neither pays taxes nor borrows. Since the size of the underground economy depends upon both inherent and external variables, such as tax rates and interest rates, the model also is able to gauge the impact of policy changes.

Policy implications and options

To simulate policy options and how firms might respond, the study uses stylized data for Pakistan, a country that has faced severe problems from tax evasion and has had parallel markets for both goods and financial assets. In these circumstances—especially given the country's difficulties with its budget deficit—economic reform is likely to rely on efforts to reduce the various forms of tax evasion.

A policy simulation that incorporates actual tax rates shows that entry into the underground economy can have a cyclical nature and be sensitive to the rate of return on investment changes. A rise in the corporate tax rate, as a possible anti-budget deficit policy, produces a counterproductive result. A large amount of production flees to the underground economy, thereby lowering the tax base and actually increasing the deficit. Aggregate investment in the economy and, hence, growth, is lowered due to greater credit rationing by the banking system. These findings suggest that even moderate tax increases can lead to entry into the underground economy and to credit rationing, which would have a significant recessionary impact on the economy.

A second policy experiment considers a reduction in the corporate tax rate. This policy does, indeed, eliminate underground activity and lowers credit rationing, but the rate of capital formation does not exhibit a significant increase. This is due to the fact that the budget deficit increases substantially, leading to a crowding out of private investment by public borrowing. The corresponding rapid rise in the interest rate tends to outweigh the beneficial impact on investment of lower taxes. At the same time, the economy exhibits high rates of inflation and a loss of foreign reserves. What this means, the study concludes, is that the low tax regime is not sustainable over the long run, due to increases in the budget and trade deficits, even though it eliminates the underground economy and reduces credit rationing.

Where does that leave policymakers? In the absence of any flexibility to adjust expenditures, it is possible that an economy may have to accept some underground activity—that is, a degree of tax evasion—as part of an otherwise acceptable tax program. ■

Era Dabla-Norris
IMF Institute

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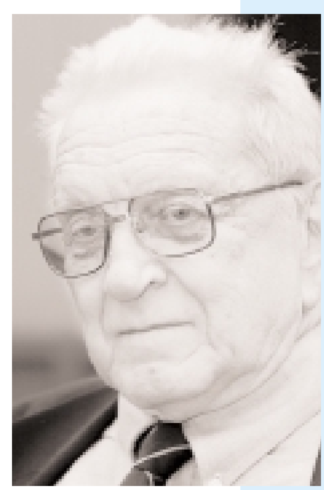
Copies of IMF Working Paper No. 03/23, "An Analysis of the Underground Economy and Its Macroeconomic Consequences," by Era Dabla-Norris and Andrew Feltenstein, are available for $15.00 each from IMF Publication Services. See page 207 for ordering details. The full text of the Working Paper is also available on the IMF's website (www.imf.org).

Interview with Arnold Harberger

Sound policies can free up natural forces of growth

The Wall Street Journal *once called Arnold Harberger the "godfather of free market economics in Latin America." How did a boy from Irvington, New Jersey, assume this role? According to Harberger, it started with high-school Latin. When the time came to pick a foreign language, he chose Spanish, thinking it would save him the most work. "My later interest in Latin America arose partly from my knowledge of Spanish. Everything else followed." What followed was a lifelong involvement in providing policy advice to Latin America, directly and through his numerous students. Currently a professor at UCLA, Harberger spent nearly 40 years at the University of Chicago making path-breaking research contributions in the fields of public finance, cost-benefit analysis, and international economics. Prakash Loungani speaks with Harberger about that long and illustrious career.*

LOUNGANI: Are you worried about the future of free market economics in Latin America?



HARBERGER: No. Some people interpret recent events as anti-neoliberal or anti-Washington Consensus, but these are hiccups in the broad move from import substitution toward more liberal, market-oriented policies. Of course, countries have done so at different times, to differing degrees, and not always in a smooth manner.

Take Brazil. The Brazilian miracle of the 1970s was a story of liberalization. The seeds were sown in 1964 when Roberto Campos was the key minister. He was followed by Antonio Delfim Neto, another liberalizing minister. If you look at everything that was happening—the opening of the internal capital market, the wide-

Harberger: "One big micro lesson for governments is to eliminate lying prices."

spread use of monetary instruments, and so on—it was very much a story of freeing up the economy. Trade barriers were lowered too, though progress was uneven. After a few years of transition, Brazil had clear sailing for a decade with liberal policies and good growth.

LOUNGANI: How do you assess Brazil's prospects now?

HARBERGER: From what I understand and have read, Mr. Lula has handled his presidency very well so far. He has certainly belied the worst fears that were being expressed before he took office. He could be on a track for which we have precedents from the region. After all, [Chilean President] Ricardo Lagos is a socialist and yet one of the most liberalizing presidents we've had in Latin America in the past couple of decades.

