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In this issue

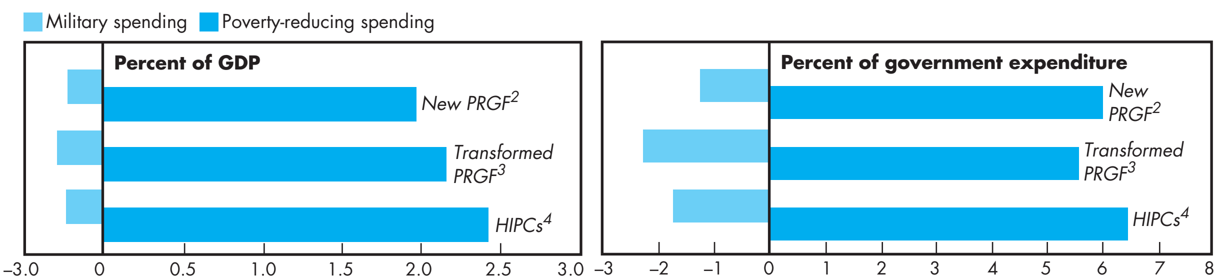
As military spending stabilizes, antipoverty outlays increase

For many years, the IMF has tracked countries' military spending. The IMF's Fiscal Affairs Department describes its most recent findings and also looks at patterns in military as well as poverty-reducing spending in countries with loans under the IMF's concessional Poverty Reduction and Growth Facility (PRGF).

Worldwide military spending, which declined steadily relative to GDP in the first half of the 1990s, appears to have stabilized since 1995 at between 2.3 and 2.6 percent of world output. In 2000–01, the latest year for which information is available, worldwide spending on the military stood at between *(Please turn to the following page)*

Poverty-reducing spending rises and military spending declines in poor countries

Selected countries with loans under the IMF's concessional PRGF[1]



[1]Changes are calculated between the pre-PRGF date (1999 in most cases) and the latest date for which information is available.
[2]Arrangements approved between July 1, 2000, and September 30, 2001 (Azerbaijan, Benin, Guinea-Bissau, Lesotho, Madagascar, Malawi, and Niger).
[3]Transformed from Enhanced Structural Adjustment Facility arrangements approved before July 1, 2000. These had two or more reviews under the PRGF framework or a review supported by a full PRSP by September 30, 2001 (Bolivia, Burkina Faso, Cambodia, Chad, The Gambia, Mauritania, Mozambique, Rwanda, Senegal, Tanzania, Uganda, and Zambia).
[4]Benin, Bolivia, Burkina Faso, Chad, The Gambia, Guinea-Bissau, Madagascar, Malawi, Niger, Mauritania, Mozambique, Rwanda, Senegal, Tanzania, Uganda, and Zambia.

Data: IMF, WEO database; country authorities; and IMF staff estimates

Birth of a nation

East Timor gains independence, faces challenges of economic management, poverty alleviation

On May 20, the United Nations transferred authority to the newly established government of East Timor. The handover marks East Timor's formal independence, making the territory the first new country of the 21st century. While offering opportunities, East Timor's long-awaited independence also poses challenges. The new nation is one of the world's poorest countries. For at least the next few years, the economy will need to rely on the technical and financial assistance of the international community. The IMF plans to assist East Timor in meeting its postindependence challenges and looks forward soon to welcoming the country as its 184th member.

East Timor's independence comes after centuries of colonial rule, a 24-year annexation, and, more recently, a 2½-year transitional administration. After more than 400 years of Portuguese rule, East Timor was annexed by Indonesia in 1975. An independence *(Please turn to page 179)*

Spending on education, health care rose

(Continued from front page) 2.4 and 2.6 percent of GDP and between 11.5 and 11.8 percent of total government expenditure. These figures differ slightly depending on the source of the data: IMF, Stockholm International Peace Research Institute (SIPRI), or the International Institute for Strategic Studies (IISS) (see table).

Large differences persist across regions, however, in the share of both GDP and total government expenditure. All data sources confirm that military spending levels remain highest in relation to GDP in the Middle East and lowest in the developing countries of the Western Hemisphere. The decline in military spending between 1995 and 1998 in the region comprising the Baltic states, Russia, and other countries of the former Soviet Union has been partially reversed in recent years for a variety of reasons, including commitments made by the Baltic states to increase military spending to qualify for membership in the North Atlantic Treaty Organization.

Overall, military spending declines have tapered off, but regional differences persist

	(Percent of GDP)[2]					(Percent of total government expenditure)[3]					Number of Countries	
	1995	1998	1999	2000	2001	1995	1998	1999	2000	2001	Latest Observation	Range (1990–2001)[1]
IMF												
All countries	2.6	2.5	2.5	2.4	2.4	11.7	11.3	11.3	11.6	11.5	127	116–133
Advanced economies	2.6	2.6	2.5	2.5	2.5	11.9	11.6	11.7	12.1	12.1	24	24
Developing countries	2.2	2.2	2.2	2.1	2.1	10.9	10.0	9.5	9.4	8.9	85	79–89
Africa	2.4	2.3	2.3	2.3	2.3	9.0	8.5	8.5	8.5	8.0	42	39–43
Asia	1.5	1.4	1.5	1.6	1.5	10.5	8.8	8.5	8.6	8.0	11	9–12
Middle East	6.1	6.2	5.8	5.8	6.3	19.7	18.8	17.5	16.5	17.0	13	13–14
Western Hemisphere	1.3	1.4	1.3	1.3	1.3	6.6	6.6	5.9	6.1	5.6	19	17–20
Transition economies												
Of which: Baltic states, Russia, and other former Soviet Union countries[4]	2.6	1.9	2.0	2.1	2.1	10.0	8.1	8.1	9.4	9.7	18	13–20
Countries with IMF programs for more than two years	2.0	1.9	1.9	1.9	1.9	9.7	8.2	7.8	8.2	7.7	65	58–68
ESAF/PRGF programs	3.7	2.9	2.8	3.1	2.7	16.2	13.6	13.3	14.1	12.1	40	35–41
HIPCs	2.3	2.0	2.1	2.4	2.2	10.3	9.3	10.0	10.7	9.3	29	29–31
Decision point	1.9	2.0	2.4	3.0	2.1	8.6	9.3	10.3	12.1	8.2	17	17–18
Completion point	1.9	1.7	1.7	1.7	1.6	9.8	8.5	8.1	7.2	6.2	4	3–4
SIPRI												
All countries	2.4	2.3	2.3	2.6	..	11.0	10.5	10.5	11.8	..	75	75–141
Advanced economies	2.4	2.3	2.2	2.5	..	10.8	10.4	10.4	12.0	..	19	19–26
Africa	2.3	2.0	2.2	2.1	..	8.5	7.4	7.8	7.5	..	20	20–41
Asia	2.1	2.1	2.0	..	..	13.6	12.6	11.4	..	..	14	14–16
Middle East	5.9	6.6	6.4	6.4	..	19.0	20.4	18.7	18.6	..	10	10–14
Western Hemisphere	1.5	1.3	1.2	1.3	..	7.5	6.0	5.3	6.0	..	5	5–21
Transition economies	3.1	2.5	2.5	2.6	..	12.0	10.3	10.0	11.6	..	21	6–25
IISS												
All countries	2.5	2.5	2.4	2.4	..	11.5	11.5	11.3	11.5	..	146	86–148
Advanced economies	2.4	2.3	2.2	2.2	..	10.9	10.6	10.4	10.8	..	26	24–26
Africa	2.8	3.4	3.3	3.2	..	10.3	12.1	11.9	11.5	..	44	17–44
Asia	3.6	3.8	3.4	3.3	..	23.5	22.6	18.9	18.0	..	15	12–15
Middle East	6.7	7.7	7.8	6.8	..	21.6	23.4	23.2	20.1	..	14	12–15
Western Hemisphere	1.4	1.9	2.0	1.9	..	7.3	8.8	9.0	9.1	..	24	15–24
Transition economies	2.7	2.4	2.3	2.3	..	8.6	8.2	8.1	8.3	..	23	6–24

[1]IMF data are available until 2001, and data from SIPRI (Stockholm International Peace Research Institute) and IISS (International Institute for Strategic Studies) are available until 2000.
[2]Weighted by GDP.
[3]Weighted by government expenditures. For countries where central government expenditure is not available, general government expenditure is used (for example, in some transition economies).
[4]Armenia, Azerbajan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Mongolia, Russian Federation, Tajikistan, Turkmenistan, Ukraine, and Uzbekistan.

