

Commentary: Balancing Growth with Equity: The View from Development

Kevin M. Murphy

I will start by saying I found the paper somewhat odd in terms of its focus. Part of that is due to the title that was given to the session (so it is not Esther's fault in that regard), which is "Balancing Growth With Equity." I would have liked to have seen it framed as "Growth With Poverty Reduction." Those are two things we really care about. I realize in mathematics it is just a change of basis, but that change of focus does matter. I do a lot of work in labor economics and people talk about, for example, the black/white achievement gap and wanting to close the black/white gap. Since destroying value is easier than creating value, the easy way is to make whites do worse. That would close the gap. It's obviously not what anyone has in mind. They have in mind: I care about overall achievement and maybe I care about black achievement, in particular, because they are lagging behind. In terms of the issues addressed by Esther's paper it comes down to saying "how do we improve things in developing countries, and, in particular, how do we improve things for those countries' poor?"

More so, the issue I had with the paper is it focuses a lot on investments in physical capital, and, in particular, investments in physical capital by the poor. It really doesn't talk much at all about labor markets and how changes in labor markets affect the poor. In fact, there is almost no mention of labor markets in the paper at all. Yet,

when I think about the vast number of people around the world who have been lifted out of poverty, the improvement in their standard of living came about mostly not because they got micro-financed or something else that allowed them to invest more in physical capital. Instead, the labor market in their country was transformed dramatically as people moved out of sectors with low productivity and into the sectors we were talking about this morning, where productivity is much higher. This process generates aggregate growth and benefits the poor as well because they are moved to a situation where they are far more productive.

So the focus on physical capital and the differences in rates of return on physical capital across the poor and rich seemed odd given the importance of the transformation of labor markets and complementary investments in human capital as the traditional source of improvements in living standards for the poor. That's the process that is going on in China today and has occurred in many countries in Asia and elsewhere over the past half century.

That is not to say we know the policies that spark such a transformation—and this was the point made in the first talk today—we don't necessarily know the policies, but we do kind of know the intermediate steps. We know what those policies—whatever they are—need to generate and those are things that transform the labor market and the demand for labor. From a production standpoint, technological improvements together with investments in physical capital by others (either domestic or international) coupled with investments in human capital raise productivity and allow the poor to improve their standard of living.

What does all of this have to do with inequality? Esther does a very good job of showing there are differences in rates of return across assets in different locations—in some cases, assets held by the poor. She discusses that in terms of market failure but I actually think it is probably much more useful to think about in terms of something akin to transportation costs. It is very expensive to provide intermediation at very small scales—the kind of scale that applies to physical capital investment by the poor.

So, if anybody in here has ever ordered rocks or gravel you have an idea of the problem—you pay about \$2 for the rocks and \$20 to have them transported. In equilibrium, there is someplace where the marginal product of rocks is \$2 and another place where it is \$22. If you could somehow costlessly transport rocks, that would be fantastic. You could capture an elevenfold increase in the value of rocks. But of course the ultimate gain in productivity at the economywide level would depend on the overall importance of rocks in GDP.

One point here is that both transportation and intermediation are real costs. Therefore, in order to capture that gain, we must figure out how to reduce that cost or whether there is a way we can avoid incurring that cost. One of the ideas behind the paper is, if we can give the poor more resources, they won't need to borrow and, therefore, they'll avoid that transportation cost. We'll get the rocks to the \$22 location without the \$20 cost.

The problem is the correlation between rates of return and income isn't necessarily that high. There are places poor people have high returns and probably, as she pointed out, middle-income people and even high-income people that have high returns. Therefore, you will drop a lot of rocks where they are not necessarily as good as where they come from.

Her example talks about how savings rates are so low yet borrowing rates are so high because the costs of intermediation are so high. In that case, if you are dumping them on the poor, you will dump them in some places where they are very productive but in other places where they are very unproductive, because they are not on the margin of investing. Also, it wasn't quite clear, if it came to redistribution, why it necessarily meant more savings. If it is a one-time thing, I can see why you'd save it. If it is an ongoing transfer, I am not sure why it affects savings rather than going into consumption. If I am giving you more money today and in the future there is no presumption that it would lead to more investment. If it is the future rather than today, it would reduce rather than increase investment by the poor.