LOUNGANI: You've had a long association with Chile.

HARBERGER: Yes, I first went there in 1955. At the time, I sent a letter to my colleagues noting my shock at the distortions they had in place—tariffs as high as 200 or 300 percent; price controls; a system of all kinds of approvals by government agencies for almost any action by the private sector. It was a pretty distorted, old-fashioned, and authoritarian economy. The course of policies was up and down for the next 10–15 years.

Then there was the big blow from Allende. Distortions went beyond all bounds. Just one example says it all: at one point there were 13 different official exchange rates, ranging from 25 escudos to the dollar to 1,325 escudos to the dollar. It boggles the mind. There is nothing more homogeneous than a dollar. Each dollar, for every single purpose, is just as good as each other dollar. Why should there have been so many different prices?

LOUNGANI: Could we talk about Mexico's experience?

HARBERGER: Mexico went through a very interesting era from 1955 to 1970 or so. Rodrigo Gomez and Antonio Ortiz Mena formed a wonderful economic team that had IMF discipline written all over it, without the IMF being there. That they had successful growth shows a country can do pretty well getting macro policies in shape even when micro policies are messed up.

LOUNGANI: But then the macro policies also broke down, and they went through the debt crisis.

HARBERGER: Right, but starting in about 1989—the tequila crisis notwithstanding—they got the macro back in shape. The struggle to get the micro in shape is ongoing. Take, for example, land reforms. There's been progress, but even now Mexico doesn't really have an open market in agricultural land by any means. On the micro side, there are still major agendas to be dealt with.

LOUNGANI: Your views on the Argentine tragedy?

HARBERGER: The overriding issue in Argentina was the experience of three near-hyperinflations in less than 20 years. That left people completely distrustful of Argentine money. A fixed exchange rate was the only plausible way of giving people some degree of confidence where there had been none. They needed a special law because they had tried fixed exchange rates a number of times already in the past and had always violated them.

The convertibility law was thus the legacy of these prior episodes. The conditions in which the law came into effect were such that the real exchange rate was not a matter of choice—if they had made the exchange rate two pesos to a U.S. dollar, the price level would have been twice as high; if they had made it four to one, the price level would have been four times as high. So it was an inherited real exchange rate. This is unlike, say, Mexico, which at the time of their so-called pact started out with a big devaluation first to allow for a future drift toward appreciation in the real exchange rate. The Argentines had their hands tied.

LOUNGANI: But initially they did well.

HARBERGER: They were lucky in the early 1990s that the flow of capital into Argentina was sufficient to validate the real exchange rate they were saddled with. But even before the tequila crisis of

1994, that real exchange rate was looking not too good.

Evidence? Unemployment rates were already 13 percent before the Mexican crisis. That was always a sign that the real exchange rate was out of whack. Too many economists saw one problem—the fiscal deficit. But solving the fiscal problem would have made the unemployment problem worse. That is the demonstration that the real exchange rate problem was not being diagnosed; too many people zeroed in exclusively on the fiscal problem.

LOUNGANI: If the real exchange rate problem had been diagnosed, what could have been done about it?

HARBERGER: With the convertibility law in place, doing something about the real exchange rate problem was always difficult. I don't want to claim that I had an answer in advance. I did call attention to the real exchange rate disequilibrium all through this period, but I did not try to put into the mouths of the government people that they should devalue or anything like that.

In hindsight, when things were looking pretty good in 1997–98, Argentina could have opened up a band in which in the initial weeks and months the Argentine currency would have appreciated. That's the way to do it. If you are going to go flexible, you can get over the biggest hump if you can flex in that direction. In retrospect, that would have been the easiest way to have elided from the convertibility law into something more flexible.

LOUNGANI: Let's talk in more general terms now about the link between growth and economic policies. A natural place to start is your 1998 Presidential lecture to the American Economic Association.

HARBERGER: For the lecture I used the modern breakdown of the sources of growth—the increment in labor and improvements in its quality, the rate of investment in new capital and the productivity of capital, and real cost reductions.

Real cost reductions are the single element that most sharply distinguishes the big success stories from the big failures. Cost reductions occur in a thousand different ways: finding a more efficient way to run a taxi fleet is quite separate from a better way to bake a cake, and that's different from a cheaper way to make steel. Real cost reductions are not easily predictable. The industries or activities that experience reductions in one decade tend not to be the ones that experience it in the next decade, and so on.

LOUNGANI: How do we bring in the role of economic policies?

HARBERGER: When you say a policy helps growth, ideally you should be able to say what the link is between that policy and these different sources of growth. Certainly bad policies can screw up growth—we have plenty of evidence of that. Bad policies can stop investment from happening or make the return on investment low. But can you predictably make the rate of return on an investment jump to 20 percent by doing two or three things on the policy front? No. When you get right down to business, there aren't too many policies that we can say with certainty deeply and positively affect growth.

