

IMF Publication



In This Issue

Public Investment	1
Bank Transaction Taxes	1
Jacques Polak Seventh Annual Research Conference	5
Country Study: Italy	6
Book Summary: <i>Divergent Paths in Post-Communist Transformation</i>	8
Staff Papers	8
Warsaw Conference on EU Enlargement and Related Flows of Labor and Capital	9
Working Papers	10
Visiting Scholars	12

Research Summaries

Public Investment

Alex Segura-Ubiergo



The study of public investment has a long tradition in the public finance literature. In recent years, it has attracted increased attention as observers have noted that fiscal consolidations may have been associated with disproportionately large reductions in public investment. New research has also focused on mechanisms to measure and improve public investment “efficiency” and fiscal risks associated with promoting investment in infrastructure by using public-private partnerships (PPPs). This article provides a brief overview of how recent research by IMF staff members has contributed to this debate.

There are at least four reasons why the public sector may need to invest directly or indirectly (Atkinson and Stiglitz, 1980). (Public investment is defined herein as the set of economic transactions that lead to changes in the stock of physical capital. This is the definition normally used in national account statistics.) First, in the presence of externalities and spillover effects, the private sector might underinvest in certain economic activities (e.g., building lighthouses), an argument that typically applies to public goods. Most public investment is not, however, on public goods. Second, asymmetric information *(continued on page 2)*

Bank Transaction Taxes

Andrei Kirilenko



Over the past twenty-five years, a number of countries, mostly in Latin America, have imposed taxes on banking transactions. Empirically, these taxes have been shown to be effective in generating revenue in the short term. Recent studies, however, question their ability to be a reliable source of revenue in the medium term and show that they result in significant financial disintermediation.

When, in 1898, the U.S. government introduced a two-cent tax on bank checks to finance the Spanish-American War, little did it know that a century later many Latin American countries would use similar taxes to fight their own fiscal battles. Since 1976, taxes on bank transactions have been introduced repeatedly in Argentina, Brazil, Colombia, Ecuador, Peru, and Venezuela. As of the end of 2006, such taxes were in effect in seven Latin American and Caribbean countries: Argentina, Brazil, Bolivia, Colombia, the Dominican Republic, Peru, and Venezuela.

There is considerable variation across countries in the design of these taxes. Usually, taxes on bank transactions are levied on withdrawals from bank accounts, including the clearance of checks and the use of *(continued on page 4)*

Public Investment

(continued from page 1)

problems or insufficiently developed institutions (e.g., the lack of clear laws and relatively independent and responsive courts) may prevent the development of capital or insurance markets and discourage private firms from investing in risky projects. In such cases, potentially viable and socially desirable projects would not be executed without public sector intervention. Third, public investment may have other social objectives, such as income redistribution, that profit-maximizing private agents would not be willing to pursue. One example would be investments in housing developments for poor families or in services, such as provision of electricity and safe water in rural areas, that are sold below market prices. Finally, certain economic activities, such as the provision of infrastructure (e.g., roads, ports, dams), are characterized by large sunk costs and increasing returns to scale, which may result in high barriers to market entry. Under these circumstances, the public sector may decide to either regulate the monopoly-dominant market structure or undertake the project directly. In practice, countries undertake public investment projects for a variety of reasons, and political considerations (e.g., upcoming elections) often trump purely socioeconomic objectives.

Recent research on public investment by IMF staff members has focused on three issues: (i) determinants of public investment levels, (ii) factors underlying differences in public investment efficiency, and (iii) fiscal risks associated with public-private partnerships. On the first topic, Tanzi and Davoodi (2002) find, on the one hand, that corruption (proxied by the International Country Risk Guide Corruption Index) increases public investment while, not surprisingly, reducing its productivity. Clements, Bhattacharya, and Nguyen (2003), on the other hand, show that high debt-service levels tend to decrease public investment. These studies by IMF researchers do not deal, however, with the perhaps more interesting question of what explains the well-documented downward trend in public investment in different regions in recent years.

