion – had this presentation been just one month later, it would have been Al's and my fortieth anniversary. I met Al 40 years ago next September, as an entering Ph.D. student at the University of Chicago, and I have to tell you my first impressions of Al were mixed. Al was at that point the chairman of the department, as he was for a number of years, and as chairman it was Al's duty to welcome all entering Chicago Ph.D. students. For those of you who don't know the Chicago tradition, Chicago admits a much larger number of students than they eventually graduate, which was good for me because I would've never gotten in if they hadn't had this sort of random lottery of effect at one end.

But Al gives this very warm welcome remark and then he says, look to your right and look to your left. Only one of you is going to get out of this institution with a Ph.D., which put the fear of God in everybody sitting around that room. But it was an extraordinary time and Al was a major input into that extraordinary time at the University of Chicago. There's no counter factual. I wouldn't know what it would have been like to go to another Ph.D. program, but it was, in my judgment, an extraordinary program. The relationship between faculty and students was – on this I'm quite sure – was remarkable and unique and I think shaped all of us for the future.

It is a very good thing that Harberger needs no introduction because his curriculum vitae is 27 pages long, and it needs updating, Al, because it stops in 2003. Al has the most remarkable output. It's worth going and just scanning over his CV to see the breadth and depth of areas he's worked in. Al has contributed to the fundamental vocabulary of economics. There are the famous Harberger Triangles, and if you go to Robert Gordon's web site, it's Northwestern University, you can see a picture of Al dressed as Triangle Man at a Christmas party in the late 60s in Chicago. He was, as I said, the chair of the – in my unbiased judgment, the best graduate economics department in the world for a number of years at the University of Chicago. He has taught at a host of who's who universities, and he has advised almost everyone you can think of at one point or another in the past 40 or 50 years.

Al will speak today on when capital earns 20 percent, a 20 percent rate of return, what is left for labor, and I'm quite sure that Hugo Chavez is waiting to hear the answer to that question. Don't be put off by the board. I've told Al this cannot be a lecture to his students. It's actually got to have content and relevance that's for a broad audience, and he's promised me he will do that, and with that let me say, Al, it's an enormous personal and professional pleasure to welcome you on behalf of myself and the Center for Global Development, and the podium is yours. Al Harberger.

Arnold "Al" Harberger: Okay. Well, it's a great pleasure to be here and thank you very much, Dennis, for that overly generous introduction. I want to say that the look to your right and look to your left and so on, it was not I, but was McCluskey; at that time Donald, now Deirdre. In any case, that story is generally quite exaggerated. The mortality of people at Chicago. Nearly everybody got and earned Master's out of the same and most of the people who didn't get the Ph.D. failed to get it because they had to go back to their home countries, not because they flunked out of the program.

But anyway, I hope that this title of this talk will not mislead you too much. Dennis was very anxious to have a catchy title and we had about a five-minute silence on the phone and we were mulling around for what in the world we could have as a catchy title, and suddenly this one came to mind, and actually it's more than that. I'll tell you the story of the title, which has partly to do with this whole presentation. I've been interested in rate of return to capital going way back to the 50s and 60s and have been measuring this in different places as I've wandered around, and I became very impressed in El Salvador in about 93 when I was doing a set of measurements of the real rate of return to capital **** careful and so on, and this real rate of return started at around 20 percent in the 1970 – early 1970s, and then there was this great coffee boom of the 70s and capital was pouring in, investment was up, capital stock grew, and the rate of return drifted down from 20 to 19, 18, 17, and so on as the capital stock emerged.

Then came the civil conflict in El Salvador. It went way down to about 6 percent and then even while the conflict was going on, the real rate of return began to recover. By the time peace broke out in Salvador, it was breaking through 30 percent and damn it all, it went 20 to 25 to 30 percent and little over 30 percent. This was the rate of return to capital in the money-earning sector of the economy. And I want to emphasize that. And I was nonplussed by this. We were doing this with FUSADES, which is a wonderful foundation that they have and very dedicated people who are mostly the oligarchs of Salvadoran economy and there they – I would be talking about this around the table and I figured they're gonna just cream me when I tell 'em they're earning a 30 percent return. They're gonna shudder and say no, no, no, this isn't true. I've been talking about this from 93 until now with those guys and every time I mention yeah, yeah, yeah. Not a single objection that I'm over estimating this rate of return.

And recently I was in Nicaragua and with the corresponding Directorate of ****, a great business school that they have there, and that board of directors was sitting around a lunch table and I was talking 25 percent real return and things like that and they nod their heads. Never a single objection. So I feel quite confident that this is quite real. And for those who haven't learned the rule of 72, a 24 percent real return doubles in three years. To think about what kind of a return to capital that is. I was really thrown when I started picking up these things. Well, then we went to Mexico and we were starting a system of public sector project evaluation in Mexico and the – there were studies being done of the economic rate of return to capital to work up the relevant discount rate, and we measured this private sector rate of return for Mexico from 1970 up to about the year 2000 and by God there wasn't a single year in which that rate of return was not more than 20 percent. And it really kind of shook me up.

