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Volume Title: Developing Country Debt and the World Economy

Volume Author/Editor: Jeffrey D. Sachs, editor

Volume Publisher: University of Chicago Press, 1989

Volume ISBN: 0-226-73338-6

Volume URL: <http://www.nber.org/books/sach89-3>

Conference Date: September 21-23, 1987

Publication Date: 1989

Chapter Title: Remarks on Country Studies

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Chapter URL: <http://www.nber.org/chapters/c7527>

Chapter pages in book: (p. 212 - 222)

Remarks on Country Studies

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I found the papers analyzing the origins of overindebtedness in a group of Latin American countries both interesting and original. I read them without the feeling of “*déjà vu*,” which now seems inevitable when facing publications on the debt problem.

A reading of the Latin American case studies and Jeffrey Sachs’s overview chapter leads one to the conclusion that an understanding of the political economy of fiscal policy may be a key to understanding both the origins of the debt crisis and the policies needed for overcoming it. The problem of fiscal policy-making in the region is therefore the issue I would like to deal with in these comments.

Concentrating on that issue, which addresses the area of national policy-making, does not mean, however, that I include myself in the camp of those who blame the debt crisis exclusively on the policy mistakes of the debtor countries. We are all aware that the best solution to the debt problem is rapid growth in the OECD countries and enhanced access for Latin American exports to the industrialized economies.

I can even imagine countries conditioning the payment of interest on their debt to certain market-opening measures or increases in import quotas. Such a bargaining strategy would require broadening the debt bargaining process to include not only developed country bankers, the multilateral financial institutions, and ministers of finance from debtor countries, but also trade ministers from indebted and industrialized countries. I should imagine that the issue of who sits at the debt bar-

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gaining table will be argued with ever greater emphasis by the developing countries in the following months.

Because the relationship between trade and debt is well known, and the inconsistency between protectionism and the servicing of the debt has been thoroughly explored elsewhere, I would like to concentrate on the analysis of national policy responses to the debt crisis.

The Origins of the Debt Crisis in Latin America

The Brazilian case study suggests that even before the second oil shock, "there were signs of an accumulating domestic disequilibrium as the ambitious investment plan was followed. Government expenditures outran its finance. . . ." The study shows, therefore, that the accumulation of debt was in good part caused by the fiscal deficit. But Cardoso and Fishlow also blame the fiscal deficit for the failure of the stabilization attempts, including the Cruzado Plan. "The budget deficit is central not only to the failure of the Cruzado Plan, but to the acceleration of inflation and high real interest rates of the 1981–84 stabilization period."

The Mexican crisis has even clearer fiscal origins. As Buffie and Krause point out, during the 1977–82 period, Mexico enjoyed very favorable terms of trade and was blessed by the discovery of enormous oil wealth. The Lopez Portillo administration simply matched those windfalls by an extraordinary increase in government spending. Fiscal statistics support their claim. Total real public-sector expenditure increased by 94.4 percent in four years, climbing from 31.0 percent of GDP in 1978 to 41.3 percent in 1981.

The cause of the Mexican crisis of the 1980s was largely fiscal, and the difficulties experienced with the economic adjustment process had the same cause. The authors conclude that

[t]he De La Madrid administration has not offset higher debt service payments and lower oil prices with adequate fiscal adjustment. Instead, limited tax increases and cuts in current expenditure have been supplemented by a variety of other policies aimed at restraining the inflationary pressures created by the large fiscal deficits. . . . In imposing high reserve ratios, in requiring banks to allocate a large share of their portfolio to the purchase of various government issued assets, in financing a greater part of the fiscal deficit through bond sales, and in reducing expenditures to augment the stock of infrastructure capital, a series of devastating blows have been dealt to the profitability of private investment.

One wonders why governments can do anything except tax reform. The other measures affect profits, as would taxes, but taxation seems politically impossible. Why? We can receive some enlightenment by looking at the extreme policy disasters of Bolivia.

I found the paper by Morales and Sachs particularly interesting. The only quibble I have with it is that they start their story after the 1952 revolution. I am not an expert on Bolivian history, but I understand that the Revolution of 1952 was truly a revolution, and that it destroyed a feudal social order. The land reform was radical and effective. The depth of the transformation may explain part of the postrevolutionary political instability. In Europe the revolutionary replacement of the feudal order by a bourgeois state was also often followed by substantial political instability and frequent military governments.