One obvious reason could be the need for fiscal adjustment. Little is known about whether there is a causal relationship between these two variables, however, since decreases in public investment could have many other explanations (such as preference for a smaller public sector or the completion of large infrastructure projects). A different, but somewhat related question is how the composition of fiscal adjustment may affect its sustainability. In this regard, a seminal paper by Alesina and Perotti (1995), which focused on member countries of the Organization for Economic Cooperation and Development (OECD), showed that fiscal consolidation is more likely to be successful (i.e.,

sustained) when it is predominantly based on cuts in current spending, as opposed to cuts in public investment and/or revenue increases. This result has also been confirmed by Gupta and others (2003, 2005) for low-income and emerging market countries. More recently, the work of Akitoby and Stratmann (2006) has shown that financial markets are not indifferent to the composition of fiscal adjustment. In particular, spreads in emerging markets tend to narrow when fiscal adjustment relies on cuts in current spending but do not change when adjustment is based on cuts in public investment or revenue increases. This suggests that financial markets may also view cuts in current spending as a stronger sign of sustainable fiscal consolidation than cuts in public investment.

Some critics of the IMF have argued that the fiscal adjustment often called for under IMF-supported programs has put strong downward pressures on public investment and social spending in many countries. However, the IMF's Independent Evaluation Office (2003) and a related paper by Martin and Segura-Ubiergo (2004) did not find any evidence that this was actually the case. In practice, whether they are undertaken in the context of an IMF-supported program or not, little can be said about the desirability of cuts or increases in public investment in specific cases without paying attention to the efficiency/productivity of specific public investment programs. This is a relatively new area where further research seems particularly warranted. A paper by Clements and others (forthcoming) explores this issue in the context of Latin America. Using nonparametric techniques, they define a production function linking spending inputs and infrastructure outputs. Their results reveal a significant amount of inefficiency in about two-thirds of their sample.

Most of this research has relied heavily on the use of cross-country regressions. There is a limit, however, to what can be learned from these regressions, which are always vulnerable to problems of sample heterogeneity and omitted variables, and can, therefore, push researchers into the dangerous "ecological fallacy trap" (i.e., the belief that the average result obtained from the regression can be applied in practice to specific countries). Interestingly, the IMF is beginning to make greater use of qualitative methods based on in-depth case studies that try to avoid this problem. The loss of generality associated with the small sample sizes of the studies seems a reasonable price to pay, given the insightful results often obtained. For example, interviews with senior government officials conducted by various mission teams of the IMF's Fiscal Affairs Department (FAD) to eight low- and middle-income countries (IMF, 2005) suggested specific ways of making improvements in institutions for investment planning and project evaluation that

could ultimately lead to higher public investment productivity. FAD economists concluded that countries would benefit from introducing more systematic use of standard cost-benefit analysis techniques, avoiding a bias in favor of new projects and against the maintenance of existing infrastructure, introducing a central institution responsible for screening sectoral public investment projects (as Chile has successfully done), and establishing mechanisms for project monitoring and ex post evaluation.

Finally, one alternative to traditional public investment that is becoming increasingly popular is using public-private partnerships (PPPs), under which a private entity builds and operates a new infrastructure project or takes over the management of a large public infrastructure asset for a given period during which it also assumes significant investment risk. Hemming and Ter-Minassian (2004) note that PPPs hold the promise of boosting efficiency and increasing the supply of infrastructure and other services. They argue, however, that PPPs should be treated with great care. First, it is not obvious that they are more efficient than traditional public investment; and, second, they have experienced a number of failures in developed countries. Third, there is a danger that PPPs will be used to move public investment off budget while obtaining no significant efficiency gains. The authors also point out some principles needed for a successful PPP program: (i) contractible services with payments that are linked to performance; (ii) competitive and/or incentive-based regulation; (iii) an appropriate institutional framework with adequate supporting legislation; (iv) specialized staff with strong project-appraisal skills; and (v) in the absence of internationally accepted accounting standards, full disclosure of fiscal risks posed by PPP schemes. Recent international experience has shown, as noted in a forthcoming paper by Pritha Mitra, that substantial project risks posed by PPPs often result in the need for government guarantees. In this regard, in the presence of uncertainty, guarantees are a legitimate form of support for infrastructure investment when the government is best placed to anticipate and control project risk. However, guarantees used as a response to project risk are also a source of fiscal risk, and pose in practice a number of transparency, accounting, and monitoring issues that should suggest great caution in their use (IMF, 2006). Fortunately, the experience of some countries with a long tradition of fiscal discipline and a centralized system of fiscal risk management, like Chile, provides some guidance on how to make effective use of them.