Now I have to tell you about how that rate of return is calculated. We build up a capital stock by taking the investment of each year and we add that to last year's capital stock and then we allow for the depreciation; a rolling system where you go adding investment, and you have to start somewhere and there are certain tricks that I won't go into here, but that enable us to get a reasonable estimate of a starting capital stock. But if that's far in the past it hardly matters because by the time you get up to the present that starting capital stock will have been mostly depreciated and you will be really working with pretty solid numbers. And then we have the actual returns that accrue to capital and we take those actual returns of interest, profits, rents, etc. that come from the national accounts, but sometimes we have to work with kind of judgment call. Why is that? Because the wages and salaries bill of an economy is not the total earnings of labor. You have the farmer who is the owner/operator. You have all the owner/operators in the kiosks and the stores. All these unincorporated enterprises whose income is partly due to labor and partly due to capital.

So some kind of an assumption has to be made about how that income is divided and you have to assign part to labor and part to capital. So that's one of the stories. Second piece of the story is that as you build up this stock of capital, you're taking the actual investments that appear in the national income accounts, what resources were devoted to investment. Well, you'll catch the leveling of land or the digging of an irrigation ditch, but you won't catch the land itself. So you have to deal with land either by making an estimate of the value of the land or the country or by sequestering the income from land and taking it out of the income side.

Well, what we do – we've learned by bitter experience, do not try to estimate the value of land. It's just too terrible. Work with the income from agriculture and the income from the housing sector and you take away that income so you have a rate of return that has the reproducible business capital stock in the denominator and the return to it in the numerator. I said business capital because we also take out housing when we do this kind of estimate because the people who own their houses aren't earning these 20 and 25 percent rates of return. We think we're generous in assigning something like a 6 percent real measured return to housing. That is to say what is measured in the GDP is 6 percent of the value of the house. If there's an appreciation going on, that's on top of what we measure in the GDP.

So we think we've got a pretty solid, pretty conservative way of measuring these rates of return, and in Mexico, as I said, from 70 on until we finished this work at the end of the 90s, we were getting 20 percent or more all the time. Well, what happens? I look at that rate of return. I look at the climate in Salvador. I look at the climate in Mexico. And then AID sends me one time to Haiti. And I look there and I just shudder. I said if people are getting 20 percent real return and more in Salvador and in Mexico, what would it take to induce a rational person to put money into this place? And I really think that the people who put money into Haiti, if they're rational, are doing so in the expectation of a 30 percent real return, not a 20.

And then I said well, gee, if capital as a whole is getting 30 percent real return, what indeed is left for labor? And I was led by this circuitous route to an absolute conviction that aid to countries like Haiti and many others in the world have to be based on altruism, on charity, and not on human interact – human sentiment rather than on the expectation that these are gonna be very productive, we are going to really reform this place, and all of that. Yes, we hope reform will happen. Yes, we hope transformation will happen, but if you think that's what you're buying with your aid, I think you're making a mistake and that one has to justify a more human grounds. So there we are. That was just the motivation of the title.

And now I want to talk a little bit more carefully about the role of the rate of return in economic growth and in our analysis. Those of you who are economists and have studied even an early course on economic growth, probably even in elementary economics these days, you'll find a breakdown of the growth where a piece of growth is attributed to the increments of labor, another piece of growth is attributed to increments of capital, and then you have another piece of growth that comes from what I call real cost reduction.

Total factor productivity increase. I hate that word. I talk to a businessman, I say how has your total factor productivity done in the last five years and he looks at me with glassy eyes. I say well, what about real cost reductions in your firm, and he says well, well, we had this and we had that and we had the other and this saved us so much money, this saved us so much other money, and why can't we use a language that people can understand and that is perfectly transmits the underlying idea that we're after instead of this sort of gobbledygook kind of stuff that only people with courses in economics know what's going on.

Well, as we take this breakdown of growth into these three pieces, the capital contribution is usually measured by the share of capital in GDP times the rate of growth of the capital stock. Now that doesn't resonate particularly with anybody. Again, it turns out that identical mathematics can represent the same thing in the following much more interesting way. What fraction of your income do you save and what rate of return do you get on that fraction? So if I save 10 percent of my income and I get a 15 percent return, 15 percent of 10 is 1½ points. That's how much my income is gonna jump as a consequence of my having saved that and earned that return.

So the way I like to represent the capital contribution to growth is net investment, which is the relevant numerator, as a fraction of GDP multiplied by the real rate of return on that investment. And if we're talking about gross domestic product, that real rate of return is gross of depreciation just because GDP is gross of depreciation. So that's the way we to about thinking of the contribution of capital to growth. Now why is that so much more interesting than the share of capital times the rate of growth of the capital stock? It's because it focuses directly on the fraction of your GDP that is devoted to net investment, and on the rate of return. The old way of thinking the rate of return never appeared and I think the rate of return is incredibly important.

There are institutionalities, there are policies in the situation where a lot of money gets dumped into areas of low rates of return, zero rates of return, even negative rates of return and to sort of have an analysis that somehow leaves these rates of return out of the picture is, I think, a tragedy. That people will think more clearly about economic growth, will understand the process much better if we think of it as a fraction of income invested times a real rate of return. Now I'm gonna come over here and draw a very simple picture, which even contains a triangle. It's not the real triangle, but anyway **** keep **** happy. We're gonna put here capital and here the marginal product of capital and the idea is that as you add more to the capital stock, the incremental gain you make goes down.