Data: IMF, *WEO* database; SIPRI, *Armaments, Disarmament and International Security, 2002*; and IISS, *The Military Balance, 2002.*

Spending in poor countries

In the poorest countries with programs under the IMF's PRGF, our study shows that, as with the world trend, military spending has stabilized. However, between 1998 and 2000, military spending in heavily indebted poor countries (HIPCs) increased, according to data from the IMF and SIPRI. This increase can be attributed principally to armed conflicts in Ethiopia and Guinea-Bissau. If these two countries are excluded from the sample, military spending appears to have declined in other PRGF countries.

At the same time, encouragingly, government outlays on poverty-reducing programs in the poorest countries have risen. These countries have prepared, in collaboration with the staffs of the World Bank and the IMF, poverty reduction strategy papers (PRSPs) that identify a range of reforms, partly involving increased spending on primary education and basic health care and on road construction, rural development, and agriculture, that help boost growth and reduce poverty. Nineteen countries with PRGF-supported programs increased spending on poverty-reducing activities, as defined in their PRSPs. This increase has significantly exceeded the reduction in military spending in percent of GDP (see chart, page 177).

This pattern is particularly evident in countries with new three-year PRGF arrangements approved between July 1, 2000, and September 30, 2001, and countries with PRGF-supported arrangements transformed from arrangements under the previous Enhanced Structural Adjustment Facility (ESAF) that were approved before July 1, 2000. A similar trend is observed for the heavily indebted poor countries with new PRGF arrangements. ■

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East Timor stabilizes, but challenges lie ahead

(Continued from front page) struggle ensued, resulting in an agreement among the United Nations, Indonesia, and Portugal in 1999 to hold a referendum to determine the territory's future status. About 80 percent of the voting-age population opted for independence.

The outcome of the 1999 referendum triggered a violent reaction by pro-Indonesian forces, resulting in widespread destruction and loss of life. An estimated two-thirds of the territory's physical infrastructure was destroyed, and over three-fourths of the population was displaced in the weeks following the ballot. The disruption caused a more than 30 percent drop in GDP in 1999, a sharp acceleration in inflation, and a breakdown of the fiscal, financial, and legal systems. In the ensuing chaos, a multinational peace-enforcement mission arrived to restore security and begin relief efforts. In October 1999, East Timor was brought under the authority of a United Nations Transitional Administration for East Timor (UNTAET), which was charged with administering the territory during the transition to independence.

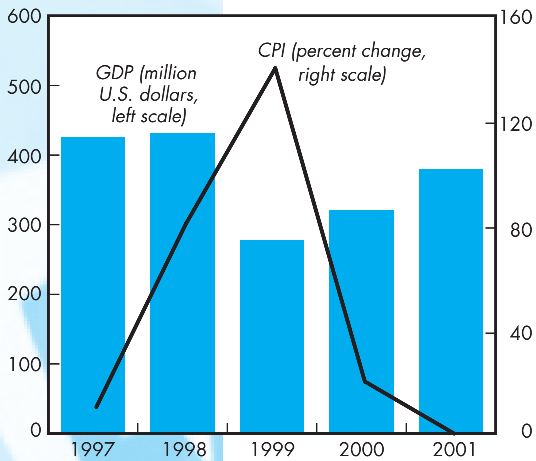
Over the next 2 1/2 years, and with the assistance of the international community, UNTAET succeeded in establishing the legal and institutional conditions for independence. A constituent assembly was elected in August 2001 to draft and approve a constitution; a self-governing structure was established under the Second Transitional Government; and an election was held for East Timor's first president in April 2002. These events culminated in East Timor's independence on May 20, 2002, when the constituent assembly was transformed into a parliament, and the new government was sworn into office.

Rebuilding the economy

International financial institutions and bilateral donors have played an important part in helping East Timor reconstruct its economy. Following the first donors' meeting held in Tokyo in December 1999, a multidonor Trust Fund for East Timor (TFET) was established to provide grants for economic reconstruction and development. Total pledges eventually amounted to over $170 million. TFET, which is expected to wind down its operations in 2003, is coadministered by the World Bank and

the Asian Development Bank, which have disbursed these funds to finance infrastructure and sectoral programs. Since late 1999, donors have also disbursed more than $60 million in grants to support recurrent budgetary expenditures, as well as additional amounts in project aid.

Real GDP has been recovering while inflation has been falling sharply



Data: Indonesian and East Timor authorities; and IMF staff estimates

The IMF's involvement in East Timor began in October 1999, at the request of the UN Secretary-General. The thrust of the IMF's role—facilitated through a resident representative office in Dili (East Timor's capital and largest city) since August 2000—has been to support economic institution building and provide policy advice in support of sound macroeconomic management. With respect to institution building, the IMF has played a principal role in establishing the Central Fiscal Authority (now the country's Ministry of Finance) and the Banking and Payments Authority (BPA, a precursor to a full-fledged central bank). The IMF is also assisting the authorities in establishing a central statistical office. With respect to policy advice, a key area has been the establishment of an appropriate currency arrangement, under which East Timor adopted the U.S. dollar as its official currency in early 2000 (in the absence of sufficient institutional and economic management capacity to issue its own currency). On the fiscal side, the IMF has helped the authorities develop a tax system and prepare annual budgets.

The IMF has played a principal role in establishing the Central Fiscal Authority (now the country's Ministry of Finance) and the Banking and Payments Authority (BPA, a precursor to a full-fledged central bank).

East Timor has recovered significantly from the chaos of 1999. Real GDP is estimated to have recovered to close to precrisis levels (see chart, this page), rising by 15 percent in 2000 and a further 18 percent in 2001. During much of this period, growth was fueled by an expansion in the service and construction sectors in Dili, associated with the presence of the international community. Recently, the recovery has become more broad-based, with a restoration of agricultural production.

At the same time, inflation, which rose to 140 percent in 1999, has been declining steadily, turning negative at the end of last year and reaching –2 percent (on a 12-month basis) in April. This trend reflects the increased availability of goods and is also indicative of the ongoing real exchange rate adjustment to the winding down of the international presence, which had driven prices and wages to unsustainable levels (well above those on neighboring islands).

Development of the financial sector has been advancing but remains limited, with access to banking services largely confined to Dili. In addition to the BPA, the financial system consists of two commercial banks and a microfinance institution recently established with the assistance of the Asian Development Bank. Deposits in the banking system have been rising steadily, although the extension of bank credit has been weak, reflecting the absence of adequate collateral and other risk factors. Although use of the U.S. dollar for transactions got off to a slow start (given the widespread use of the Indonesian rupiah), the dollar has, in recent months, become the principal means of payment throughout the country.

East Timor has had to rely heavily on external grants for its public finances. In the current fiscal year, grants are expected to finance some 80 percent of total public sector spending. The tax system remains appropriately simple, given the early stage of economic development and limited administrative capacity. The tax base is narrow, with most revenues derived from indirect taxes levied on imported goods and selected services. Income taxes are levied on a relatively small number of workers and businesses.

Challenges ahead

Notwithstanding recent progress, the near-term economic outlook remains difficult. The winding down of the international presence, albeit gradual, is expected to dampen economic activity. With private sector growth being held in check by impediments to investment, overall output is likely to decline this year and next.