Many questions still remain and others have not been properly answered. Ongoing projects on public investment and fiscal risk (including risks posed by public enterprises that often carry out substantial investments) and research

on public investment efficiency in Latin American and transition economies will, it is to be hoped, advance our understanding of these issues further. Other useful contributions to the debate may also develop in the context of technical assistance missions on PPPs that are currently being conducted to a number of countries for which limited academic research is available so far.

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Bank Transaction Taxes

(continued from page 1)

automated teller machines (ATMs), as well as on payments of loan installments. In addition, in Argentina, Colombia, and Ecuador, these taxes have been levied on all, or some, bank credit transactions. There is also considerable diversity in what these taxes are called, with names including *bank debit taxes*, *bank account debit taxes*, and *financial transaction taxes*.

Bank transaction taxes (BTTs) were typically introduced at a time of crisis to quickly generate a burst of revenue. There are several reasons why these taxes are quite appealing as fiscal instruments, especially at times of fiscal distress. First, collection and administration costs of bank transaction taxes are minimal, since the banks simply transfer a portion of each qualified transaction to a government account. Second, the government enjoys an immediate and continuous revenue stream, since these taxes are collected from transactions in real time. Third, there is not much organized popular opposition to these taxes, since they are typically introduced as a “tax on the rich.” Finally, and most importantly, the short-term revenue performance of bank transaction taxes is usually quite strong. In their descriptive paper, Coelho, Ebrill, and Summers (2001) confirm that BTTs have been successful in raising revenue in the short term. They also document abundant anecdotal evidence, however, that these taxes have resulted in financial disintermediation. The authors argue that BTTs should be avoided unless the country has significant fiscal needs that cannot be met by more appropriate tax instruments.

Kirilenko and Perry (2004) estimate the degree of disintermediation (a permanent erosion of the tax base) resulting from the introduction of a BTT. They construct monthly series for real BTT revenue (nominal revenue adjusted for inflation and changes in the tax rate) for six countries (Argentina, Brazil, Colombia, Ecuador, Peru, and Venezuela) assuming that during the first month after the introduction of the tax, there is no change in the behavior of providers and users of banking services. This assumption allows them to use the decline in revenue from its starting value (in the first month the tax is in effect) as an estimate of financial disintermediation. The authors show that, on average, the introduction of a BTT results in disintermediation of between 4 and 44 cents for every dollar in revenue. According to their estimation, for every dollar raised through these taxes, financial disintermediation has reached maximum values of 46 cents in Argentina, 58 cents in Brazil, 64 cents in Colombia, 48 cents in Ecuador, 66 cents in Peru, and 49 cents in Venezuela. The authors also find that disintermediation effects tend to cumulate as the taxes remain in place, providing additional evidence for the hypothesis that these taxes quickly erode their own tax bases.

Baca-Campodónico, de Mello, and Kirilenko (2004) employ the persuasiveness of a full-fledged panel study to analyze the revenue-raising ability of bank transaction taxes. The authors use a panel of quarterly data from six Latin American countries that have had BTTs during the last nine years—Argentina, Brazil, Colombia, Ecuador, Peru, and Venezuela. They find that, for a given tax rate, BTT revenue declines in real terms over time (owing to erosion of the tax base). Therefore, in order to meet a given revenue target, the tax rate needs to be raised repeatedly. They also find, however, that a 0.1 percentage point increase in the statutory tax rate reduces the revenue base (or productivity) by 0.18–0.30 percent. Thus, increasing the tax rate erodes the tax base by more than it raises revenue and accelerates the speed at which the tax base is being eroded. They conclude that these taxes should be used only as a temporary means to mobilize revenue in situations of fiscal duress.

While the studies already discussed look at a cross section of countries, a complementary strand of literature focuses on experiences of individual countries with bank transaction taxes. For example, Albuquerque (2003) argues that a BTT increases the cost of government borrowing in Brazil. He calculates the inflection point of a Laffer-type curve adjusted for the higher cost of government borrowing and argues that an 80 percent increase in the actual average tax rate during the period (0.34 percent) to the estimated maximum rate (0.62 percent) would have yielded only about 36 percent more in revenue in 2000. The author also estimates that the losses for the actual and the calculated maximum tax rate are 21.5 percent and 57.8 percent of revenue (net of estimated higher government borrowing costs), respectively. In light of this evidence, he seeks to discourage the use of this tax.