So what is the equilibrium of the economy if you have real rate of return here then this is earnings of capital and up here, this part of the product that doesn't go to capital goes to labor. So that is a picture that I hope, Dennis, is straightforward enough that it doesn't give you any problems. Now what happens in a country that has bad policies? That has insecure property rights, probabilities of expropriation, distortions of the price system so that you don't know if your inputs are arbitrarily going to be too cheap or too expensive or your outputs be forced down by price controls to too low a price. You have all of that uncertainty and what's gonna happen? You're gonna be less likely to invest. What's gonna happen is this capital stock instead of being out here, is going to be here. Now look at what goes to labor. And when you get the cases like Allende's Chile or Alan Garcia No. 1's Peru or Daniel Ortega No. 1's Nicaragua, you're gonna get even less of a capital stock and the wage return – the labor force pretty much stays constant.

It's mitigated by out migration of people, but the rate of such out migration is never big enough to make a hell of a lot of difference in the story that you're really – the absence of capital is one of the biggest provable reasons why those countries that have very low real wages – why those wages are low. And the impact of policy in generating in a country a big capital stock, a middle-sized capital stock, or a small capital stock for its labor force, those policies are precisely the ones that kind of dictate what's left for labor. It's so to speak the what's left for labor story is a question that is not answered by looking at labor. It is answered by looking at the incentives to capital. And when you have more capital, you might think that oh, gee, that means more going to capital and less to labor, but it doesn't work that way as our little picture shows. That the more capital there is combining with a given labor force, the higher will be the average real wage of that labor force.

Okay. Now these very high rates of return that we see in some developing countries come because the international capital market is not totally connected and integrated with the country. It takes a great deal to bring about a total integration, but what we do see in many countries is that if they start out with a high rate of return and if their policies are halfway decent, capital does flow in from the rest of the world and if they're having good economic growth, their capital stock is enhanced by the savings of their own people, and as a consequence there is a drifting down of this rate of return. That is all –drifting down connected with there being a bigger capital stock, and obviously, if you like, the perceptions of risk have to be squeezed in order to generate that. You have to have a better policy environment, a better expectations environment.

Perceptions of risk are a tremendous mess. I know people, personal friends, who have – who emigrated from Mexico prior to the recent election because they didn't want to be around when Lopez Obrador won and so they're somewhere else than in Mexico because of that I feel utterly confident that people who were thinking about investing in Mexico prior to that last election were saying eh, we don't know what's gonna happen there. We're going to be careful. How does that carefulness work out? They want a high rate of return and a quick payback of their investment. What does that mean? They're leaving off the list of interesting investments; those with a 15, 20, 30-year life or those without this very high rate of return, but with rates of return that are perfectly acceptable in most parts of the world. They're just squeezed out of that.

It isn't even by bad policies. It's just by this expectation of what might happen if. And we have that in all kinds of places. We have it in El Salvador with the FMLN sitting in the sidelines and waiting to jump in. We had it in Nicaragua with the Sandinistas and to a degree with Ortega again in power. It is still there as a deterrent to people who want to invest and to overcome this kind of uncertainty is not sufficient that the government will come in and say well, you know, we did bad things in the past or we said bad things in the past, but we're not gonna say or do those things any more. Everything's going to be different. People are not going to react quickly to that kind of statement. What they're gonna react to are actions of government and their own experience as time goes on.

So you have to realize that if you start from one of these places with bad expectations, it's gonna be a while before all of that gets turned around, and the rates of return are gonna go down gradually and the capital stock as a multiple of GDP is going to go up only gradually, etc., etc. Now what we have on the good side of the story – well, I am just enormously pleased with the evolution that has happened in Chile. My students were involved in making some of the early reforms in Chile and I'm very proud of them, but I say there Chile has really had at least two miracles.

One was the economic miracle where in a period where – we used to call it cepalismo – was dominant where import substitution, protectionism, price controls, market interferences, all of those things – approvals for everything you – and a business wanted to do needed approval from some bureaucrats before it could be done. That changed a great deal in Chile and proved to generate 5, 6, 7 percent growth over a very substantial period of time. But the other miracle is the political miracle. The military government was succeeded by what is now four different presidents under what they call the Concertacion; a coalition of anti-military partners.

And so this coalition gets into power and what does it do. Does it tear down the structure of economic policy, etc., that the – that had been in place and that was performing quite well? Not at all. Just the opposite in fact. Patricio Aylwin was the first Concertacion president and I'll never forget something I saw on TV. He was in campaign for the presidency, and he was making a speech on TV, and after the speech, he had a panel of newspaper reporters who were asking him a bunch of questions. And so one reporter said well, surely when you get to be president you're not gonna keep the value-added tax on food items and on newspapers and periodicals and books and things like that. You're not gonna be such a cretin as all that. And Aylwin in the middle of the campaign said look, my experts tell me this value-added tax is one of the best technical taxes in the world and that the right way to have an administer of value-added tax is to have a broad-based and a uniform rate, and when I get to be president that's what we're gonna have. We're not gonna fall prey to the kind of arguments that you, sir, are presenting. And to do that in the middle of a presidential campaign, I say, takes a lot of honesty as well as a lot of guts, and I was so pleased to see that happen.

Well, in these four successive presidencies of Chile, as you know, under the Concertacion, not only was the general structure that they inherited from the military government maintained, it was actually more improved than chipped away; that there were a few places where there a few – couple a chips, but the overall picture was further privatization, further deregulation. Aylwin inherited a uniform tariff of 15 percent. It got down to 6 percent within a relatively short period of time under the Concertacion, and if I'm not mistaken, it's now 5 percent, but the average tariff collected in Chile is much less than 5 percent because they got a ton of free trade agreements with lots of countries so that the average tariff is much less than the legal uniform rate.