The post-1952 story, however, rightly emphasizes the pervasiveness of an ideology that assigns the state a leading role in development policy, in a political context where governments do not have the power and organization to tax income and wealth. The contradiction between the role assigned to government in the development process and the political impossibility of producing income for the government through taxation meant that governments of both right and left continuously tried to finance a large modernizing state either through foreign debt or inflation.

The interesting question to ask is why in Bolivia, and in other Latin American nations, taxation was never really tried as a source of finance for the kind of state that the dominant ideology demanded.

Some Hypothesis on the Political Economy of Fiscal Policy

Morales and Sachs relate how in Bolivia governments on the left sought redistribution through higher wages and a larger role for public-sector workers, while governments on the right sought instead to bolster favored segments of the private sector through generous government subsidies. What appears to happen is that the middle class political and military elites pressure for increased government expenditure and never consider the possibility of taxing themselves.

When the power base of a regime is exclusively middle class, taxation is unattractive because the easiest group to tax in developing countries is employees of the formal sector. Latin American middle-class ideologues, therefore, are not fanatics of the income tax or of sales taxes. Middle class governments also do not have sufficient bureaucratic control of the countryside to tax land directly, so they attempt to do it through import tariffs and price controls. But short of stalinist agricultural price controls, agricultural price policy is not easily translated into central government tax revenues.

The more traditional politicians, with a rural landlord base of support, do not want to tax land since this would mean taxing themselves. They cannot, on the other hand, tax the middle class because the army and organized labor can be mobilized to pressure the regime against urban taxes through urban violence (general strikes or threats of a coup). In

summary, regimes whose only base of support is the middle class may be unable to tax. Is that the nature of political regimes in Bolivia since 1952?

It should be pointed out that if the middle class is defined as the 7th–9th income decile, it includes the military, organized labor, and the bureaucracy. All of these groups are interested in a large state and low income and consumption taxes. This is the worst possible environment for fiscal policy. It may indeed be that in Bolivia, as in Colombia and Venezuela in the 19th century, the object of politics, as the authors point out, has been “the battle of the ‘ins’ versus the ‘outs’”. The state is then viewed as an instrument of redistribution of income *within* the middle class.

In Mexico, before Echeverría, maybe the political base was broader. Certainly the PRI had strong peasant support, which allowed it to maintain legitimacy without having to deliver large state benefits to the urban classes. The PRI could not achieve a large proportion of tax revenues to GDP, but it could maintain fiscal equilibrium by not overspending. As Mexico urbanized, the peasant base became less important and internal politics within the PRI became very dependent on the distribution of benefits within the state bureaucracy itself. This pressured government expenditure without creating a constituency for tax reforms. Also, institutionally, the chances of fiscal equilibrium diminished when the function of spending was separated from the Secretaría de Hacienda, responsible for revenues, and given to the Secretaría de Presupuesto, only responsible for spending. Significantly, the best way to get elected presidential candidate of the PRI has been to become head of the spending agency.

The military governments of Argentina also seem to have had a very narrow middle-class base. The Peronistas, dominated by the public-sector unions, simply represented another faction of the middle class.

The Colombia Case Study

There was one case in Latin America of a country that did not increase its debt excessively in the 1970s—Colombia. It also carried out at least two wide-ranging tax reforms, and maintained a low budget deficit.

Politics in Colombia have some interesting characteristics, and this may explain the country’s uncommon fiscal policies. It is a formal democracy and the political process was more participatory in the 1970s than in other nations. In this, Costa Rica, Venezuela, and some of the Caribbean countries have greater similarity to Colombia than to the countries studied in the NBER project. In Colombia, the political parties (in power for 140 years) are multiclass, and rural and urban informal sectors are influential in the parties. Finally, the government in 1974–

78 had a large rural base of support, and the president had developed a strong commitment to promoting development in the rural sector and dismantling the import substitution model of development. He was against subsidizing organized labor and industrialists, was antibureaucracy, and had his urban support among the unorganized who suffered most from inflation. In summary, the political base of the government was not middle class, and not surprisingly middle class income grew less rapidly than the income of the poor and the rich in the 1970s.