Suescun (2004) presents a multisector, dynamic-general-equilibrium model that is used to evaluate the distortions owing to a transaction tax. Using calibrated data from Brazil, he argues that “a transaction tax imposes an intermediate level of distortions. In some cases, it is the best option after a consumption tax . . . in all model specifications, the growth toll of a transaction tax is small, even comparable to that of a consumption tax.”

Arbeláez, Burman, and Zuluaga (2002) use panel-data analysis to estimate the effect of a BTT on interest margins and profitability of 43 financial institutions in Colombia during 1995–2001. They find that the BTT increased the cost of credit and led to significant disintermediation. As a result, profits of financial institutions declined in the short term by more than the amount of revenue raised by the government. The authors consequently recommend abolishing the tax.

Lastrapes and Selgin (1997) investigate the impact of a two-cent check tax on the U.S. economy during the 1930s. They estimate the impact of the tax on the currency-deposit

ratio and the money stock using a vector autoregressive model and monthly data from August 1921 to December 1936. They show that the tax led to significant disintermediation. As a result, the monetary contraction in the United States during the 1930s is estimated to have been 15 percent higher than it would have been without the tax. The authors also argue that policymakers were aware of the likely adverse effect of the tax but deliberately chose to overlook it in order to raise revenue. They present the two-cent check tax as a typical example of the Depression-era policies that disregarded the impact of fiscal measures on monetary and financial outcomes.

There is also a broad body of literature on the taxation of financial intermediation. For example, a comprehensive volume edited by Honohan (2003) presents an analytical overview of the four main types of tax bases for the financial sector: income, expenditures, assets, and transactions. In the introduction to the volume, the editor points out many theoretical considerations and practical hurdles that need to be addressed in designing a tax system for the financial sector.

Finally, there is a large related body of literature on corrective financial transaction taxes. It argues that these taxes can correct distortions in financial markets to some extent. This argument runs counter to a view that these taxes cause greater financial disintermediation and damage revenue-mobilization capacity more than they help ease the distortions that they are purported to rectify. Habermeier and Kirilenko (2003) examine research on market microstructure, asset pricing, rational expectations, and international finance with a view to assessing the impact of securities transaction taxes on financial markets. They argue that transaction taxes can obstruct price discovery and price stabilization, increase volatility, reduce market liquidity, and inhibit the informational efficiency of financial markets.

Overall, the literature on bank transaction taxes shows that these taxes have been quite effective in generating revenue in the short run. Empirical evidence suggests, however, that bank transaction taxes are distortionary, have contributed to significant financial disintermediation, and are not a reliable source of revenue in the medium run.

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Jacques Polak Seventh Annual Research Conference

The International Monetary Fund will hold the Jacques Polak Seventh Annual Research Conference at its headquarters in Washington on November 9–10, 2006. The conference is intended to provide a forum for discussing innovative research in economics, undertaken by both IMF staff and outside economists, and to facilitate the exchange of views among researchers and policymakers.

The theme of this year's conference is "Capital Flows." Topics include (but are not restricted to) (1) the role of capital flows in economic development and growth; (2) booms and busts in capital flows to emerging market countries, and policies that can mitigate their effects; (3) global financial imbalances and their resolution; (4) the impact of capital mobility on domestic policies and institutions; and (5) the determinants of the direction, size, and structure of international capital flows.

This year, the Mundell-Fleming Lecture will be given by Olivier Blanchard (Massachusetts Institute of Technology). Further information on the conference program will be posted on the IMF website (www.imf.org). The Organizing Committee includes Gianni De Nicoló, André Faria, Olivier Jeanne (chair), Jaewoo Lee, Andrei Levchenko, Eduardo Ley, and Nikola Spatafora.

Country Study

Italy

Bogdan Lissovlik



Italy's economic performance over the past few years has been disappointing. Despite the benefits accruing from its participation in the European Economic and Monetary Union (EMU), growth has lagged, competitiveness has fallen, and government accounts have

progressively weakened. The sources of this poor growth performance have been major focuses of recent IMF staff research, as have the structural, fiscal, and financial policy challenges arising therefrom. Staff papers have also investigated aspects of Italy's financial and regional development, and longer-term issues related to debt sustainability and pension reform in the context of impending aging-related pressures.