LOUNGANI: Given this unpredictability, what should the IMF's policy advice be?

HARBERGER: What policies can do is to free up the natural forces of growth and allow them to have their full effect. As we talked about in the case of Mexico and other countries, this means keeping macro policies in shape—fiscal and monetary restraint.

At the micro level, you want decision makers—that is, businesses and households—to perceive as closely as possible the true real cost of what they are producing and the true real price of selling it in the market. If you have an undistorted price structure, including wages and other factor prices, that will tend to be the case.

The more distortions you have, the more you have what my friend Ernesto Fontaine calls "prices that lie." Prices that are the products of 200 percent tariffs and 13 different official exchange rates are perfect examples of prices that lie. That's inimical to entrepreneurs being able to find proper ways to reduce costs. One big micro lesson for governments is to eliminate lying prices.

LOUNGANI: Do those of us who are in the business of giving policy advice—the IMF included—promise too much when we say "do these three things and your growth will be better"?

HARBERGER: It's more a case of the IMF sometimes becoming captive of the political game in the country. You'll see opposition parties saying: "In these recent parlous times, we're having only 4 percent growth. If we were in power, we'd have 7 percent." Opposition parties are forever blaming the government's policies for reductions in growth that stem from totally different causes.

Of course, if the government gets lucky and gets high growth, it, too, claims credit for its policies, even though they may have had little actual impact on the growth rate. That kind of debate pervades the politi-

Opposition parties are forever blaming the government's policies for reductions in growth that stem from totally different causes.

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cal arena in just about every country. It's hard for the IMF to keep a distance from that debate when it's deeply involved in a give-and-take with the government to get agreement on a program.

I like to sell good policies another way. Good policies are like the person who takes good care of himself, eats a good diet, and exercises regularly. When the flu comes around, who is most likely to survive or get better faster? Good policies help you avert disasters that might otherwise happen or surmount unavoidable disasters at lower total cost. That is a message that I think can be sold all the time and almost everywhere, even if we cannot promise that particular growth rates will follow from a given set of policies.


Harberger: "Good policies help you avert disasters that might otherwise happen or surmount unavoidable disasters at lower total cost."

LOUNGANI: The effects of some economic policies are better understood thanks to your academic contributions. You did path-breaking work on whether capital or labor bears the burden of the corporate income tax.

HARBERGER: There are interesting developments to report on that front. In the closed-economy case that I analyzed in the 1960s, the natural result is that capital bears the burden of the tax and can easily bear more than the full burden. But my students and I have now analyzed the open-economy case, which is more applicable to today's global economy. The result in this case is that labor bears the burden and can easily bear more than the full burden.

LOUNGANI: That's quite a flip. Why does it happen?

HARBERGER: Think of the so-called "tradable goods" sector of an open economy, the sector that produces goods that are traded on a world market. The prices of these goods are determined in the world market. And, with an open economy, the rate of return to capital is largely determined in the world market, because capital can flow from country to country in search of the highest return. Now the government gets in there and tries to impose a corporation tax on capital. Well, who bears the burden? Capital can move across national boundaries to try to escape the tax. So it's labor, the factor of production that can't easily escape national boundaries, that ends up bearing the burden of the tax.

LOUNGANI: Given this result, what advice can we offer developing countries on how to tax corporations?

HARBERGER: They should equalize their rates with those of the rich nations—somewhere near 30 percent. Keep in mind that many developing countries have multinationals living in them. If they don't tax the multinationals, the home country will. So they need the corporation tax to avoid giving revenue away. But to keep their own labor from bearing the burden of the tax, countries can integrate the corporation tax and the individual income tax. Essentially, you rig it so that for the local taxpayer, the tax paid at the corporate level is really just the withholding on his personal tax on that income. That's what countries like Chile have tried to do.

LOUNGANI: You revolutionized measurement of deadweight losses from distortions—they're now called "Harberger's triangles." But despite better quantification of the loss from trade distortions, policies don't seem to change. Think of the deadweight loss from tariffs and subsidies that rich nations have on agricultural products.

HARBERGER: At the University of Chicago in the 1950s, Theodore W. Schultz, who revolutionized the study of agricultural economics, was forever railing against U.S. policies of subsidizing our own agriculture, encouraging overproduction, and then dumping the surplus on the world market.

And it's not just the United States. The Danes, for example, heavily protect their agriculture. The result? I've been buying Danish blue cheese for years in Los Angeles at the very affordable price of $3.50 a pound! D. Gale Johnson, and later Anne Krueger, showed that cost of U.S. sugar policies was a billion dollars a year even at that time.

The main beneficiaries are a small number of rich sugar farmers in the United States. But the cost of such policies to developing countries is enormous, because a large fraction of their population is in the agricultural sector. ■