The main objective of the government in power between 1974 and 1978 was to control inflation, and, with this objective, it carried out a tax reform in 1974, and, also to control inflation, the government did not increase the foreign debt. In contrast, in the early 1980s another government, whose political base was largely the bureaucracy, increased debt and government expenditure rapidly. That policy created a minor debt crisis in 1983–84, but Colombia was the only country in Latin America that adjusted successfully after 1982. It did it by almost wiping out the fiscal deficit in 1984–85, not only by decreasing expenditures, but also by increasing taxation.

The president in 1984–85 had his political base largely among the unorganized urban masses. He had little support from the army or the upper middle class, and substantial support from a political class whose source of income is politics and not industry or large landholdings.

In summary, fiscal responsibility may only emerge in the region as the basis of support for Latin American governments is diversified. Narrow middle class governments may be incompatible with fiscal equilibrium.

Conclusions

The optimistic conclusion of the previous analysis is that the deepening of democracy that has occurred in the 1980s may facilitate in the future a more rational fiscal policy. The lesson, on the other hand, is that adjustment policies must be designed keeping in mind the high political cost of policies that affect negatively primarily the politically strong middle class.

The point is not that policies unpopular with the middle class should not be adopted. Quite the contrary. The objective should be to design components of the adjustment policy that must include tax reform, but, at the same time to take measures which will create political support for the government from other groups in society. This means the design of social investment projects and social safety nets which will develop political support from nonmiddle class constituencies.

It is not prudent to limit adjustment programs to wage restraints, liberalization of labor legislation, decreases in government employment, and elimination of urban subsidies, for all of these measures

negatively affect the politically powerful middle class. Some of the democracies in Latin America have shown that tax reform is viable within an adjustment program that generates employment and improves the prospects of the very poor or marginal groups in society. It may be that a good criterion for judging an adjustment package is to examine whether it includes tax reform *and* measures which make tax reform politically viable.

Anne O. Krueger

To provide an overview of the country studies presented is a real challenge. To focus the discussion, I shall concentrate my remarks on two main issues: the origins of the debt problems of the developing countries in the 1980s, and the political-economic assumptions that seem implicitly to underlie much of our thinking on policy issues such as foreign borrowing and debt.

Origins of the Debt Problems

There is no doubt that the worldwide recession of the early 1980s, coupled with falling commodity prices and rising nominal interest rates, exacerbated the difficulties of all debtor countries. However, some countries (e.g., Turkey) were unable to maintain debt-service even before 1980, and some (e.g., Mexico) clearly did not encounter difficulties because of external circumstances. There is no point in asking whether domestic policies or worldwide conditions led to the problems. In each country the debt problem had a magnitude, and both domestic and external factors contributed. The precise quantitative contribution of each varied from country to country.

In a sense, the fundamental question is: When a country borrows to finance current-account imbalances¹ on a continuing basis, is that borrowing path sustainable? From economic theory, we know that the current account deficit equals the excess of investment over savings. When borrowing finances additional investment with a rate of return greater than or equal to the rate of interest at which borrowing takes place, and barring serious mismatches between the timing of debt-servicing obligations and the stream of earning from the additional investment, a current account deficit should be associated with additional earning sufficient to finance debt-service obligations.

This simple framework permits development of a taxonomy with which to analyze the origins of the debt difficulties of developing

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countries. We note that investment can exceed savings either because investment is “high” compared to “normal” domestic savings (relative to a country’s per capita income level) or because investment is “normal” and domestic savings are low.²

Case 1: Investment “high” and in excess of savings; the real rate of return on investment exceeds the real interest rate. In this case, debt-servicing obligations should be readily met, except perhaps for transitory difficulties associated with jumps in the real interest rate (on variable-rate debt) or with worldwide recession. This is the “textbook” case of self-financing debt. Among the countries covered in the NBER project, Korea seems to fit here: the real rate of return on investment was high (estimated to be in excess of 30 percent); and capital inflows permitted a higher rate of investment, and therefore, economic growth, given Korean savings (which do not appear to have been low relative to per capita income, at least after the mid-1960s when borrowing started). Indonesia may also be in the group.

Case 2: Investment high, savings “normal,” but a low and possibly even negative real rate of return on investments. In this circumstance, borrowing would not be indefinitely sustainable. Earnings from debt-financed projects would increasingly fall short of debt-servicing obligations and, at some point, further borrowing along this path would be unsustainable. A rise in the world real interest rate on variable rate debt would certainly accelerate the time at which unsustainability became evident, if it did not itself precipitate a cessation of voluntary lending and an inability to meet debt-servicing obligation.