The current output slowdown has generated substantial academic and policy debate in Italy. One particularly puzzling aspect of economic performance since the late 1990s is that the significant increase in employment that Italy has experienced has not been matched by broadly commensurate increase in output. Put another way, the growth impact of rising employment has been almost fully offset by worsening productivity. Sgherri (2005) examines the nature of Italy's exceptionally low productivity performance using information drawn from the comovement of output, employment, and inflation to distinguish trends from cycles. The results point to a sizable deterioration in trend productivity growth since the mid-1990s, yielding estimates of potential annual output growth as low as 1¼ percent in 2004.

The apparently large structural component to the growth slowdown has raised questions on the extent to which it is related to a loss of competitiveness since the advent of monetary union. Kent (2003) investigates the sources of Italy's small, but persistent inflation differential vis-à-vis the euro area, concluding that it is partly related to convergence in price levels and tight employment conditions in the north. Looking ahead, the paper suggests that pressures for real appreciation are likely to persist, which will require adopting policies to safeguard price competitiveness. Sgherri (2006a) instead emphasizes the productivity element of the competitiveness problem. Her analysis of cross-country data and estimates of trade equations specific to Italy for 1980–2004 point to an across-the-board deterioration of Italian competitiveness in recent years, with poor productivity growth, rather than euro appreciation, the main culprit. The results suggest that Italy's competitiveness problems are largely homegrown and are likely rooted in its inefficient model of dynamic specialization and its economic and policy rigidities.

Some of the particular institutional and policy causes behind the weak growth are examined in two papers by Lissovlik (2005, 2006). The first focuses on the business environment and the legal system, two areas where Italy fares relatively poorly in standardized international quality measures (especially with regard to the length of its legal processes). Cross-country correlations based on objective measures of institutional quality show a close association with long-term growth. The results suggest the link likely goes from the quality of the business environment to growth, though data problems impede a thorough investigation of the direction of causality. The second paper looks at how policy choices might have influenced Italy's recent medium-term performance, using subnational European Union (EU)-wide and Italy-specific data in cross-section and panel regressions for 1995–2004. It concludes that national product market rigidities and high labor tax rates have depressed growth within the EU. In addition, the paper finds that within-Italy regressions, which also extend the work of Vamvakidis (2003) on growth and regional disparities, offer comparatively weak evidence of adverse effects of export specialization on regional growth, against the background of substantial regional convergence in Italy since the mid-1990s.

Despite considerable employment gains as a result of ongoing labor market reforms, Italy's employment ratio is still among the lowest in the euro area. Vamvakidis (2002) shows that there could be substantial scope for employment gains if Italy's rigid system of regional centralized wage bargaining permitted greater wage differentiation in line with productivity differences and local labor market conditions. The empirical evidence suggests that a more decentralized wage bargaining system would increase Italy's regional wage dispersion by 5 percent, bringing it close to the euro-area average and substantially reducing unemployment in regions with low productivity.

Competitive and efficient financial and corporate sectors are also essential to promoting growth. Drummond, Maechler, and Marcelino (2006) investigate competition in the Italian banking system in detail. They find that although competition has increased in recent years, banks still operate in a high-cost and high-income environment, suggesting scope for further efficiency gains. In particular, greater market contestability would serve as a powerful incentive in this regard. Focusing on the impact of the financial system in general, Muñoz (2006a and b) examines macroeconomic transmission mechanisms and household behavior with respect to risky assets. She finds substantial structural differences between Italy and the United

Kingdom, including evidence of household liquidity constraints in the former. Drummond and Friedman (2005) evaluate Italy's corporate governance in light of recent high-profile bankruptcies. The overall assessment is favorable, especially since some weaknesses in investor protection had already been rectified by the so-called post-Parmalat legislation.

