

Arnold Harberger's Contributions to Public Policy

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Abstract:

It is with great pleasure that I review some of the contributions to the field of public policy that Arnold Harberger has made in his distinguished career. Arnold is a teacher, researcher, policy economist, and missionary for the adoption of good policies in countries around the globe. His enormous influence on public policy has come about because of the last four factors. First, his considerable intellectual energy has stayed focused on issues that are rooted in the real world. Second, the intellectual leadership and mentoring that he has provided to hundreds of graduate students both at the University of Chicago and UCLA have created a crop of policy economists who are prepared, with enthusiasm, to apply Harberger's fundamentals-based, real-world-oriented training to the economic problems facing many countries. Third, the care and attention he has taken to communicate the results of his explorations of economic theory and policy analysis set him apart from much of the profession. Fourth, Harberger is the ultimate country doctor, who still makes house calls.

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ARNOLD HARBERGER'S CONTRIBUTIONS TO PUBLIC POLICY

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IT IS WITH GREAT PLEASURE THAT I REVIEW SOME OF the contributions to the field of public policy that Arnold Harberger has made in his distinguished career. Arnold is a teacher, researcher, policy economist, and missionary extraordinaire for the adoption of good policies in countries around the globe. His enormous influence on public policy has come about because of at least four factors. First, his considerable intellectual energy has stayed focused on issues that are rooted in the real world. Second, the intellectual leadership and mentoring that he has provided to hundreds of graduate students both at the University of Chicago and UCLA have created a corps of policy economists who are prepared, with enthusiasm, to apply Harberger's fundamentals-based, real-world-oriented training to the economic problems facing many countries.

Third, the care and attention he has taken to communicate the results of his explorations of economic theory and policy analysis set him apart from much of the profession. Over the years, I have heard many of my colleagues remark how much they have enjoyed reading Harberger's papers. About 20 years ago, one of my Canadian colleagues summed it up nicely: "Harberger's papers always teach me something, and they always have a conclusion."

Fourth, Harberger is the ultimate country doctor, who still makes house calls. For the past 45 years, he has been working on the economic policy issues facing the countries of Latin America. This has been done through dozens if not hundreds of trips to the region, plus countless seminars and discussions at Chicago and UCLA with his graduate students from these countries. In addition, he has spent significant time in India and made frequent trips to Canada, Indonesia, and Russia, among other countries. Their economies have been his laboratory.

Whether in the classroom, working with fellow economists on theoretical and empirical issues, or advising governments on how to get out of their current economic crisis, a similar approach is taken. What is the fundamental issue at question? What does a detailed economic analysis of the problem

tell us about the forces at work in this situation? What is the right policy prescription to deal with this problem?

His style of advising governments has not changed over time. There is modesty in his approach. Until he has studied the situation with considerable care, he resists the urge to start giving prescriptions. Once he is clear about the issue and the economic forces at work, he engages in a process of putting the relevant empirical facts together, checking and cross-checking to see if the same conclusion holds when the problem is examined from different angles. The problem is not solved until the numbers sing.

Arnold Harberger is the ultimate economic fundamentalist, covering a range of fields and topics. Whatever the topic, he first looks to see what light can be shed on it by the application of fundamental economic principles.

Some of his earliest work was done on the efficiency effects of monopoly (Harberger, 1954) and the tax treatment of the mineral industries in the United States (Harberger, 1955). While these papers stimulated a whole stream of research efforts by others, they addressed important issues of public policy that are still relevant.

Over the years, he has given a lot of attention to the study of inflation—its causes, behavior, control, and effects (Harberger, 1979). This follows from his long and deep involvement with the study of economic policies of the southern cone Latin America countries that have had long histories of inflation. Harberger's intellectual influence both directly and through the work of his students, is one of the important elements that have assisted these countries in breaking this inflation syndrome.

