

Property Rights and Income Distribution

Recent strands of the investment literature have begun to consider nonconventional determinants that are thought to be of particular relevance for developing and transitional economies. Among these are the enforcement of property rights, the elimination of unnecessary regulation, and the implications of income distribution for a stable investment climate.

The importance of property rights for investment is well established. From a practical point of view, however, the formal definition of property rights must be complemented by a judicial system that guarantees their effective enforcement (Shleifer 1994). The lack of impartial mechanisms to resolve contractual disputes increases the cost of doing business by increasing the probability that contracts will not be respected and that expenses such as bribes will become necessary to enforce them.

The issue of corruption is a critical matter for investment projects because implementing the project may involve many administrative steps, particularly in highly regulated economies. The cost of doing business may rise substantially if the investor is forced to pay bribes to expedite passage through the system. Corruption thus effectively amounts to a tax on investment. Recent cross-country work by Knack and Keefer (1994) and Mauro (1995) shows that higher levels of corruption and poor contract enforcement are associated with a significantly worse-than-average investment performance.

Eliminating unnecessary regulations and reforming the civil service to reduce corruption can therefore promote investment and growth. If, to eliminate corruption, it is necessary to raise taxes to increase salaries of civil servants, it may appear that formal taxation will just replace informal corruption levies, leaving capital formation and growth unaffected. Ethical issues aside, however, the two regimes still differ in critical respects; most important among these is that corruption “contracts,” unlike formal contracts, are notoriously difficult to enforce and thus leave unresolved the central question of property rights.

Income distribution affects capital accumulation by influencing the choice of public policies and the degree of social and political stability. An uneven distribution of income may encourage workers’ demands and incite labor militancy, increasing the degree of political conflict. It might also compel governments to seek populist policies of rapid redistribution of income that may be fiscally and economically destabilizing, as witnessed several times in Latin America during the past few decades (Dornbusch and Edwards 1991). If redistributive policies are, in turn, financed through higher taxes on capital, they will further discourage investment and growth.

Because the relation between investment and income distribution is filtered through political institutions, it may be stronger in democracies than in nondemocracies. Persson and Tabellini (1992) show for a cross-section of industrial countries a positive and marginally significant correlation between equality in income distribution and the ratio of investment to GDP, although the in-

come distribution data used, which are typically derived from household surveys, are subject to serious bias (see appendix).

Alesina and Rodrik (1992) obtain similar results. In cross-sectional regressions using the ratio of total physical investment to GDP as the dependent variable and controlling for the type of political regime (democracies or nondemocracies), they find a positive correlation between the degree of income equality and the investment ratio. They obtain a similar result when using average GDP growth rates as the dependent variable, thus suggesting that investment is an important channel through which income distribution affects the growth of GDP.

Conclusions and Policy Implications

Despite the virtuous circles of high saving, investment, and rapid growth experienced by some countries (notably in East Asia), the connections among these three variables are complex, and causality may run in several directions. Nevertheless, the recent theoretical and empirical literature supports four main conclusions. First, saving and growth reinforce each other—causality runs in both directions. Second, saving and investment are highly correlated due to low capital mobility, domestic policies that restrict large current-account imbalances, or common factors that push both variables in the same direction. Third, physical investment is a necessary, but not sufficient, condition for growth. And fourth, human capital investment, technological innovation, and appropriate policies are also necessary for sustained high growth.

Encouraging Saving

Ensuring adequate levels of saving remains a central policy concern, not only to guarantee sufficient financing for capital accumulation, but to avoid an excess of investment over saving, which may create inflationary pressures or balance of payments disequilibria. In developing countries, moreover, where extensive capital market imperfections and liquidity constraints on firms and households are the norm, increasing private saving may be essential to expanding investment.

Five lessons about the effectiveness of policies may be derived from our discussion of saving determinants and their relevance in developing countries. First, raising public saving is an effective and direct way to raise *national* saving, because the evidence shows that public saving does not crowd out private saving one to one. Indeed, available data show that the private sector offsets each dollar of public saving by dissaving only \$0.25 to \$0.50.

Second, inflows of foreign saving should be allowed and encouraged to support domestic investment—even if they help to finance consumption—as long as the country's domestic economic policy framework is sustainable, its banking

system effectively regulated and supervised, and its government restrained from providing guarantees on foreign credit flows. Foreign aid, however, is less effective than nonconcessional capital inflows in boosting domestic investment. The historical literature suggests that foreign aid finances consumption and investment in roughly equal proportions. More recent and systematic evidence, however, estimates that most aid is spent on consumption and that little goes to investment, with the exception of those countries receiving aid in excess of 15 percent of GNP. For these countries, the effects on consumption and investment are approximately equal, a result that shows that the larger the recipient economy is in relation to the amount of aid, the more fungible are foreign aid resources.

Third, one should not expect private saving to rise in response to interest rate liberalization. The evidence shows that market-determined interest rates are likely to improve financial intermediation, the quality of investment, and the quality of portfolio choices (thus avoiding or reversing capital flight and possibly raising measured saving flows). Interest rates will be ineffective, however, in increasing overall saving flows.

Fourth, financial deepening, as reflected by larger stocks of financial savings, has ambiguous effects on private saving. Relaxing constraints on consumer borrowing depresses private saving, sometimes contributing to unsustainable consumption booms, such as those in Latin America during the early 1980s and in Mexico during the early 1990s. Fifth, the evidence on the effects of mandatory unfunded social security on private saving rates is mixed, possibly because saving for bequests takes precedence over saving for retirement. Because large numbers of (poor and young) households have little or no access to credit, however, and are not saving much for retirement, starting a mandatory, fully funded pension system may boost private saving significantly.