Italy's fiscal accounts remain a focal point of academic interest, given the high public debt and the complex trade-offs involved in adjustment and reform. A number of studies have advocated the adoption of a transparent, rules-based framework that would ensure an effective fiscal policy. Daban Sánchez and others (2003) argue for the adoption of binding expenditure-constraining fiscal rules in the four largest euro-area countries, with the case of Italy being particularly compelling, given its very high public debt. A complicating factor in the implementation of such a rules-based framework is the fiscal devolution under way in Italy. Fedelino (2005) reviews developments in fiscal federalism in Italy and draws on the experience of other countries to distill lessons about how to design the framework to implement such a decentralization. With the obvious caveats concerning the primacy of the domestic political process and the need to account for country specificity, this review highlights the importance of transparent and stable rules, effective monitoring, and enforcement mechanisms.

In the context of short- and medium-term forecasting and policies, a key issue is the effect of impending fiscal consolidation on economic growth and investment. Sgherri (2006b) provides estimates of the associated fiscal multipliers, based on an intertemporal model of durables consumption. The results suggest that Italian households are relatively farsighted, which implies small multipliers and, hence, a relatively minor adverse effect on growth of an eventual expenditure-based adjustment. Fedelino (2006) examines options to reduce the impact on public investment of tight budget constraints through the creation of public-private partnerships (PPPs), which are relatively little used in Italy but are expected to become more common. Although the experience in a number of countries suggests that PPPs can play an important role in fostering public investment, they should not be a vehicle for evading budget restrictions, and experience demonstrates that careful project implementation is essential. Greater project prioritization, enhanced transparency in recording these operations, and the transfer of an adequate degree of risk to private partners would be instrumental to the efficiency of these operations.

Over the long term, Italy's fiscal outlook is dominated by concerns about debt sustainability. In this regard, a relatively bright spot over the past decade has been the improvement in the outlook for the public pension system. Zanolini (2003) documents the success of various pension-related

reforms from the early 1990s in reducing future liabilities. Still, simulations suggest that aging-related spending is likely to rise considerably in Italy over the next two decades, partly as a result of continuous increases in health care spending. The paper highlights the need to jump-start economic growth, ensure substantial medium-term fiscal adjustment as a complement to pension reforms, and create room for a broader overhaul of the social protection system, which is so far heavily tilted toward pension spending.

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IMF Staff Papers

Volume 53, Number 2

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Luis Catão and Sandeep Kapur

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Selim Elekdag, Alejandro Justiniano, and Ivan Tchakarov

“Relating the Knowledge Production Function to Total Factor Productivity: An Endogenous Growth Puzzle”

Yasser Abdih and Frederick Joutz

“New Rates from New Weights”

Tamim Bayoumi, Jaewoo Lee, and Sarma Jayanthi

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Richard Podpiera

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Book Summary

Divergent Paths in Post-Communist Transformation: Capitalism for All or Capitalism for the Few?

By Oleh Havrylyshyn

Palgrave Macmillan, April 2006, 400 pp., \$100.00 (clothbound)

This book reviews the experience of post-communist transformation since 1989 in 27 non-Asian countries. Although the focus is on economic dimensions, political and social phenomena are found to be too tightly intertwined to ignore altogether. The analysis has three objectives: first, to describe what happened, how much progress there has been toward a market economy, and how the transition may have differed across countries; second, to explain the differences among countries in evolution and outcome; and third, to ask what is coming next. It argues that one need not tell 27 different stories, though, of course, each country has some interesting particularity. There are five groups of countries with considerable internal homogeneity, and they can be ranked, by the degree of their progress in achieving transition, approximately as follows: Central Europe; the Baltics; Southeastern Europe; the Commonwealth of Independent States (CIS) countries that have made significant, but still incomplete progress toward a market economy; and the CIS countries that have completed only very limited reform of the regimes they inherited. This ranking is shown to be strongly maintained when various criteria of performance are used: recovery of output, financial stabilization, minimization of social costs of adjustment, institutional development, and achievement of democratic liberalism. The differences in outcome are analyzed using a simplified framework consisting of three key factors: the rapidity of or delay in the initial start, the proclivity to fall prey to rent seeking and eventual state capture by vested interests, and the impact of having access to institutional safe havens such as European Union (EU) membership.