Among the countries in the NBER project, Argentina, Mexico, and the Philippines arguably fall into this category. A high fraction of domestic investments had relatively low rates of return, for reasons discussed further below.

Case 3: Investment normal, but savings “low” and/or a low real rate of return on investment. Low savings could result either because incentives failed to reflect changing conditions, as in Turkey where domestic petroleum prices were not increased significantly after the oil price increase of 1973 (so that the private consumption share was unaltered at domestic prices but increased at world prices), or because of public-sector behavior, discussed further below. Brazil, as well as Turkey prior to 1979, appears to fall in this category.

Case 4: Investment equals saving. Here there are three subcases.³

- a. Savings and investment are approximately normal relative to income, and the real rate of return is reasonably high. In this circumstance (Colombia in the 1970s) the growth rate is satisfactory and could have been augmented by borrowing.

- b. Savings and investment are “normal,” but the rate of return is low. Growth is therefore slow, but again, no debt problems emerge. India probably falls in this category.
- c. Savings and investment are “low” with either a normal or a low real rate of return on investments. In this case, growth is sluggish, but again, debt is not a problem. Burma and Haiti, among others, may fall into this category.

As these cases indicate, a country can fail to have a debt problem and nonetheless have poor economic performance. Conversely an apparently satisfactory rate of growth may be possible only because of borrowing, which may mask difficulties either with resource accumulation or resource allocation.

Case 5: Everything that can go wrong does. In addition to low domestic savings and a low real rate of return, the terms of trade deteriorate sharply enough (or crops fail badly enough) so that imports cannot be reduced as quickly as export earnings fall. In this case, debt mounts sharply and no corresponding income streams are generated.

Among the countries in the NBER project, Bolivia seems to belong here. It may simply be an extreme example of case 3, but seems to have encountered sufficiently bad fortunes to deserve a special category. Some African countries not included in the NBER project also undoubtedly belong in this group. Given earlier economic policies and low rates of return, adverse shifts in the terms of trade have been large enough to render the problem qualitatively, as well as quantitatively, different from those of other heavily indebted countries.

This taxonomy is, of course, rough, and only suggestive. It may, nonetheless, provide an organizing framework for diagnosis. To complete it, however, it is necessary to analyze the sources of low rates of return and/or savings and investment rates.

Consider low or negative real rates of return first. How can these come about? While there are obviously any number of possibilities, two sources appear to have figured prominently: (1) a trade and payments regime that provided distorted incentives of private-sector investment⁴ and (2) inefficient public-sector investment programs.

That a highly restrictive trade and payments regime can lead to privately profitable investment opportunities with a low or negative social rate of return has been documented in both theory (see Bhagwati and Srinivasan 1978) and practice (see Krueger 1978). Further, Brecher and Díaz-Alejandro (1977) have shown that capital inflows in these circumstances can have negative real returns to the economy as a whole. Cumulatively, one would expect debt-servicing difficulties to mount in these circumstances, and one suspects that the trade regime

was a major contributory factor to the debt-servicing difficulties of Turkey in 1979.

Likewise, public-sector investments can be highly inefficient. The Philippines study cites a nuclear power plant never put into operation, and that may be less inefficient than continuing to operate some white elephants. Loss-making investments are not infrequent. Mexico's and Brazil's low rates of return on investment appear to be largely attributable to this factor.

As to determinants of the savings rate, a significant factor in the 1970s was the failure of some governments, possibly most notably Turkey, and to a lesser extent Brazil, to let the domestic price of petroleum reflect the altered international terms of trade after 1974. The result was that consumption as a percentage of GNP remained relatively constant at domestic prices but rose in international prices by 2 to 3 percentage points. The borrowing that offset the current account deficit clearly did not generate any earning streams to service the debt.

Public consumption also rose sharply in a number of countries, and was not offset by tax increases. In these circumstances increased public consumption absorbed public and/or private savings. Debt accumulation permitted the maintenance of investment levels in the short term, but cumulatively, earnings streams were not generated to service them.⁵

Political Economy of Government Policy

In any discussion of debt, the role of government and governmental decision features prominently. An important question that arises in this connection is the assumptions to be made about governmental behavior. Are all actions taken by governments rational? Do governments, like individuals, decide rationally? Are choices deliberate outcomes of rational processes?