Over the medium term, sustainable GDP growth could rise substantially to 5–6 percent a year if

Joining the IMF

In anticipation of independence, in March 2002, the East Timorese authorities applied for membership in the IMF. Membership would facilitate East Timor's entrance into other financial institutions and foster the new country's integration into the global economy. The IMF's staff, management, and Executive Board worked quickly to process the application, enabling the Board of Governors to approve East Timor's membership resolution on May 29, 2002. Membership will become effective upon the authorities' acceptance of the Articles of Agreement, expected shortly, and enable East Timor to become the IMF's 184th member.

appropriate policies are implemented, in line with the authorities' recently drafted National Development Plan. Significant oil and gas revenues in the Timor Sea—conservatively estimated at about $3 billion over the next 20 years—are expected to lift the economy as they materialize over the next few years. The recent signing of the Timor Sea Treaty with Australia has facilitated prospects for these inflows, shifting the revenue share in favor of East Timor to a 90:10 split for fields within a Joint Petroleum Development Area. There are prospects for much higher revenues, pending the development of other oil and gas fields and the outcome of maritime boundary issues.

Although East Timor has made impressive strides in restoring stability and can look ahead to significant oil and gas revenues, many of the most difficult challenges of nation building and economic management lie ahead. The economy suffers from low productivity—the result of weak investment, shortages of management skills, and inadequate infrastructure. East Timor remains a very poor country, with more than 40 percent of the population, according to a recent household survey, living below the poverty line. Much of the population has only limited access to social services, including health care and education, and unemployment remains high.

A major task for the new government will be to sustain the progress made during the transitional period. It will be particularly important to maintain and strengthen the institutions that have been established. This will require significant efforts to build local capacity through training and technical assistance.

Achieving significant reductions in poverty will require sustained high economic growth over the medium term. The National Development Plan lays the basis for a sound poverty reduction strategy. The plan envisions a market-based approach to economic development, underpinned by a strong and dynamic private sector. It will be important to maintain open trade and investment policies. It will also be crucial to eliminate impediments to investment, among them the lack of a business regulatory framework, and problems relating to land and property rights (competing land claims are the legacy of Portuguese and Indonesian rule, exacerbated by the destruction of land and property records in 1999).

Future prospects will also depend on maintaining sound fiscal policy. Given the limited scope for domestic revenue mobilization, and the authorities' desire to refrain from borrowing, the government will need to rely on donor support for at least the next few years, until the country can benefit from oil and gas revenue inflows. It will therefore be important for the government to prioritize development goals and channel donor resources efficiently.

Once oil revenues come on stream, the challenge will be to maintain expenditure at a level consistent with the government's capacity to use financial resources effectively. For this purpose, the authorities are seeking to develop an appropriate savings and investment strategy to manage oil inflows. Such a strategy would help insulate the economy from the volatile oil market and foster the growth of the other sectors of the economy.

The challenges facing the new country are significant. To meet them, East Timor will need the continued support of the international community and the commitment of the East Timorese leadership to setting the country on a sound policy path. While the challenges are difficult, prospects are bright. At the most recent donors' meeting, held in Dili on May 14–15 just prior to independence, the international community reaffirmed its commitment to assisting East Timor. With the East Timorese people having demonstrated an ability to overcome unspeakable difficulties in the past, expectations are high that they will now be able to meet the challenges that come with their long-awaited independence. ■

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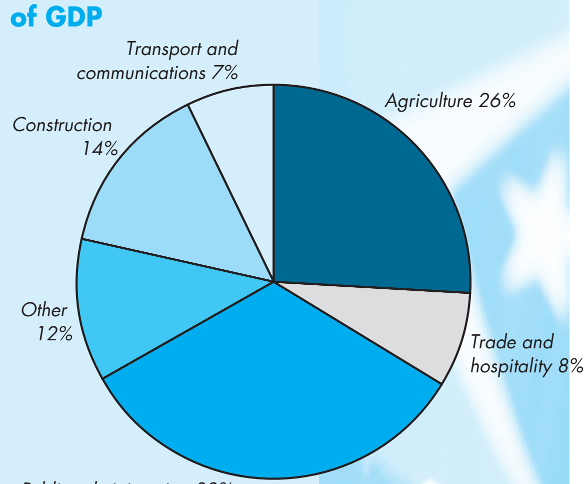
East Timor remains a very poor country, with more than 40 percent of the population living below the poverty line.

The promise of oil and gas

East Timor is situated on the island of Timor, located at the eastern extremity of the Indonesian archipelago. A mountain chain runs along the middle of the island, which has narrow coastal plains and relatively poor soil quality. Agriculture—mainly subsistence farming—accounts for one-fourth of total output (see chart) and about three-fourths of employment. The underdeveloped manufacturing sector is constrained by poor infrastructure and a limited supply of skilled workers. The island has long been known for its sandalwood, and more recently for its high-quality coffee, which constitutes its principal export. Looking ahead, the exploitation of oil and gas resources in the Timor Sea is expected to alter significantly East Timor's export profile and economic prospects. Given the island's natural beauty, tourism is also a sector with development prospects.

In 2000, agriculture and public administration accounted for the bulk of GDP



Data: East Timor authorities

To offer or not to offer tax incentives —that is the question

What's a developing country—eager for an infusion of foreign direct investment and nervously eyeing competitors that offer all manner of tax incentives—to do? In their no-nonsense primer on the limited benefits and numerous pitfalls of tax incentives, Howell Zee and Janet Stotsky (both from the IMF's Fiscal Affairs Department) and Eduardo Ley (from the IMF Institute) urge these countries to exercise caution in using such incentives. Their advice, summarized from a forthcoming September 2002 article in World Development*, underscores that while such incentives can be justified in certain circumstances, in general their costs outweigh their benefits, and some forms of tax incentive are more harmful than others.*

(From left) Authors Howell Zee, Janet Stotsky, and Eduardo Ley stress the need for transparency and accountability if tax incentives are used to attract foreign direct investment.

No question about it, tax incentives for investment are popular. Developed countries tend to use them in a targeted fashion; developing countries customarily use them more widely. Indeed, developing countries—jostling for investment inflows in a world of high capital mobility and mindful of the success of certain East Asian economies that have used incentives heavily—appear increasingly interested.

What does the IMF advise? For starters, it urges countries to take a careful look at the decidedly mixed track record of such incentives. The empirical literature offers inconclusive evidence of their success and points to serious downsides, notably eroded tax bases, distorted resource allocation, and increased opportunities for corruption and favor-seeking from governments. Still, with countries locked in intense competition for foreign direct investment, governments may not be inclined to submit to economic dogma if it means losing out on factories, jobs, and growth potential. But the IMF counsels clear-eyed pragmatism rather than dogmatism, urging countries—as Zee, Stotsky, and Ley stress—to use tax incentives prudently and to take steps to minimize the harm that can be done.

The central message from research on investor behavior is that what matters most is a country's underlying economic and institutional environment, although foreign direct investment can also be sensitive to tax factors that are out of line with international and regional norms. In truth, tax incentives rarely provide the best solution to systemic problems. They do not, for example, ease investor anxieties about high effective tax burdens (stemming from various imperfections of the tax system); redress deficiencies in the macro/microeconomic or structural environment; or make up for flawed legal, regulatory, or political economy environments. Countries are better off tackling these problems directly.

But there are certain circumstances in which tax incentives can help. They may sometimes offer a means to redress market failures and accomplish broader goals than private markets, left to their own devices, would achieve. Governments might, for example, seek investment projects in less developed regions to alleviate congestion or pollution elsewhere or to reduce income disparities. Other investments might serve longer-term goals, perhaps building up human capital or spurring technological advances. In these instances, tax incentives can function as a corrective policy instrument.