The logic of the framework is best understood by analyzing a simplified vicious-circle case in which the greater the delay in reforms, the more opportunities there are for rent seeking, and for building up new capitalist wealth and concentrating it by means of insider privileges. Some countries may have a greater proclivity to engage in such behavior because of prior conditions, limited change in political elites, and greater opportunities afforded by a large resource sector. A counter to these tendencies is the discipline of reforms and institutional change required by membership in international organizations such as the International Monetary Fund (IMF), the World Bank, the World Trade Organization (WTO), and especially the EU. Finally, the prospects for further successful transformation are best for countries that have moved fast enough and far enough to minimize the rent-seeking effects; not coincidentally, these are generally the same countries that have either become or are on the way to becoming EU members. For those countries where vested interests have become entrenched, there is a likelihood of transition being frozen half-way to an open and competitive market economy and, again not coincidentally, democratic liberalization being slowed or even reversed.

Conference Summary

Warsaw Conference on EU Enlargement and Related Flows of Labor and Capital

Clinton Shiells



The recent enlargement of the European Union (EU) ushered in its largest-ever group of new member countries, some of which have relatively low per capita incomes.

Raising incomes in the new members has therefore taken on increased importance

within the overall goal of European integration. Indeed, the union of the capital-poor, generally low-employment new members and the higher-employment, capital-rich old members has set in motion forces driving labor migration from east to west and capital flows from west to east. To encourage better understanding of these trends and the policies that will influence how they play out, the Joint Vienna Institute (JVI), the IMF Institute, the IMF's European Department, and the National Bank of Poland gathered academicians and policy-makers for a conference at the National Bank in Warsaw on January 30–31.

The Warsaw conference on impacts of EU enlargement began with a review of large migration episodes and their effects on labor markets (papers by Tim Hatton, University of Essex and Australian National University; and George Borjas, Harvard University). It went on to a presentation of estimates of potential labor flows resulting from EU enlargement (Tito Boeri, Bocconi University) and a discussion of the public's concerns (Christian Dustmann, University College London). It then turned to a description of the large foreign direct investment flows from old to new members (Philip Lane, Trinity College Dublin; and Gian Maria Milesi-Ferretti, Research Department, IMF) and the influence of tax rates on investment location decisions (Michael Devereaux, University of Warwick). Two presentations documented the extensive use of outsourcing and offshoring by German and Austrian firms (Claudia Buch, University of Tübingen; and Dalia Marin, University of Munich). These were followed by a survey of new theories of trade and factor flows (Elhanan Helpman, Harvard University) and an empirical study of possible complementarities between these flows (Poonam Gupta and Ashoka Mody, European Department, IMF). The dominant views on the principal topics—which were brought out clearly and underscored in the final panel session—are discussed in the following paragraphs.

Labor flows since enlargement have been much smaller than projected. Flows to the United Kingdom and Ireland have been larger than to other destination because of fewer restrictions, better labor market conditions, or more flexible institutions that allowed better utilization of labor inflows. Possibly because of restrictions, flows to the other countries in the EU-15 have so far been quite small, even in relation to standard estimates suggesting that migration might reach about 3 percent of new members' (and about 1 percent of old members') populations. Removing restrictions on inflows to other EU-15 members would probably elicit relatively small flows—especially those originating outside the EU.

An important basis for popular antagonism to labor inflows was a perception that migrants could overwhelm domestic welfare systems. Limitations on access to these welfare systems—along the lines of policies in the United Kingdom—therefore made sense.

Analysis of factor flows requires a global, rather than a purely European, perspective. In an outstanding survey of the new literature on trade, factor flows, and firm behavior, Helpman contributed to an important view that emerged from the discussions—namely that, given the huge amount of global trade and insourcing and outsourcing of intermediates, wage relativities were being established in global markets. Attempts by one country or cluster of countries to set high reservation wages, reduce wage dispersion, or introduce social policies aimed at achieving more egalitarian income distributions would likely be detrimental to growth, employment, competitiveness, and investment in human capital.

There was compelling evidence that German and Austrian firms had improved their competitiveness (particularly in the face of skill shortages) by using labor inputs from the new members. In this emerging “war for talent,” firms in the capital-rich old members were employing migrants domestically but also, to an even greater extent, outsourcing and offshoring intermediate inputs.