Raising Investment

If investment and innovation are essential to sustainable growth, is an activist investment and innovation policy necessary to boost growth? In theory, the need for an activist policy can be justified by the existence of investment externalities—implied, for example, by the “public-good” nature of many technological innovations and R&D activities—that result in insufficient social investment. To correct the externality, the conventional policy response would involve subsidies, tax exemptions, or both. Alternatively, encouraging investment in public infrastructure or in human capital, both of which show strong complementarities to private investment, could also promote growth.

Although a direct intervention policy involving tax concessions and subsidies might theoretically boost growth, there are, in practice, serious limitations to the administrative and institutional abilities of government agencies to target the “right” investments and to avoid rent-seeking. In addition, recent investment studies show that, under conditions of uncertainty or

macroeconomic instability, large investment incentives will be necessary to overcome the “value of waiting” and to have a material effect on private investment.

A less direct, but potentially very effective, way to promote capital formation, product innovation, technological advancement, and growth is to provide a supportive policy and institutional framework. Such a framework would consist of four ingredients: (1) macroeconomic stability, to reduce the uncertainty surrounding investment; (2) a comparatively distortion-free relative price structure, to raise the productivity of investment; (3) a well-defined (and effectively enforced) code of property rights, to create an environment conducive to a low cost of doing business; and (4) adequate political institutions, to foster social consensus and political stability.

Appendix: Data Measurement and Quality

Available data for income, saving, and investment suffer from inadequacies, inconsistencies, and biases that undoubtedly affect the quality of empirical work (discussed in detail by Visaria 1980; Berry 1985; Fry 1988; Gersovitz 1988; Deaton 1989; and Srinivasan 1993, 1994). The following list of problems is surely not meant to stop empirical research. Its purposes are to raise awareness of possible sources of bias in existing data and to call for better data.

Saving, Investment, and Consumption

Aggregate data from national income and product accounts (NIPAs) suffer from accounting deficiencies and inconsistencies in accounting methods across time and countries.

Much income and production is excluded from NIPAs; in particular, that of informal and illegal sectors, subsistence agriculture, and households. The omission of noncash (more generally, nonrecorded) components from both income and consumption causes ratios of saving and investment to GDP to be overstated. The omission of noncash investment from income causes saving and investment ratios to be understated. The levels of saving and investment are unaffected by the omission.

Saving and investment are systematically undermeasured because purchases of consumer durables and resources spent on human capital formation (education, health, training) are misrecorded as consumption instead of investment. Theory suggests that a more adequate consumption measure should be based on the flow of services of currently owned consumer durables and part of the services rendered by human capital.

Unrecorded capital flight (underreporting of net exports) is an overestimation of external saving. It implies an underestimation of gross domestic saving, an overestimation of gross domestic investment, or both.

Investment

Gross domestic investment is often obtained as the sum of additions to overall capital by capital categories, that is, machinery and equipment, construction, and inventories. Gross investment by the public and private corporate sectors is often independently estimated from reported corporate statements. Gross investment of the rest of the economy (households and unincorporated businesses) is a residual between gross domestic investment and corporate sector investment.

The distinction between inputs and capital goods in production sectors is frequently arbitrary. The difference between gross and net investment (and saving) flows often results from arbitrary depreciation calculations for which methods vary across countries.

Maintenance of public sector capital is typically misrecorded as current expenditure, that is, as government consumption. In the United States, current and capital public expenditures are not separated; all public expenditure is misclassified as current.

Intertemporal comparisons of investment are partly spurious because they involve capital of different vintages and quality. (A similar point may be made about consumption goods.) Even in the spatial dimension, capital heterogeneity makes it difficult to compare and aggregate investment from different sectors of origin.

Consumption and Saving

Some countries construct their NIPAS by computing consumption from independent household surveys. In most cases, however, aggregate consumption is obtained residually as GDP minus investment and net exports.

Estimates of public sector consumption are obtained from central and local governments. Private consumption is typically obtained as the residual difference between aggregate and public consumption. Household consumption is residually defined as private consumption minus consumption by nonprofit institutions.

Aggregate and sector saving data are the ultimate residual: they are defined as income minus (typically residual) consumption. In addition to reflecting the errors and biases in measuring all preceding variables, this definition of saving follows an arbitrary accounting convention that bears little relation to economic theory. The reason is that reported saving is inconsistent with changes in nonhuman wealth stocks because it excludes the capital gains on assets held by the consumer. For instance, private interest income from public debt and external assets (and, thus, private saving) is overstated by the inflation component of nominal interest payments on public debt and by the exchange rate depreciation component of nominal foreign interest payments. Private saving also excludes the capital loss from inflation suffered by money holders and, more generally,

any other net capital loss or gain caused by changing asset prices. Some research has been done on adjusted saving measures that include capital gains on some assets and liabilities, but such measures are typically not comprehensive because assets and liabilities are underreported.

Aggregate (NIPA) saving data also suffer from the problem of aggregation over age cohorts, income groups, or any other relevant dimension. This problem is avoided by using household survey data, which provide microspecific information. The standard household survey, however, severely underestimates overall, and thus individual, income and saving levels. Many surveys report grossly implausible values for saving; they show, for example, large numbers of dissaving households. Because income is underreported in relation to consumption, saving ratios and levels are underestimated. The most severe discrepancies are for nonlabor income and self-employed income. In addition, household survey data suffer from accounting problems similar to those affecting aggregate data, including the omission of capital gains and losses. Finally, household data are for households, not individuals, and they reflect features that are not valid at the individual level.

Notes

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1. The unweighted average saving ratios depicted in figure 1 are for twenty-one industrial countries and ninety-seven developing countries. Within the latter group the figure depicts separately unweighted average saving ratios for eight East Asian, twenty-five Latin American and Caribbean, and thirty-nine Sub-Saharan African countries.

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