When are incentives worth using?

If some tax incentives are justified in some cases, the key questions are, which incentives and when? The most important thing for countries to remember, the authors observe, is that tax incentives always come with a price tag. The benefits of tax incentives can prove difficult to quantify, but the costs are real and potentially substantial. For highly profitable projects (with the greatest economic merit), tax incentives are often not incentives at all, but gifts to investors who would have undertaken these projects in any case. And ineffective incentives—those unable to attract worthwhile investment—pose a risk in their own right, because their mere availability opens the door to potential abuse.

Indeed, abuse and leakage are perennial problems for any tax incentive system, and tackling these issues often entails redirecting scarce resources from overall tax administration. Administrative costs clearly escalate as the scope and complexity of the incentives increase. A far more serious problem, the authors note, is the unofficial condoning, even encouraging, of abuse by the authorities charged with administering the system. And, once in place, incentives are exceedingly difficult to dismantle, even if formally time-bound.

If tax incentives are indeed necessary, the most effective way to deal with the attendant political economy problems, the authors say, is an incentive-granting process that is transparent and accountable. To ensure transparency, incentives must have

- a basis in tax law (thus giving them statutory authority, making them hard to amend without public debate, and avoiding the conflicts or inconsistencies that could arise if these incentives were to be embedded in unrelated legislation);
- an explicit economic rationale (well-thought-out economic arguments, with an evaluation of both impact and costs, and subjected to public scrutiny in the budget process as tax expenditures); and
- simple, specific, and objective qualifying criteria that minimize the need for subjective interpretation and application (this also argues for a triggering mechanism that is as automatic as possible).

What are the options?

All tax incentives are not created equal, and they certainly are not equally cost-effective in achieving their intended objectives. The authors examine the two broad categories of incentive—direct and indirect—and weigh the respective economic payoffs and administrative costs that accrue to the various types of incentive in these categories.

Direct tax incentives generally fall within two broad types: lower taxes on corporate profits and more attractive terms for recovering investment costs. The two types share the same intended goal—a lower effective corporate income tax burden on business investment—but have very different policy and administrative implications.

Corporate tax rate incentives. Tax "holidays" or exemptions are among the most popular incentives offered by developing countries. They relieve the host country of administrative headaches, allow investors to sidestep often onerous legal and regulatory requirements (and corrupt tax administrations), and are neutral in terms of their impact on the capital-labor intensity of proposed projects. But these holidays also have distinct shortcomings. Notably, they favor high-profit investments that do not need incentives and encourage tax avoidance, because it is relatively easy for nonexempt firms to shift their profits to exempt firms. The duration of tax holidays is also notoriously susceptible to abuse and extension, and, because they are time-bound, they tend to attract short-term rather than longer-term investments. And without paperwork to document forgone revenue, the costs of these holidays are rarely transparent.

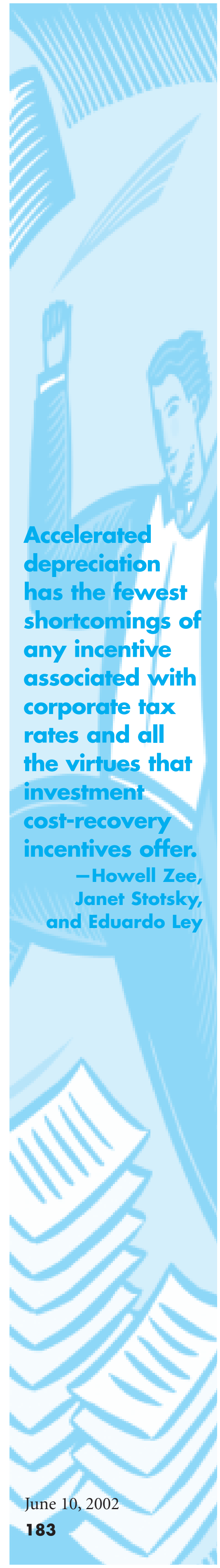
Many developing countries also offer *preferential rates*, which have essentially the same shortcomings as tax holidays, albeit on a smaller scale. One clear advantage of preferential rates, however, is that their revenue costs are both lower and more transparent.

Investment cost-recovery incentives. Both developing and developed countries offer cost-recovery incentives, which primarily cover plant and equipment costs. These incentives encourage capital intensity but may benefit the economy as a whole if the level of investment is otherwise less than would be socially optimal—that is, when investors take only private—rather than social—benefits into consideration. Cost-recovery incentives can offer some advantages over corporate rate exemptions/reductions.

Investment allowances, which allow investors to write off a certain percentage of their costs immediately in addition to normal allowable depreciations, provide a much better targeting instrument to promote particular types of investments and ensure that the attendant revenue costs are both more transparent and easier to control. Investment allowances do, however, distort the choice of capital assets in favor of short-lived ones and may open the process to abuse if enterprises try to sell and repurchase equipment to claim multiple allowances (a minimum holding period can forestall this risk).

Investment tax credits allow investors to deduct a stipulated percentage of their investment costs from corporate tax liabilities. This type of incentive can be implemented fairly simply by depositing tax credits in a special tax account (in the form of a bookkeeping entry) and allowing these credits to be paid down to meet tax liabilities. The total revenue forgone is easily tracked, and total credits can be determined in advance and included in the budget as a tax expenditure.

According to the authors, *accelerated depreciation* has the fewest shortcomings of any incentive associated with corporate tax rates and all the virtues that investment cost-recovery incentives offer. It does not distort in favor of short-lived assets and permits few of the abuses connected with investment allowances/tax credits. Accelerated depreciation also effectively moves the corporate income tax closer to a consumption-based tax, thus reducing the distortion that an income-based tax typically produces against investment.



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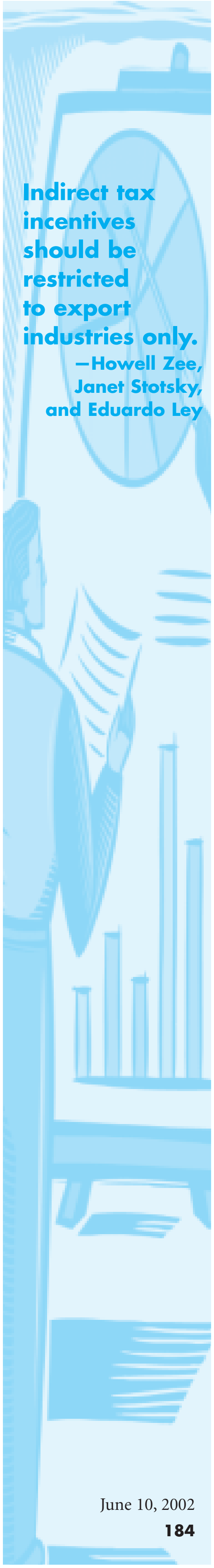
—Howell Zee, Janet Stotsky, and Eduardo Ley



Indirect tax incentives should be restricted to export industries only.
—Howell Zee, Janet Stotsky, and Eduardo Ley

Investment subsidies share some of the merits of investment allowances/tax credits—such as ease of targeting and transparent revenue costs—but the downsides make them the least advisable of all tax incentive options. These subsidies entail up-front out-of-pocket government expenditures (rather than forgone revenue) and benefit investors even when investments prove nonviable.

Indirect tax incentives usually take the form of partial or full exemptions from import tariffs, excises, and/or sales tax (including the value-added tax (VAT)) on inputs. Though these incentives are commonly provided to export-oriented industries, many countries also grant them to other targeted industries. The drawbacks of indirect tax incentives are many and serious: they are prone to abuse (purchases can readily be transferred to unqualified uses) and are difficult to justify on policy grounds. In most cases, better solutions exist elsewhere, and, in all instances, the authors stress, indirect tax incentives should be restricted to export industries only.