With respect to capital mobility, converging institutions and substantial differences in capital-labor ratios were bound to elicit huge flows into the new member countries. For the fixed exchange rate countries, *(continued on page 10)*

Warsaw Conference (continued from page 9)

this would mean substantial increases in liquidity, bank credit, external liabilities, current account deficits, and foreign exchange exposure—along with rapid growth. The sooner these countries could join the euro area, the smaller would be the window of currency-related vulnerabilities. For the flexible exchange rate countries, incipient inflows could force excessive currency appreciations, with dampening effects on competitiveness, profitability, and growth. A degree of vulnerability associated with substantial capital flows was intrinsic to the capital flow-driven convergence process, although some participants thought that capital account volatility would be mitigated insofar as flows were being driven predominantly by long-term investment decisions. In any event, the nature of vulnerabilities would be changed—from broad foreign currency exposure to individual credit risk—by early euro adoption; and, of course, sound macroeconomic policies would serve to lessen risks.

Tax policies could exert an influence on the amount and location of investment. There was, nevertheless, little

enthusiasm for strict tax harmonization and some support for tax competition.

The conference was opened by Leszek Balcerowicz (President, National Bank of Poland) and Susan Schadler (Deputy Director, European Department, IMF); both talked about the principal questions to be examined and themes likely to emerge from the discussions.

Anne Krueger (First Deputy Managing Director, IMF) gave a dinner speech on the history of EU integration, the need to nurture trade creation and avoid trade diversion, and the importance of continuing this stance in the current environment.

The final panel, chaired by Leslie Lipschitz (Director, IMF Institute), included Marek Belka (former prime minister and finance minister of Poland), Lajos Bokros (former finance minister of Hungary), André Sapir (principal author of *An Agenda for a Growing Europe*, the “Sapir Report”), and Erik Berglöf (Chief Economist of the European Bank for Reconstruction and Development (EBRD)).

The conference program and papers are available on the JVI website at www.jvi.org/index.php?id=4447.

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 Implications for Africa”**
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 Banking Systems”**
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 Socorro
- No. 06/33
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 Programming: A New Framework”**
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 Hardy, Daniel C.
- No. 06/35
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 Development? Evidence from Topography”**
 Ramcharan, Rodney
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 Feyzioğlu, Tarhan; Willard, Luke
- No. 06/37
**“The Impact of Foreign Interest Rates on the Economy: The Role
 of the Exchange Rate Regime”**
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**“Providing Official Statistics for the Common Market and
 Monetary Union in the Gulf Cooperation Council (GCC)
 Countries: A Case for ‘Gulfstat’”**
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 Nancy, Gilles; Yontcheva, Boriana
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 Europe: An Overview”**
 Sorsa, Piritta
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 of Geography”**
 Berger, Helge; Ehrmann, Michael; Fratzscher, Marcel
- No. 06/42
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 Equally? Did They All Behave Equally?”**
 Barajas, Adolfo; Basco, Emiliano; Juan-Ramón, V. Hugo;
 Quarracino, Carlos
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**“Quasi-Fiscal Deficits and Energy Conditionality in Selected
 CIS Countries”**
 Saavalainen, Tapio; ten Berge, Joy
- No. 06/44
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 Gelos, R. Gaston
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 Evaluation”**
 Botman, Dennis P. J.; Laxton, Douglas; Muir, Dirk; Romanov,
 Andrei
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Olayinka Adenikinju; University of Ibadan, Nigeria; 3/14/06–4/21/06
Aradhna Aggarwal; University of Delhi; 3/27/06–4/28/06
Laura Alfaro; Harvard University; 1/8/06–1/26/06
Franklin Allen; University of Pennsylvania; 1/3/06
Alayande Babatunde; Lagos State University, Nigeria; 2/13/06–3/24/06
Philippe Bacchetta; Study Center Gerzensee, Switzerland; 2/20/06–4/29/06
Laurence Ball; Johns Hopkins University; 1/9/06–2/28/06
Gian Luca Benigno; London School of Economics; 4/3/06–4/21/06
Sami Bennaceur; IHEC Carthage, Tunisia; 2/27/06–3/31/06
Olivier Blanchard; Massachusetts Institute of Technology; 1/26/06
Olivier Blanchard; Massachusetts Institute of Technology; 3/13/06–3/24/06
Michael Bordo; Rutgers University; 2/1/06–2/28/06
William Brafu-Insaidoo; University of Cape Coast, Ghana; 3/20/06–4/28/06
Fernando Broner; Universitat Pompeu Fabra, Spain; 4/10/06–4/14/06
Ehsan Choudhri; Carleton University, Canada; 2/21/06–2/24/06
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