So I think that this idea of left wing parties embracing good economics is one of the greatest things that has happened economically in the entire world over the last 20 or 30 years. It's starting the Felipe Gonzalez in Spain, with Bob Hawke in Australia, with Mr. Lange in New Zealand, with Mr. Blair, with the Chileans. Now, of course, we have Mr. Lula in Brazil, Mr. Menem came in on a sort of a populist campaign, but by God he – his chief economics minister, Domingo Cavallo, bragged to be at one time. He said, Alito, we've done all or nearly all of the Chilean reforms, but in half the time. Now that was approximately true in Argentina. They didn't – not quite as deep, but one of the great mysteries that economists are struggling with these days is how does it happen that Mr. Kirchner, whose economic rhetoric and whatnot are not the greatest. How has he managed to provide Argentina with a growth rate that is astounding lots of people?

Well, I say one of the contributing factors to that is that he inherited from the 1990s a package of economic policies that was infinitely better than what the 90s governments inherited from the 1980s, and it was indeed a pretty – very good package of economic policies. Another thing that contributed to this Argentine advance is that the latter 90 from the 94 onward, there was no doubt that the economics – the real exchange rate wanted to depreciate, but they had a dollarization practically economy and the way that the depreciation was trying to take place was through deflating prices and wages, and prices and wages didn't want to go down fast enough so they had a 15 percent unemployment throughout that remaining – the last half of the 1990s before the crisis took place and I draw the analogy of that with Great Britain in the 1920s when they tried to restore – when they went back to the gold standard at a very excessively appreciated old parody.

You don't see many cases of that – such a protracted suffering under a fixed exchange rate situation, but that's because most countries end of up devaluing before it happens, and here were two cases where they didn't devalue and really the chronic disease played out. Well that was just – sort of obiter dictum on how Kirchner is with – when they had the crisis in Argentina then they did have a big devaluation and this really sort of allowed the economic forces that were trying to work all this time allowed them to have their scope and really work and that is the second big reason why they're having this prosperity, and the third is the high prices of their principal export products. So none of my three reasons involves any kudos for Mr. Kirchner's policies, but it helps us to understand who the Argentine situation got to be what it got to be.

So anyway, what's the story? We ought to think more about the real rate of return. We ought to think about the real rate of return to private investment and about policies that allow private sector investors to search out and invest in those opportunities that have really high rates of return. On the side of public policy, we have one of the great challenges for the 21st Century, which is to do for the public expenditure side the sort of thing that we did quite well in the last 30, 40 years on the tax side. Tax systems around the world are technically much sounder, much better, much less distortionary than they were 20, 30, 40 years ago and I think the economics profession has a lot of claim – can claim a lot of responsibility for that.

Well, we're not nearly so – in such good circumstance with respect to public investment and we all know of public investments that have zero real return, negative real return, very low real return. If public investment can be brought to have a 10 percent real return instead of a 2 percent real return, that will actually be a permanent contribution to the growth rate of a country, but we have to work on that. And the political barriers in the way of sound cost-benefit analysis are simply there. You've all heard in the United States about Senator Stevens' bridge to nowhere in Alaska where he wanted to build this bridge that was gonna have a trivial amount of traffic.

Well, actually, to prove that Ricardo Lagos was indeed human, he also made a mistake in advocating and pumping real hard for a bridge between the continent of South America and the Island of Chiloe, which is just like Stevens' bridge to nowhere, and nothing could stand in the way and it was really in the hopper and ready to be done and stuff like that when President Bachelet came in and I can say in another piece of praise for the Chilean system, one of the early things that the Bachelet government did, was X out that bridge to Chiloe, and I think again another victory for sound economics. Well, I don't know if I've used up my time or not, but in any case, I take it we're going to have a conversation from here on in. So let me turn the platform over to whoever comes next.

Dennis de Tray: Well, thanks very much for an as always extraordinarily stimulating presentation that ranged over an enormous set of issues from some fundamental and basic economics to some wonderful anecdotes about the successes and failures of the continent that you know so well. So it is really a delight to listen.

The next part of our presentation today, we are extremely fortunate to have two exceptionally well suited commentators on Al's presentation. Let me introduce them both and then I will ask them to speak briefly. Peter Hakim is the president of the Inter American Dialogue here in Washington. Peter is – any of you who actually follow American issues is one the principal spokes people for issues of north/south relations, of Latin American U.S. relations and frequently cited, frequently published, and a – a leading proponent of good relationships between these two important parts of the world. And Peter, we are delighted that you could find time to be here today.

Our second discussant did not have far to travel. He is here at the Peterson Institute. John Williamson is someone I have known for a great many years and have an enormous amount of respect for. He has an eminent career that is not unlike Al Harberger's. He has been associated with many of the great universities in the world. He has been active in Latin America since the golden era of populism and – and ****. He is associated with the famous Washington consensus, much maligned, and I think often mistakenly misaligned discussion and – and a wonderful and insightful student of – of development. So we are delighted to have you, John.

Next Speaker: Thank you.

Dennis de Tray: I am just going to go in alphabetical order so Peter, I will allow you to go first, and then John, and then we will have a conversation.