In discussions of the debt problem and needed reforms, implicit assumptions about these issues appear. Were exchange rate distortions the result of policies deliberately chosen with a full understanding of the future consequences? Or, instead, were ideas of the day with respect to the infant industry argument and the allegedly low costs of protection an important factor? This is not the occasion on which to develop a full-blown theory of government behavior. But a few comments seem to me to be in order, inspired by the implicit theories that are present in some of the papers and today's discussion.

First, what is politically infeasible today may not be tomorrow, and ideas influence both the range of choice and the feasibility of change. It was "politically impossible" to abandon a highly restrictionist trade regime in Turkey in much of the 1970s, but it was done starting in 1979

and the architect of the economic reform has won several elections based largely on his economic policies.

Second, markets respond to government policies and those responses often induce political reactions. Thus, smuggling may persuade policymakers to tighten controls or to alter the exchange rate and reduce incentives for smuggling. Either way, people respond to perceived problems based on their understanding of the consequences of alternative responses. Politicians may fear change, be uninformed as to the benefits of change, and thus resist. Within governments there are normally competing ideas and interests. But again, the professional knowledge of the economist can be important in affecting thinking.

In this regard, it is important to ask whether government policies "cause" outcomes. It is true, for example, that the Korean government "targeted" exports. But it is also true that those targets were set in consultation with exporters whose plans, in turn, were in part determined by the real exchange rate and other components of the incentive system. Were "targets" responsible for exports, or was there a process whereby the desire to increase export earnings (and the realistic exchange rate that accompanied it) set in motion a selection process to induce economically efficient exporters? If the latter, the government could still have "targeted," but the interpretation is quite different.

More generally, however, policies which have with hindsight turned out to be ill advised were often buttressed with justifications such as "infant industry," or "import substitution," or other ideas of the day. While particular interests might in any event have held sway, it is nonetheless important to bear in mind that governments are not monolithic, and that decisions are often the result of a process in which conflicting claims are resolved. In this context, the "legitimacy" of ideas is important. If there are bases on which it can be demonstrated that, e.g., the costs of an overvalued exchange rate are higher than the opponents of change assert, the likelihood that action will be taken increases.

There has been learning in the past thirty years. It has come partly out of experience, and especially from the contrast between countries whose policies were outer-oriented and those whose policies were inner-oriented. It has also come partly out of research results. It is all too easy to forget that the "climate of professional opinion" twenty years ago was much more forgiving of the policies that have been so condemned in discussions today. The role of economists in sanctioning, or at least not condemning, policy mistakes should not be ignored. Ironically, the power of ideas is often most underestimated by those whose stock in trade it is!

Evidence such as that coming out of the NBER project should further the progress of ideas. There is fear of policy reform, beyond that which

would appear warranted based on the experience of past reform efforts. The gains are usually underestimated and the losses overestimated. In the Korean case, the benefits came very quickly. As other reforms, such as the Turkish, prove less injurious and more beneficial than expected, it is to be hoped that knowledge will once again facilitate the adoption of policies leading to higher levels of economic and political welfare.

Notes

1. For expository simplicity, I ignore other techniques of financing current account deficits such as running down foreign exchange reserves (because that path is unsustainable in the longer term) and direct foreign investment (because it was not a major factor in the debt difficulties of the 1980s).

2. It could, of course, be that investment was high and savings low. Among the countries covered in the NBER project this does not seem to have been the case.

3. Ignore the case where savings and investment are "high" and the real rate of return on investment is high. This is probably the Japanese case and Korea may have entered this group in 1986.

4. It should be noted that one cannot necessarily identify the source of the problem with the category (private or public) of the borrower. Any government confronting a fiscal deficit can either borrow abroad or it can borrow domestically. If it does the latter and drives up the domestic rate of interest, private firms will be induced to borrow abroad. This mechanism seems to have been deliberately employed in Brazil, on the theory that lenders would provide more favorable terms to private than to public borrowers.

5. Note that there are two transfer problems associated with public-sector debt servicing: raising revenue domestically and buying foreign exchange. The revenue problem is apparently more acute in countries where fiscal deficits were financed with foreign borrowing, while the foreign exchange problem has probably been more acute in instances where the foreign trade regime led to low rates of return on investments.

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