There is a long way between establishing that we have differences in productivity and establishing that redistribution will increase the

overall efficiency of investment. It wasn't clear the relationship or the correlation between inequality and rates of return was so high or that we had a mechanism for transporting rocks at a much lower cost than the existing system does.

There is another issue. The kinds of sectors where Esther identifies high rates of return are the traditional sectors where the potential magnitude of the physical capital investment is low. These sectors use lots of labor relative to capital. If we subsidize capital investment in those sectors, that will make those sectors more efficient internally, but it is going to generate a subsidy tending to move people toward them and away from probably where we are trying to get them to move (i.e., toward the more formal sectors of the economy). You might make them more efficient in the activities there are, but you distort the mix of activities in a perverse way. You would move people in a counterproductive way and probably on a dimension where the productivity differences are large, as was pointed out earlier today. Given the importance of labor in these economies (particularly for the poor) in terms of factor endowments, improving the productivity of labor is clearly the most important goal. Subsidizing people to stay in traditional sectors is probably not the best way to do that.

What is really important about the paper is it does a great job of pointing out, when we talk about productivity and technology, that we don't just think about patents and how to do the process to make a chemical or something like that. A lot of productivity is about systems for allocating resources. It is about the economic side of productivity, not the engineering side of productivity.

Part of that is intermediation. Where we often write down these models with frictionless capital markets, those are lousy models for these kinds of countries, because these countries are so far away from that. It is like the model of zero transportation cost. It is a good model for some goods. It is not a good model for rocks. You have to understand transportation costs, if you want to understand the market for rocks (or concrete) or any of those goods where weight is really important. In these countries, intermediation costs are critical but not just for the poor. Intermediation costs are important through such economies.

In order to understand the impediments to growth in such places I think we need to understand these costs and how to get around them. What I couldn't understand is why there is a tight link between the importance of intermediation costs and some kind of notion of the need to think about inequality. We know if we can get the intermediation costs down, which to me probably sounds like where Esther ended up, we think we can take advantage of high rates of return and provide the technologies and physical capital that will make these countries' most abundant asset—labor—more productive. As I see it, there is a limit to what you can do at the low end in terms of capital investment, because there is not much capital there anyway. Even though they can make some improvements, it's probably improving allocation of capital in the rest of the marketplace that will then improve the labor market and end up benefiting them more even if the percentage gain in productivity is less. What matters is the gain in efficiency multiplied by the quantity of assets where we realize that gain. The poor mostly have labor, and improving the productivity of that labor is the key to success. Almost by definition the majority of capital will be held elsewhere. Improving the allocation and efficiency of that capital and ensuring that the poor can take advantage of the opportunity to combine their labor with that capital through the labor market should be, and has been, the key to success at poverty reduction.

In terms of policies, I didn't find much in the policy recommendations. There was a discussion of sharecropping as one thing we wanted to reduce. I find it somewhat odd that there is a dislike of sharecropping, because there is also a claim we won't have enough insurance. One of the roles of sharecropping actually is insurance. That seemed like an odd dichotomy to me as well. I agree sharecropping generates inefficiencies, but there has been work in the area that suggests contracts are structured in ways that try to minimize or reduce some of those inefficiencies. A pure rental model is not without its inefficiencies in itself.

Where do we end up here? The paper talks about important issues. It's funny; even though I am a microeconomist and I think the paper is too "micro," because when it discusses the determinants of the

welfare of the poor it focuses a lot on policies directed at the poor. In thinking about what makes the world a better place for poor people, it's been the benefits they've received from policies that weren't directed necessarily directly at them, but policies directed at things that did the types of things that Larry Summers said we need to do—even though we don't know how to do it. But, if they are going to get there, they will get there through those channels. Those to me seem the first-order effects.

I didn't understand the last thing Esther said, which is that somehow having access to credit and other things is going to make the poor able to take advantage of those broader changes. They are probably going to receive benefits from the broader changes, whether or not they have great access to credit. It is probably more important that other people in the economy have good access to credit, so they can do what they have traditionally done in the world, which is use their labor together with other people's capital to earn a higher wage than they can do working on their own. If the poor need anything, they need opportunities to invest in human capital so that they have the ability to take advantage of the labor market opportunities that arise from improved overall economic performance. In isolation, having the capital to complement your labor is important but in a market economy people are free to combine their human talents with the capital owned by others. Doing so also allows us to avoid solving the thorny problems of the high cost of small scale intermediation that are difficult to solve even in advanced economies.