Peter Hakim: First, I want to make sure everyone understands that I am not an economist; that I studied physics and mathematics and then I studied some sort of incoherent program called public affairs during which I was largely bored by courses in economics and let me say that I did learn economics. It is hard not to learn it when you live in Latin America, and 40 years Dennis by the way. It was 40 years ago that I arrived in Latin America. You were off by only a month. It was in July that I first went to live in Brazil. And, you know, one of the things I have learned that – that it is hard to disagree with Al Harberger's statement that good policy is important.

I have sort of watched countries over time and, you know, his relationship between capital coming in and policy – good policy which is the relationship you first stated, I think is right. I think his modification thereafter was even more right that it has to do with more than good policy. It is perceptions of stability, good policy, perceptions of risk so it goes beyond that. But good policy plays a role and the question that I guess is addressed is where does good policy come from? Why does a country like Chile have good policy and so many neighboring countries have bad policies? Why if good policy produces such good results, why aren't other countries imitating Chile?

And those are some questions that I – and it has to do with, I think – or one big thing, and I just want to give an anecdote and I think it is important is trust and I just recall I was in El – no, it was in Guatemala and we had a meeting on the Central American Free Trade Agreement which brought together legislators, labor union leaders, business leaders, legislators from the U.S. and from the country. At the end of the meeting, you know, there were lots of disagreements. We had both Republicans and Democrats there so you could imagine. And the vice president of Guatemala, Eduardo Stein, gave absolutely the best defense I had ever heard of the Central American Free Trade Agreement. In fact, free trade generally, and I won't go into it because I won't be as persuasive as he was, as elegant as he was, but basically he said this was a path to the future and as a senior official of Guatemala, he couldn't keep Guatemala out of this future.

In other words, there was just no other path on which he – and then we had a period of questions and answers which was quite lively. He stayed for quite a while, and then the last person to raise their hand was a labor union leader from El Salvador who said you know, Mr. Vice President, I want to congratulate you on that speech. You have convinced me. If I believe what you said was right, was true, was going to happen, I would be out there protesting in favor of a free trade agreement, a good policy. And he says, you know, but I don't trust you. I don't trust it when I am told that this is going to bring these kinds of benefits because we have been told before that we don't and we have never seen the benefits. They always seem to disappear into that triangle – the Bermuda Triangle of benefits, and we never see those benefits so why should we believe this kind of massive change which is going to be disruptive, is going to produce them this time. And until you can get over that trust, it is going to be very hard.

I mean, the Chileans, we are not going to see any more **** sort of introducing good policies any more. And one could also raise the question about when the Chilean miracle started. I think I would probably start it a little bit later than you might have but in any event, the point is how you build up that trust. The people are ready to accept important changes and believe they are going to benefit from them and I think that is one of the biggest obstacles to good policy is this – this lack of confidence and trust.

Dennis de Tray: Peter, thank you very much. John?

John Williamson: Well, it is a great privilege to be here and to have this opportunity to comment on what Al Harberger said. I want to address the – the big issue that he proposed to us, the question of whether the high rate of profit in Latin America doesn't curtail the opportunities for growth and other incomes and of course the answer is that it does and it is doing. That is one reason that Latin American income distribution is so skewed. It is well known to be the most concentrated in the world with the possible exception of one or two **** in African countries, but comparing the major regions, there is no question about it, it is skewed. And I think this is one important contributory factor. What can one do about it?

Let me first say that I think this is now emerging as the issue in Latin America. For a long time, it was the region's propensity for macro economic crisis, but one had to worry about first and foremost, that was the reason for the last half decade and that was the reason for the last decade, and it was right to worry about that. But it seems to me the policy has been revolutionized in that respect despite the fact that there are several countries which are not pursuing Harbergerian policies like now. If one looks at the regional averages, they really are quite transformed from a decade ago. The rate of inflation is well and securely in single digits. It is predicted to be 5. something percent this year. Physical balances are mostly the deficit, overall deficits not primary deficits which don't exist because most countries have a primary surplus at the moment, but the total deficits are under 2 percent each year. The calendar count is in surplus. Reserves – the reserves to import ratio is 46 percent. The rule of thumb is that you should have 25 percent or more. Debt export ratios are down to under 100 percent. The **** was construction on the assumption that it should not go above 150 or 200 percent and here we have a group of countries which used to have debt export ratios of 500 or 600 percent which are down below 100 percent.

The debt composition is much more concentrated and domestic balance is much less in dollars than it used to be and so a whole series of dimensions in which it seems to me that to continue worrying about a regional macro economic crisis in Latin America is just wrong. That is not the problem. Al has put his finger on what is the problem and the problem is in income distribution primarily. Now what does one do about that?

Well, traditionally it is the fiscal system. One looks first and foremost at the fiscal system if one is a government that is trying to fix an income distribution. I – I have to say that I fear that there is not a lot that can be done as long as we continue to have a world system in which one can essentially evade taxes by putting one's money abroad and that is the position in Latin America right now and I think it – **** phenomenon. It's not that one wants to blame the rich people who do put their money abroad, it is that they don't pay taxes to their own government when they do it. Some countries have a law which says they should and ha ha, it is essentially a voluntary law. You can pay taxes if you want to, but nobody knows if you don't when you send in your tax form, right? And so there is no incentive. There is no – it's not obligatory, to tell the truth and many people don't. So I think that is something which one has to fix if one wants to make a major contribution through a fiscal system.