Export-oriented incentives are common worldwide and are frequently justified on the basis of destination-based taxation. For these incentives, then, the key question is not whether but what form the exemptions should take.

Tariff exemptions can be offered under two possible mechanisms—duty drawback schemes (refunds for the portion of imported goods that is embedded in exported goods) and suspensive regimes (suspended tariffs for qualified exporters). The choice between the two hinges on the quality of a country's customs and tax administrations. Drawback schemes, which have a lower risk of leakage, are more suitable for countries with relatively weak administrative capabilities, but they cause cash-flow problems for exporters. Suspensive regimes eliminate the cash-flow burden completely but expose countries to higher risks of leakage. For this reason, they are appropriate only for countries with strong and effective customs and tax administrations.

VAT exemptions. Under a destination-based VAT regime, exports are zero rated. In theory, a zero rating of inputs used in the direct production of export is unnecessary; taxes paid on such inputs will be credited. In practice, however, major exporters chronically find themselves with excess credits and thus bear a significant cash-flow burden. To address this problem, many countries suspend the VAT imposed on inputs for export-only production, but again, given leakage risks, this action is advisable only in countries with strong customs and tax administrations.

Export processing zones, often fenced off and treated as extraterritorial areas, are common in developing countries and are designed to promote exports and attract labor-intensive industries. Typically, these zones offer both direct and indirect tax incentives, and complete exemptions from all taxes are not uncommon. In practice, however, there is rampant leakage of goods from these zones into domestic markets and little compelling evidence to suggest the zones, in and of themselves, promote exports. The authors advise countries to avoid setting up such zones and to dismantle existing ones. Where dismantling is not an option, they recommend using only indirect tax incentives so that the loss of revenue can be minimized (direct tax incentives tend to attract non-export-related activities and may violate World Trade Organization rules).

Rules of thumb

What's an investment-hungry developing country to do, then? Zee, Stotsky, and Ley summarize their primer with six pieces of advice:

- The best approach to stimulating investment is always to ensure that your tax system conforms with international norms and that your country offers sound macroeconomic, structural, legal, and regulatory environments.
- If tax incentives can be economically justified, make certain that their design and administration maximize transparency and minimize discretion.
- In choosing an appropriate tax incentive, remember that a faster recovery of investment costs is more cost-effective than a reduction in corporate tax rates (and tax holidays are the worst).
- Keep in mind that indirect tax incentives invite abuse. Limit their use to the removal of import duties on export-related inputs.
- In general, export processing zones are a bad idea. If they cannot be shut down, at least avoid the use of direct tax incentives.
- Make the legal basis for incentives, their economic consequences, and their administrative procedures transparent, and use simple qualifying criteria to ease enforcement and monitoring. ■

Photo credits: Denio Zara, Padraic Hughes, Pedro Márquez, and Michael Spilotro for the IMF; Darren Whiteside for Reuters, page 177, and 179–180; United Nations, page 178.

Interview with John Shoven

Personal retirement accounts can be a long-term fix for U.S. Social Security

The U.S. Social Security system—created in the 1930s as an antipoverty program for widows and their dependents—has expanded dramatically to include a retirement program (Old Age, Survivor, and Dependent Insurance) and a health care plan (Medicare). By 2017, however, expenses for Social Security benefits will exceed incoming revenues. While the Social Security trust fund is currently accumulating large surpluses, there will be sharp demographic shifts once the baby boomers retire. The Social Security system is projected to run a deficit by 2017 and run out of money between 2028 (for Medicare) and 2047 (for its retirement program). In a recent IMF Institute seminar, Stanford University Professor John Shoven detailed his proposal for a system of personal retirement accounts that would restore financial soundness to the retirement portion of Social Security. He speaks here with Christopher MacDonagh-Dumler of the IMF's Western Hemisphere Department about Social Security options and why the fiscal accounting used for this and other U.S. government trust funds warrants closer scrutiny.

MacDonagh-Dumler: The debate on how to "save Social Security" has produced many options, but few proposals advocate meaningful change, particularly given Social Security' s current large surpluses. Indeed, why should we change now?

Shoven: Whatever changes are needed for 2017 and beyond, it is better politically and economically to announce them now, so that people can plan for them. Don't be fooled by the surpluses; they are merely the product of uneven demographics. If you simply look at the cash flow, Social Security is doing fine and will continue to do well for another decade or so. But the surpluses are misleading. They reflect the taxes of a large cohort of baby boomers who are in their peak earning years. These taxes are underwriting the current benefits of a relatively small cohort born during the Great Depression and World War II. We have 6 to 10 years before the first baby boomers—those born in 1946 and 1947—begin to retire. After that, the number of baby-boomer retirees will grow quickly, and the economics of the system will deteriorate rapidly. But this is all foreseeable, and we would be foolish to do nothing until that happens.

MacDonagh-Dumler: How would your proposed system work, and how does it contrast with the three proposals that came out of the Bush administration's Commission to Strengthen Social Security?

Shoven: "Don't be fooled by surpluses. They reflect the taxes of a large cohort of baby boomers who are in their peak earning years."

Shoven: Our plan, developed jointly with Syl Schieber of Watson Wyatt, takes a "clean sheet" approach. It entails virtually a complete change in the system, but is phased in very gradually. Under our plan, those currently over the age of 55 would receive exactly their present legislated benefits. Anyone under 25 would be solely on this new plan. For everyone between the ages of 25 and 55, benefits would reflect a mix of the old and new plans.

Our proposal has two components. The first tier is a safety net; it would provide a flat monthly benefit of $550 in today's dollars. Two-earner married couples would get $1,100. For low-income workers, $550 is a pretty solid floor. For those making $80,000, $550 a month does not look nearly as good, but that is how we wanted it.

The second tier is a mandatory personal retirement account that reflects 5 percent of a worker's wage up to an $85,000 cap. Workers would contribute 2½ percent of their pay; and the government would match this on a 1:1 basis. It would be similar to a 401(k) account with a 100 percent match—something that is very popular in the U.S. private sector. Of course, workers would still need to pay existing payroll taxes to fund the program for the current set of retirees. Using assumptions from the Office of the Chief Actuary for Social Security, our system is financially viable. We have estimated that total benefits would very likely be as high as, or higher than, current legislated benefits. I say "very likely" because investments in risky assets, such as stocks and bonds, have uncertain rates of return. If you took no risks and invested in inflation-indexed government bonds, most people would receive a little bit more than they would today.,

We can fiddle with the retirement age, adjust the way initial benefits are indexed, raise taxes, or do some of each. But a significant overhaul is needed to save the traditional system.
—John Shoven

So, the benefits are as generous as today's, but the program requires an additional contribution of 2½ percent. No plan to return Social Security to financial soundness will work if it does not cut benefits or find new money. We decided to find more money. Two of the three Bush commission proposals went in the opposite direction and cut benefits.

MACDONAGH-DUMLER: Are benefit cuts the biggest difference between the commission's plans and yours?

SHOVEN: Essentially. I would be very happy—and I hope the commission would be happy—if people recognized that there are *only* two options: provide additional money or cut benefits.

While there are several ways to cut benefits, the commission suggested one that has not received much attention but deserves greater scrutiny because it can greatly improve the system's finances by changing the way initial benefits are indexed. Under the current system, initial benefits are based on a retiree's past wages, with past wages brought up to date using an index of U.S. wage inflation during the retiree's working years. During retirement, these benefits then increase with the consumer price index (CPI). One of the commission's plans would switch the indexing of initial benefits from average wages to the CPI. This simple change nearly returns the system to solvency without raising taxes.

However, the change is larger than it seems. Fifty years from now, those benefits would be quite a bit lower than current legislative promises—maybe one-third lower. But that is the magnitude of the problem and the amount by which benefits will need to be cut if taxes are not raised. The bottom line is that benefits need to be cut by 30–40 percent or taxes raised by 40–50 percent.