I think there was some modest things that could be done that certainly includes improving the pattern of government expenditure through cross benefit analysis. I am not myself convinced that it doesn't also involve – that one couldn't get a certain amount of mileage out of changing the value added tax by exempting some of those categories that Al Harberger said he had so admired the professor **** for resisting the attempt to exempt them. If one exempts food, that does have a progressive impact. Can one police that? It seems to me that it is not beyond the wit of man to have an adequate policing mechanism. So on that maybe we have a disagreement. If one wants to move to reduce profits, how does one go about it?

Well there are alternative ways. One could control prices. We have an example of that in Argentina and it is producing exactly the results that one would expect. There are shortages of some of the goods whose prices are controlled like energy products right now. The alternative is, first of all, as far as tradable goods are concerned, there is actually a very simple way to police. It matter to have a policy free trade or very low tariffs and that does seem to me a sensible policy. It is one I am afraid I don't think it is going to go make great advances in Latin America in the near future. I am not quite sure that bilateral free traders have the same impact as general – general free trade would in this respect.

The – the alternative is to try and reduce the rate of profit without discouraging capital in flow, the **** in the economy. That really involves two approaches; one is to improve the skill level of the population so that even if there are other incentives to invest in the country besides the fact that – or there are incentives to invest in other types of industries besides capital intensive industries where one is relatively unimportant, how trained the people are.

The alternative – the other incentive is to increase the probability of non–expropriation and in that way to increase – to reconcile the incentive to invest with a lower expected rate of return. I think that is quite important and I do think that a number of the countries in Latin America have made important moves in that direction. I think that one is likely to see the benefit of that in countries like Brazil in the future and that is one important policy which could contribute to resolving this dilemma without ****.

Dennis de Tray: John, thank you very much, and again, thanks to both of our discussants. I want to ask Al to respond, but I would like to try to add my own twist. But following on for both of those comments and I hope these are consistent. Peter rightly raised the issue of trust. I would put it slightly differently but it's – it is a dubious trust and the question I would like Al to think about and the panelists more generally is if you have a balance between good policies and predictable policies that aren't so good, which is more important?

I was, as many of you know, the country director for Indonesia for many years with World Bank and one of the things that struck me there was that they had okay policies and really not bad, but the real feature of Indonesia was the consistency, was the predictability, and that is because it was run by a dictator – a dictator who had the good sense to listen to a good economics team. So – and it gets – so part of the question is what does the role of predictability play in attracting investment?

My sense of the private sector is if you give them predictable rules, they will find a way around any bad parts and they will bring capital in if there is returns to be earned so predictability versus good policies in this equation. Then following up on John's point, I mean, I think he has really captured what I think is the essence of the global debate, the going on about globalization, about Latin America, about all of these things and that is the distributional impacts and what you do about them and it's –and I had a bit of a conversation on this before this presentation, and it's – in some fundamental sense, if you look – if you look at East Asia and you look at Latin America, you are still left with questions as to why this triangle has apparently shrunk in Latin America but it didn't shrink in Asia.

They both, I mean, there is the issue of capital in flows to some extent, but at least for the last 20 years, my perhaps incorrect sense is that it is not that much difference in the broad policy framework, that both of them really follow modestly macro economic policies, had fairly stable and predictable regimes and so forth and yet in one case, it might take away from Indonesia and from East Asia more generally is that they did quite well during the boom periods and in Latin America they at least were dissatisfied with what they do and that is part of what is undermining the current or the **** consensus on direction. So Al, can you help us understand these two sets of issues?

Al Harberger: Okay. Well let me do my best here. Responding to Peter, I would say and I think John mentioned this in his presentation that many Latin American countries have imitated Chilean policy to a considerable extent and whether it is the PACS system, Social Security, central bank reform, grade liberalization, control of inflation, all of that has been pretty wide spread and many of the Chileans I know have made whole careers of going around helping other Latin American countries do their best to try to imitate some of the reforms that Chileans have done.

Now there is no other Latin American country where the reforms are as deep, as well implanted, and I want to mention the great importance of having a really top class economics profession in this. I believe that **** have better economics than the New York Times, Washington Post or Los Angeles Times, not better than the economists. The economists are the champion of good economics as far as I am concerned in the periodical press, but those guys have been writing good editorials and good stories about economics to the whole literate public of Chile for something like 40 years and they have had courses in economics that are better than what you get at a lot of universities in the United States today in terms of understanding the link between economic science and reality at – at the very least.

So anyway, I think that – I certainly agree with Peter in terms of the issues surrounding confidence and trust. That – that we – that is the name of the game and progress is halting and slow and hard to predict, but that is the story. The fact that labor doesn't see benefits as something, a lot of the time, it is a question of understanding. It's – it's amazing how the auto workers in the United States have modified positions that they historically had which if they – if they had persisted in, then that damn industry just wouldn't make sense today. There are still problems but certainly they have recognized a lot and they have economists understand some of these real issues.

And John's comments, I want to start out seeding a point. Value added tax on food. I agree. Exempt tortillas, rice, beans, tripe. I am all for that, but none of this exempt food business. That is just out of this world. I mean, the great bulk of the tax that is received on food comes from middle and upper class people in every country in the world and the idea that you are doing the world a favor, a distributional favor by exempting food in general, I would say absolutely not. So there is that part.

Now the issue of income distribution and what to do about it. Somehow in – it is interesting in that as I was making my presentation, I wasn't thinking about income distribution in a broad sense. I was thinking just about the equilibrium, wage of labor, and how it is modified by doing things with respect to capital. It is tough in economics. You know, the dismal science was linked to Malthusian thinking for so long, but I think we are dismal in another sense. The good thing is that it is a creative destruction, is a modern dismal science story. The things do get destroyed when people get creative and when we progress and if we try to preserve what is being destroyed, we impede or eliminate the progress itself. That is, I think the cross that we have to bear in almost all of the areas we deal with so that as we are trying to help labor, we say be kind to capital and that doesn't resonate politically.

People have to understand more how that all works and it – I don't know – I don't know that I have – better than that to say when you reduce the rate of profit as – as John was talking about it, you don't go about it by kind of focusing on the rate of profit. It is a think you do. You actually create it neutral incentives that attract people pursuing profitability and the more of them that come in, the more labor is helped. One of my fields is in corporation income tax and it is fascinating to note that when I wrote my first article on that subject, that it was for a closed economy situation and it turned out that capital was the likely bearer of most of the burden and could actually bear more than the full burden of the tax or less than the full burden but it floated around there and it wasn't that capital bearing the full burden was an extreme situation.

When I came around to analyzing the open economy, it turns out that the good argument could be made that labor bears more than the full burden of the corporation in income tax and it is precisely if a country all by itself raises its corporation income tax, it is going to chase the capital abroad and it is going to do exactly what that little triangle did, but if all the world changes the corporation income tax, then capital is the likely bearer of the burden or beneficiary of a reduction which we have had by the way. Over recent time worldwide, rates of taxation of capital have dropped from 50 percent and over to something floating around 30 percent and this has been in every major country in the world and there, the closed economy model still applies.

Dennis' issue of good versus predictable policies, boy that is a tough one in the sense that, you know, you don't want to hang too tight with predictability because then you end up setting in stone a bunch of bad policies. At the same time, if you have a great deal of uncertainty, that screws up the works from another point of view and I don't have any – deep philosophy to answer that dilemma; however, now comes the other triangle economics into the picture. One of the interesting things about distortions in economics and the corresponding triangles is that the cost of a distortion varies with the square of its extent. So a triangle that has a height of 10 percent and a base of 10 percent, let's say, is .01 x 1/2. If you – if it becomes 20 and 20, it is .04; it becomes 30 and 30, it is .09 x 1/2 so the idea of judging a government by its kind of batting average is recognizing that everybody commits sins from our idealistic technical points of view, but there are very big sins and little size sins and little sins and a bunch of little sins is a lot better than even one huge one. So kind of be a bit tolerant of small deviations from ideals, but try to be very firm about getting rid of major distortion. I think that is a very good practical rule to follow.

Dennis de Tray: I actually think that is a very description of why many East Asian countries did well and why many others – because they did focus on, in my hindsight judgment on this, on the right things and in some ways. And in other ways, the way other things go, the rest of the world thought were important, they were not important in terms of the in flow of ****.

You have all been very patient. I am going to now ask for questions and comments from the floor before we run out of time. Heather has a microphone and you are just going to have to – any – why don't we start at the front here and then move back slowly. Front and then go to the back and then come forward just to try to be egalitarian about it.

Next Speaker: David Tar from the World Bank. Uh, both Al and John mentioned property rights and investment climate were crucial, and John mentioned that several countries have been making – in Latin America have been making considerable progress in this and that you would expect to see some benefits, could you elaborate a bit on those issues?

Dennis de Tray: Let's take maybe three questions and then go forward. The gentleman that just stood up, I think had his hand up. Sir, do you want to – did you have a question?

Next Speaker: Oh, my name is Courtney Blackman. I am former governor to Central Bank of Barbados and former Ambassador for Barbados to the United States. He spoke of fiscal policy. I noticed in his anecdote he used the **** but he didn't use the collapsing bridge. The point that I want to make is that just as bridges to nowhere are – are harmful, collapsing bridges are harmful and so fiscal policy is not so bad in this country, one begins to wonder. You applaud presumably economists for these wonderful policies that we have now in this country. I don't think there is anything to applaud about it when it comes to fiscal policy. Do you really believe that it was severe tax cuts that have thrown this economy out of kilter or represent good policy? I don't think so.

And – and one comment, you know, what I learned from your lecture is that a lot of these economics is nothing as important in developing countries as non–economic factors which economists insist is new. People like Sir Arthur Lewis and – and **** must have knew that but now they are being followed by the people who believe that the markets cause you to grow and I think that is one of the reasons why we still have less development in Chile. Thank you.

Dennis de Tray: I will take one more question. This gentleman right here who – yes, you sir.

Next Speaker: Uh, my name is Ron Boble. I am formerly with ****. I am now a consultant. My question is with regard to the bilateral free trade agreements with Central America and the United States. My concern is with Central American farmers, especially of those with corn, soy beans, and rice. I think there is evidence in Mexico that the corn farmers are being severely hurt there because of U.S. exports which are caused partially by U.S. subsidies. I just would like your comment on that.

Dennis de Tray: Okay. I am going to stop there and let Al respond to those questions and then we'll take another round.