It is also worth debating a change in the normal retirement age or, more accurately, the age when one can claim full Social Security benefits. Under current law, the normal retirement age increases to 67 in the mid-2020s, but remains fixed at 67 thereafter. It seems reasonable to expect that by 2080, life expectancy will be four years longer, so the retirement age should also increase to help keep the system in balance. The proposal that Schieber and I developed would index increases in the retirement age to changes in life expectancy to keep the proportion of working life to the length of retirement constant.

MACDONAGH-DUMLER: In last year's report on the U.S. economy, IMF staff noted that with relatively small parametric changes—for example, a 2–4 percentage point increase in payroll taxes—the United States could maintain the current system. This does not seem like a large increase. Are more resources required than that?

SHOVEN: No, but you have only 100 percentage points to play with, so 2–4 percentage points should not be taken lightly. Our plan has a mandatory contribution of 2½ percent, which—over 40 years—is equivalent to one year's pay that is being forced into an account. A plan to maintain the current system would divert even more. We can fiddle with the retirement age, adjust the way initial benefits are indexed, raise taxes, or do some of each. But a significant overhaul is needed to save the traditional system.

If the retirement portion of Social Security were the only problem, shoring up the current system would be more thinkable. However, Medicare—the health care portion of Social Security—is, by most accounts, in even worse shape. It will, almost inevitably, need more taxes. Neither we nor the commission has come up with a Medicare fix.

MACDONAGH-DUMLER: An often overlooked component of personal retirement accounts is how to draw down the money during retirement. Currently, retirees use annuities, but the annuity market is actuarially unfair. Does your plan address this? And, do you require annuitization?

SHOVEN: Great question. Why are annuity markets unfair? Adverse selection. The only retirees who currently want an annuity are those who are in good health and expect to live longer than the average age.

The private part of our plan would be susceptible to this problem. People will be free to do what they want with their own part of the individual account. But the government's half would be mandatorily annuitized and, for that half, there would be no adverse selection. I would encourage people to annuitize their own money as well, but economists do believe in choice, particularly with one's own money.

Selected IMF rates

Week beginning	SDR interest rate	Rate of remuneration	Rate of charge
May 27	2.31	2.31	2.96
June 3	2.32	2.32	2.97

The SDR interest rate and the rate of remuneration are equal to a weighted average of interest rates on specified short-term domestic obligations in the money markets of the five countries whose currencies constitute the SDR valuation basket. The rate of remuneration is the rate of return on members' remunerated reserve tranche positions. The rate of charge, a proportion of the SDR interest rate, is the cost of using the IMF's financial resources. All three rates are computed each Friday for the following week. The basic rates of remuneration and charge are further adjusted to reflect burden-sharing arrangements. For the latest rates, call (202) 623-7171 or check the IMF website (www.imf.org/cgi-shl/bur.pl?2001).

General information on IMF finances, including rates, may be accessed at www.imf.org/external/fin.htm.

Data: IMF Treasurer's Department

MacDonagh-Dumler: What impact would these accounts have on the annuity market?

Shoven: With or without these proposed individual accounts, the annuity market in the United States is going to grow rapidly. The 401(k)s and IRAs [individual retirement accounts], which became popular in the mid-1980s, are still in the accumulation phase. The payout phase is approaching, though, with the impending retirement of the baby-boom generation. As that generation begins to retire, the annuity market will grow. Obviously, a new system of individual accounts would just increase the attention paid to annuities.

Now, will we need additional regulation? I would be tempted to wait and see as we get to this payout phase.

MacDonagh-Dumler: What can the IMF do to help advance the Social Security debate?

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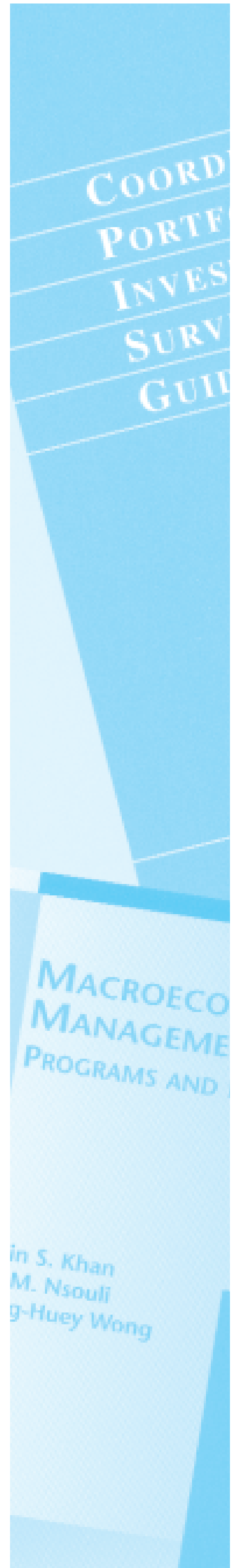

SHOVEN: I see two important roles for the IMF. First, greater attention needs to be paid to the impact of demographics on current budgets. The current method of fiscal accounting in the United States can hide the impact of demographics and make budget surpluses seem larger than they really are.

Second, U.S. budgets are not consistent in their handling of trust funds. In many ways, the U.S. government has used trust funds—such as the Social Security trust fund—to hide liabilities in the same way that U.S. corporations have used offshore accounts to shelter themselves from taxes. The U.S. government budget has announced artificially large surpluses (and smaller deficits) because U.S. consolidated budget accounting has counted the Social Security surplus toward the overall budget surplus but excluded interest payments on those trust funds.

If there were proper accounting, one of two things would happen. Either trust funds would not count their bonds as assets—in which case the surplus calculation is correct but the Social Security System will be insolvent in 2017 when benefits exceed tax revenues. Or it could extend the life of Social Security to about 2040 by treating the trust fund bonds as legitimate assets, but then the U.S. government could not count the trust fund surpluses as income and would have to recognize the interest payments it makes on trust fund bonds. If the government took these steps, then the announced deficit would be significantly higher (by at least $200 billion).

The magnitude of this error is so large because it is not only Social Security, but Medicare, highway, and military retirement trust funds that we are talking about. Taken together, these account for $2 trillion in government bonds. If the United States charged itself interest on its trust funds and kept its hands off the Social Security trust fund, the United States would be running a much larger deficit.

I would like to see the IMF look at government and trust fund accounting and ask the questions that the auditors should have asked of Enron. The U.S. government should not be able to commit the same accounting sins that the private sector did. In many ways, these trust funds have been the "offshore" accounts for the U.S. government, allowing Congress or the administration to consolidate the surpluses—and exclude the costs—when it is politically expedient. ■

IMF Institute seminar

Is finance good for growth?

Do countries with better-developed banks and stock markets grow faster? Ross Levine, Carlson Professor of Finance at the University of Minnesota, pointed out in a May 24 IMF Institute seminar that economists hold startlingly different opinions about whether financial markets help or hurt economic growth in the long run. Drawing on theoretical debates and evidence collected from a wide range of sources, he suggested that banks and securities markets stimulate economic growth through improved resource allocation rather than through a higher saving rate. He also explored which regulatory policies promote healthy financial development.

Two key questions frame the financial development and growth debate: Do stock markets and financial institutions in developing countries function as little more than casinos where international investment bankers come to place bets? Or do financial markets fundamentally affect how countries develop over the long run? And, assuming some relationship between financial development and economic growth, what type of legal, regulatory, and policy changes should a country adopt?

The debate has a long history and prestigious participants, but its arguments can be broken down into five major viewpoints. U.S. Treasury Secretary Alexander Hamilton argued in 1791 that "banks are the happiest engines that ever were invented for creating economic growth"—encapsulating the view that financial systems play a positive and prominent role. Ever Hamilton's opponent, John Adams, second president of the United States, took up the opposing view that "banks have done more harm to the morality, tranquility, and even wealth of this nation than they have done or ever will do good."