Al Harberger: Oh yeah. I'm – I'm – property rights I think that the efforts that are underway in lots of countries to regularize property rights and make them more firm are extremely positive and that they add – they – they form a part of the skeleton of major reform. But I am going to take this opportunity to say that I don't think there is hardly any reforms that we ever talk about that impact in the long term the rate of growth. The reforms that we talk about impact the level of the GDP so that you can expect that because you regularize property rights you are going to have a 1 or 2 percent greater growth rate over the next 20 years or forever.

If that were the case, the rate of return, the real rate of return on that reform would be astronomic and it – and the simple fact is it is just not true. The property rights are one element. They will add a bit to the growth rate of the economy for a period. They will add to a level of efficiency of the economy forever and let's just accept this type of truth and not be starry eyed about the things that a given type of reform is going to produce. In order to impact both – take efforts – new efforts every period and most of the new efforts are taken or not by the policy makers, they are by the people who do the investing, the people who find new techniques and cheaper ways of doing things, that is where the growth really takes place and policy impacts growth only in the way that it helps them make better choices in their decision making.

Now with respect to the Ambassador's comments, first of all, I love to point out American sugar policy which I think is a wonderful story. It is one of the worst distortions we have in the economy. The costs, according to B. Gale Johnson, to the American consumer are something like $1 billion a year and it is very interesting what our story has been. You see, if we are going to have this kind of protective sugar policy, and we are really interested in American interests, we would do this by a tariff and we would drive down the world price of sugar tremendously, but we don't do that. We don't have a tariff. We are favoring our sugar producers and then we feel guilty about it and we want to have imports too and we have friends who are sugar producers so we let them share in this bonanza that we are handing to our own sugar producers and we hand out these quotas that they can come in too, right?

And I think that – that mixture of perfectionism and guilt is kind of fascinating and – and – but I think – so it – does the United States have the ideal world economic policy? Absolutely not. Do we have a complicated political system? Yes we do. Do I expect others are going to do greatly better than the United States? No, but I think that we do avoid the biggest distortion and we have proved capable of having continuing economic growth over a long, long period of time, and the reason for that is the reliance on the forces of the market and on the fact that the growth really takes place right there on the factory floor and in the decision making that goes on in the boards of directors, the investments and other decisions that are taking place.

So that's that part of the story. On the issue with respect to the bilateral agreements with Central America, I think the corn issue is being solved by ethanol. What happens is that the price of corn in Mexico is higher than ever as a consequence of the world price of corn going up so much which, in turn, has been propelled by the commodity price boom generally and within that commodity price boom, a special boost to corn on account of ethanol.

John Williamson: I just want to make one comment about David Tarr's question. When I, I try not confuse Latin America with Brazil, but I do know Brazil the best, as it happens, it is 40 percent of the total. I was specifically thinking of Lula's election. One reason the return to capital used to be high in Brazil without provoking an investment boom was exactly that people thought there was a left-wing bogeyman waiting to expropriate them in the wings. Well it turned out this left-wing bogeyman was elected president and he was actually a very friendly fellow. He turned out not to be a left-wing bogeyman at all. I think that's going to extremely good for investment in Brazil in the longer term.

Dennis de Tray: Peter.

Peter Hakim: Yeah, I just wondered one question that I have for Al, if I can ask, answer a final question. Is, how you, or how the public, not the University of Chicago, distinguishes between good economists and bad economists. Good economic advice and bad. I was asked recently to comment on a project at the World Bank that was looking at trade and poverty, what were the impacts of it? And I actually took it seriously. I sometimes don't, but this one I did, and I sort of read three or four books from Joe Stiglitz to Bill Cline, who I saw here before, and not only they didn't really engage one another, but they had very different outcomes, very different conclusions. And indeed, one book, Jeffrey Sachs, 450 page book on how to deal with poverty, mentions trade in one paragraph. So the question is, I mean these are all very prominent economists. They teach at the best universities. They advise our leaders. How do we choose among them?

Al Harberger: Whoa. Well most of them would say, "Choose me."

Next Speaker: Should we have licensing?

Al Harberger: Well it's very interesting and I think, first of all, we have to recognize that this international community, I would say led by the fund and the bank and other international financial institutions, USAID and other aid-giving organizations, I think, has been a vehicle by which some watered-down version of the Washington consensus has been pushed and gotten to be implemented in many places around the world, and I think that is a wonderful story and it represents our profession of economics as a bunch of professionals that, in the highest academic level, there is a kind of a competition and people are trying to differentiate their products in the quest for fame and goodness knows what all, and somehow, the utter three-legged stool of solid economic principles doesn't get the weight that it should get.

I have long, long, long believed in a profession of economics and then trying to bring up students so that they are good professionals and not necessarily great innovators of new ideas, but who know what the 200-year-long history of our ancestors in economics, what that teaches us and tells us. I think this bunch of entities that I talked about just now has done a pretty good job of encapsulating and transmitting those absolute fundamental lessons and yes, there are plenty of more reforms to do. Yes, they have made some mistakes in the process, but I think the world is a hell of a lot better for all of this effort than it would have been without it.

Dennis de Tray: Yeah, that's such a wonderful concluding remark, that I think, plus we're out of time, so Peter, the short answer to your question is call Al.

Peter Hakim: Do you have your cell available?

Al Harberger: I don't have a cell, I know better.

Dennis de Tray: To our panelists and to Al--thank them for an exceptionally good set of conversations and questions. To all you, thank you very much for coming and we look forward to seeing you next time. Thank you.

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