According to another perspective, that of economist Joan Robinson and others, there is a relationship, but it is reversed: finance follows growth. A fourth view dismisses finance as not mattering for growth, attributing growth to such factors as technological progress. Finally, a fifth view sees a role for financial markets that derives from the crises that emerge from time to time, rather than because of any strong links between finance and economic growth per se.

Which of these views is right? To try to answer this, Levine first looked at some of the theoretical arguments about what financial intermediaries and markets do and why finance would, or would not, matter. According to banker and journalist Walter Bagehot's observation from the mid-nineteenth century, financial intermediaries and markets boost growth by mobilizing capital to undertake "immense works." An important point to keep in mind here, Levine stressed, is that the link between finance and growth does not run through savings—because a lot of evidence suggests that high saving rates have little impact on economic growth. Bagehot's key argument is that if one entity can mobilize a large amount of capital and channel it to certain large projects that require a huge investment of capital—such as building railroads—there may be economies of scale.

Joseph Schumpeter, commonly known as the father of development economics, believed that financial intermediaries promoted growth by mobilizing society's savings and deciding which firms could use them. So, to the extent that the financial system makes the right choices as to where these savings should go, capital will be allocated more efficiently, boosting economic growth. A key follow-up aspect of this allocation process, Levine explained, is the monitoring of firms by banks once funds have been invested. In other words, there must be a way to ensure that the managers of a particular firm don't misuse the loaned funds by acquiring information about a firm and its managers.

Financial intermediaries—specifically, liquid financial markets—reduce a major disincentive to investing in large, long-term projects that take time to pay off investors. A liquid market allows investors to get in and out of investments—making it more likely investors will get in, because they know their funds will not have to remain tied up for the long term. Thus, an economy with liquid markets has greater opportunity to exploit investment opportunities.

Managing risk is another way financial intermediaries and markets promote growth. Financial markets with the ability to diversify risk make it easier for individuals to undertake risky investments. That is, total risk goes down if assets are invested in a large number of different entities.

Does finance hurt growth?

But there are also a variety of theoretical models suggesting that financial development and improvements in financial systems can hurt growth in the long run, Levine noted. First, if the financial system does a good job of allocating capital, the returns to savings may increase. There is a theoretical possibility that higher returns may lower saving rates, however. And if savings are key to growth, the improvements in the financial systems may decrease savings enough to slow growth.

Another key way in which financial development can hurt long-run growth has to do with the ambiguous effects of diversified risk on saving rates. If the riskiness of investors' portfolios declines, the accompanying decline in general uncertainty may reduce investors' precautionary savings. Again, here, if savings are key to growth, financial development may decrease savings enough to slow growth.

According to a third model that does not see any positive link between financial development and growth, some third factor may be driving finance and growth. In this case, finance actually doesn't matter for growth.

How does one measure how well the economy provides these financial services? Levine first looked at how the size of a financial system could be gauged, noting that financial depth can be measured in a variety of ways. For example, some measures deal with the total size of the financial sector, others focus just on the size of

the commercial banking sector, and still others focus on how much credit is allocated to the private sector as a share of GDP. Despite the various forms that these measures take, they tend to do a "phenomenally good job" of predicting GDP growth trends, Levine observed. Categorizing nearly 100 countries into four groups based on their financial depth in 1960, Levine found that those countries with deeper financial markets in 1960 tended to grow faster over the next 40 years than those countries with more shallow financial markets.

Through what channel does this link occur? Looking at productivity growth trends during 1960–99 for the same four groups of countries, Levine found that the positive link between financial depth and growth seemed to be closely associated with productivity growth. Looking at private savings over the same period for these countries, Levine found the link to be much weaker: financial depth does not predict saving rates.

In relating stock market liquidity to GDP growth and productivity growth, Levine also found a strongly positive correlation: countries with more liquid stock markets tend to grow faster. Again, the data do not show a close association between stock market liquidity and private saving rates.

The data also show that neither stock market size nor stock market volatility is a good predictor of economic growth. This suggests, Levine argued, that the

The impact of finance on growth is big, is not due to reverse causality, and runs primarily through productivity.
—Ross Levine

ability to trade shares on a stock exchange—rather than the total value of an exchange's share listings or the volatility of market indices—is the important factor for stock market development to have a positive impact on economic growth.

Moreover, Levine said, the issue is not whether banks *or* stock markets should provide liquidity but rather that banks and stock markets could *both* provide a liquidity function. When he categorized countries according to stock market liquidity, Levine found that those with more liquid markets grew faster. When he categorized the same countries according to the level of banking development, he found that those with more highly developed banking sectors grew faster. But economies with liquid equity markets and highly developed banking sectors grew still faster.

Levine also found that the strong link between finance and growth doesn't seem to be due to other country-specific effects—for example, openness to trade or inflation. Furthermore, he concluded from the evidence collected that the impact of finance on growth is big, is not due to reverse causality, and runs primarily through productivity.

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Transcripts

Press Briefing, Thomas C. Dawson, Director, IMF External Relations Department, May 16

Best "best practices"

Assuming some relationship between financial development and growth, what should we do about it? Levine said he had devoted most of his work over the past five years to the question of what works and what doesn't with regard to bank regulation and supervision.

More and more work is under way to create larger and larger lists of "best practices," Levine acknowledged. And these lists cover many things—including what banks can do, bank entry policies, ownership, supervisory power, capital adequacy, loan classification, deposit insurance design, and information disclosure. The problem, he pointed out, is that there has essentially been no cross-country evidence that best practices in these areas are truly "best." In addition, actual data on the interrelationships between bank performance and best practices are scarce. For example, Levine argued, how can one properly assess whether official supervision of banks is effective when information on the ability of the private sector to monitor banks is lacking?

Together with James Barth and Gerard Caprio, Jr., Levine undertook the first broad cross-country study—surveying bank regulation in 107 countries—to try to remedy this data gap somewhat and examine the interrelationships between bank performance and best practices. Describing the data collection process as "painful," Levine recounted the experience he and his colleagues had had in designing (and redesigning) surveys and then administering the surveys with extensive follow-up. They concluded that creating a powerful official supervisory agency may or may not produce good outcomes because the agency may not actually do what it was created to do. Moreover, closed political systems, which can be vulnerable to corruption, may worsen this negative relationship between official supervisory power and bank development.

They also found that generous deposit insurance schemes and government ownership of banks are associated with "bad outcomes" for bank stability and for performance, respectively. The disruptive effects of a generous deposit insurance scheme tend to be mitigated in countries with a strong rule of law, however. Data also showed that restrictions on bank activities and entry tend to negatively affect bank stability and performance. By contrast, diversified bank activities and ownership tend to produce good outcomes. In countries with extensive private monitoring of banks—forcing banks to disclose information—outcomes also tend to be successful. Levine thus concluded that a major regulatory focus for financial sector development should be on incentives for diversification and private monitoring. ■

IMFSURVEY

Nobel Laureate North argues institutions have crucial role in economic growth

Why do some economies grow, while others remain stagnant? This question lies at the heart of economic growth theory and was the focus of a recent IMF Institute seminar offered by Douglas North, Professor of Economics at Washington University (St. Louis). North, who was awarded the Nobel Prize in economics in 1993 with Robert Fogel for their work in reviewing research in economic history by applying economic theory and quantitative methods to explain economic change, outlined why he believes institutions are at the heart of the dynamic process of economic development.

Economists know a great deal about the benefits of economic development, but much less about how to generate it. Why this incomplete picture? North contended that economists have long struggled with two fundamental limitations. First, the neoclassical economic theory they use is mostly static—that is, concerned with the performance of an economy at an instant in time, while economies are dynamic and their players change all the time. Indeed, most of the interesting problems that occupy national policymakers and IMF economists deal with how to make economies perform over time.

Second, neoclassical economic thought originally viewed economies as frictionless, assuming markets worked perfectly, information was symmetrical, governments were neutral, and institutions did not matter. North, who came to the study of neo-institutional economics from the perspective of a historian, holds that institutions do, in fact, matter a great deal. From his vantage point, institutions form the incentive structure of a society and, as such, provide the underlying determinants of economic performance. Any economic prescription that fails to take institutions into account, he emphasized, is bound to fail.

What are institutions? According to North, they are, broadly speaking, the rules of the game in a society. They are the way humans structure their interactions. Without them, there is no order, no civilization. These rules of the game, he said, have three components:

Formal rules—namely, constitutions, laws, and regulations—are straightforward and are put in place and enforced by political entities.

Informal rules—that is, the norms of behavior, conventions, and self-imposed codes of conduct that govern so much of human interaction—are more complicated and much less well understood. North cited the example of many Latin American countries that adopted the U.S. Constitution when they gained their independence in the nineteenth century, but whose economic and political results differed radically from those of the United States. What determines a country's performance, he said, is a combination of formal rules, modified by informal rules and enforcement characteristics. If informal rules do not complement the formal rules, the results will be radically different from what was intended. And while formal rules can be put in place quickly, informal rules, such as norms of behavior, take hold over a long period. A country can adopt property rights in an afternoon, but enforcing them and developing the norms to complement them can take another 20 or 30 years, he noted.

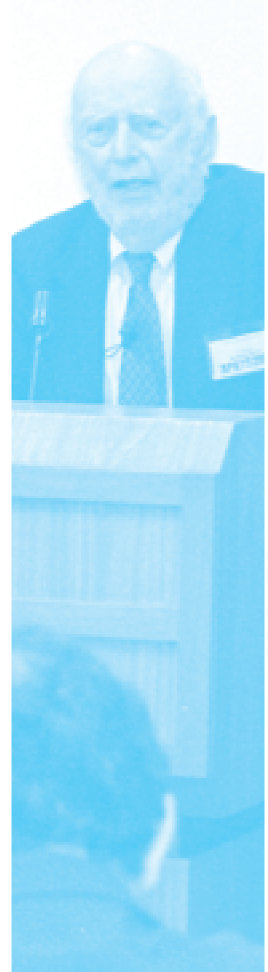
Enforcement, which typically takes place in multiple, often reenforcing, ways in societies, takes place on three levels. First-party enforcement relies on self-enforced codes of ethics or behavior; second-party enforcement depends on the ability to retaliate; and third-party enforcement depends on governments to carry out the terms of agreements.

It is the mixture of formal and informal rules and enforcement characteristics that shape a society's incentive structure, North observed. And it is the incentive structure, in turn, that determines the way in which participants in the economy, such as organizations and firms, play the game. When incentives encourage people to be productive, economies grow, and when they encourage unproductive behavior, economies stagnate. The beginning of wisdom, according to North, is to understand how the game is played in any society.

Determining transaction costs

Political entities establish the formal rules and specify how they are enforced. For this reason, they are always at the heart of the incentive structure. But political organizations, which are the result of aggregated choices, are also imperfect. The choices of certain groups have mattered more in this process, and thus political entities are never completely impartial, even in working democracies. And herein lies the dilemma, according to North, because far less is known about how to make political markets work well in the short run than is known about economic markets.

To explore this dilemma, North used the transaction cost framework. Transaction costs are the costs of engaging in exchange. As economic systems grow and become more successful, the aggregate resources invested in transactions also grow. In the United States, for example, transaction costs accounted for 25 percent



Any economic prescription that fails to take institutions into account is bound to fail.
—Douglas North

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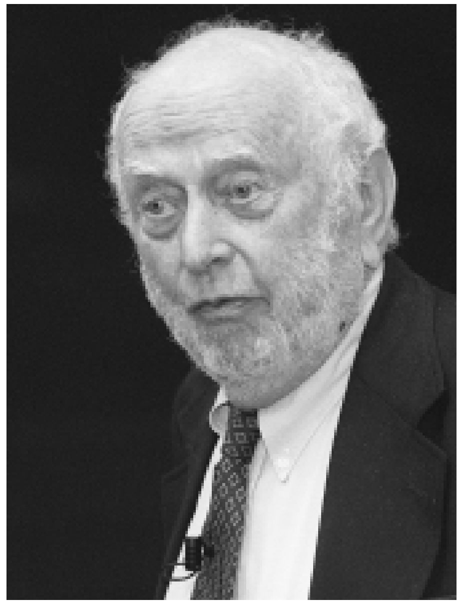
of GNP in 1870. By 1970, they had grown to 45 percent and may be well over half of GNP today. They grow not because an economy becomes more inefficient but for the opposite reason: as economic activity increases, more resources are needed to handle transactions. But while transaction costs grow overall (providing employment for accountants, lawyers, regulators, and the like) in an expanding economy, they induce falling production costs and hence falling total costs. The reduced cost for each transaction encourages further exchange and, hence, increased growth and productivity.

But in political markets, participant incentives are so diluted that they are far less effective in reducing transaction costs. In a democracy, for example, knowledge that a single vote is unlikely to make a difference affects the behavior (and motivation) of the voter. Moreover, as already noted, it is the informal rules, more so than the formal rules, that constrain behavior.

Obstacles to good performance

What constraints keep economies from growing vigorously? North combed economic history to highlight three fundamental obstacles to good performance.

Institutional requirements for the transition from personal to impersonal forms of exchange. Throughout most of history, North noted, transactions took place through personal exchanges based on the reputations and personal relations of the parties involved. But as markets grew, this form of exchange had to give way to more impersonal exchanges. This highly complex transformation required both institutions and enforcement mechanisms. From 1000 A.D. to 1800 A.D. in Western Europe, for example, a host of such institutions and institutional devices evolved. Such things as banks and bills of exchange made large-scale and impersonal exchange predictable, safe, and, therefore, possible. But look at poor economies, and you will see that these same institutions failed to develop. And, as mentioned earlier, enforcement must complement and sustain essential institutions as they develop. Economies need third-party enforcement, for example, to allow capital markets to develop and thrive. Third-party enforcement, of course, is established by governments that are rarely completely neutral, but to be effective, the system must be impartial enough to encourage people to engage in exchange. We do not know how to get governments to do that.



North: "The beginning of wisdom is to understand how the game is played in any society."

As markets grow, knowledge itself becomes specialized. But specialized knowledge becomes valuable only when it can be combined with other knowledge at a low transaction cost. For example, for genetic research in the United States to produce economic results, a vast network of entities from disparate parts of the economy must be able to interact. This does not occur automatically, even in an advanced country with a well-developed price system. Economies have to build bridges between different parts of their markets to allow the exchange of knowledge to take place at a low transaction cost. Poor countries find it difficult to achieve this type of integration over a short time span.

Knowing how to make markets work efficiently. Every market is different, and to work well, each market must find the right mix of formal and informal rules and the appropriate enforcement characteristics. But what makes a market work well in one moment in time may not necessarily continue to work well over time. Important elements (technology, information costs, and political entities) can change, raising transaction costs in the process (Japan is a case in point). Thus, to provide prescriptions that work, economists need to view constraints over time rather than at a single point in time.

What lessons can be drawn from all this? First, North said, history tells us that the world does not have an inherent structure built upon predetermined rules. We can learn from the past, but we cannot rely solely on past experience to provide solutions to today's complex problems. Second, because we are limited in our ability to influence informal rules and enforcement, we are also limited in our ability to improve economic performance.

Finally, while we do not know how to make political entities work well, our knowledge is growing in this area. We know, for example, that successful economies, such as the U.S. economy, have flexible rather than rigid institutions, capable of adapting and evolving as change is needed. To cope with uncertainty, North concluded, institutions must have the scope to try different ways of doing things and discard those that do not work. ■

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