Harberger's deep understanding and respect for the challenges faced by the real-world policy economist has often let him resist joining the bandwagon of fads that have sometimes swept particular areas of economics. The field of economic cost-benefit analysis is a fine illustration of Harberger's pursuit of relevance. There is hardly any field of economics that is more focused on assisting the public policy practitioner than is cost-

benefit analysis. Harberger is recognized as one of the pioneers in this field (Harberger, 1987), and his theoretical and applied work covers nearly all of its important topics. Yet during the 1970s and 1980 there was a strong theoretical movement toward economic pricing of the benefits and costs via general equilibrium planning models, within a framework of analysis that assumed an isolation of the public sector from the private sector. That approach demanded data that were almost never available to the project analyst, and assumed a decisionmaking environment that was far from the world that practitioners operate in. As a consequence, international organizations and governments during this period stopped using an economic analysis to assist them in the area of investment decisionmaking. Throughout this period, and up to today, Harberger kept working to see how the fundamentals of economic analysis could be used in a way that was theoretically correct, but at the same time user friendly. It is interesting to note that we are witnessing a significant return of interest in this field, particularly by the multilateral financial institutions, and the approach being followed is the one advocated by Harberger. Both the latest published Guidelines for Economic Analysis by the Asian Development Bank (Asian Development Bank, 1998) and the recently published Economic Analysis of Investment Operations by the World Bank (Pedro Belli et al., 2001) follow the Harberger approach without significant deviation.

Harberger has kept coming back to taxation in his theoretical work, and that has long been a theme in his applied efforts. In fact, many of his theoretical insights have been stimulated by the problems or situations that he has faced in his tax reform work throughout Latin America and in other countries, such as Indonesia. Issues of the design of tax systems, their efficiency, and incidence have been a recurring theme throughout his career. His 1962 paper on the incidence of the corporation income tax and his 1964 paper "Taxation, Resource Allocation, and Welfare" were landmarks in the field of taxation. They brought general equilibrium analysis into the core of the taxation aspects of public finance. A great tide of theoretical literature has followed that is known as the field of optimal taxation. This literature has brought distributional weighting into the issues of economic efficiency and incidence that Harberger so eloquently brought to light. Unfortunately, the prescriptions that fol-

low from the optimal taxation literature are really not workable (see Boadway, 2001). Harberger has not followed that route, although deeply concerned about distributional issues. He could not see how this strand of research could be used into the design of the tax systems that people could live with. In 1995, he returned to the topic of income distribution in his paper on "Monetary and Fiscal Policy for Equitable Economic Growth" (Harberger, 1998a), in which he makes three important points.

- First, the size of the exponentially declining distribution weights that are often assumed in the optimal income tax literature would also justify unacceptable levels of economic waste if used to evaluate a variety of other income transfer schemes. It is not acceptable to use a particular distributional weighting system in tax design issues and simply ignore it in the case of the design of other equally important policies.
- Second, income distribution is mainly a product of deep economic forces. As a consequence "progressive" tax systems have had very little impact on changing the income distribution anywhere.
- Third, the expenditure side of the budget tends to have a greater effect on income distribution than does the tax side, but even so the total impact of government on the distribution of income is likely to be limited.

His conclusion is that a realistic benchmark for calibrating tax-expenditure systems considers taxes in proportion to income, and the "allocable" expenditures accrue to different groups in proportion to their numbers.

"Monetary and Fiscal Policy for Equitable Economic Growth" is a good illustration of Harberger's ability to consider the full range of economic forces that bear on a particular issue and come up with recommendations that are both true to the foundations of economics and also provide a beacon to follow by the practitioners. Lawrence Summers, commenting on this paper at the 1995 International Monetary Fund Conference at which it was presented, had the following things to say: "There are a lot of good papers, there are a lot of clever papers; there are a whole lot of smart papers; there are not actually that many wise papers, but Harberger has written such a paper. It is crammed

full of wisdom and I encourage everybody to read it with care." I might add, Harberger has written many wise papers on a lot of different topics.

He has spent a lot of effort over the years studying the determination and effects of the real exchange rate and its relationship to other macroeconomic variables. He has produced numerous papers on the subject, going back at least to 1980 with "The Real Exchange Rate of Chile: A Preliminary Survey" (Harberger, 1981). This was followed by in-depth studies of the role of the real exchange rate and its movements in many of the economies of Latin America, and more recently in Indonesia and Russia. His work in this area also included a series of papers and a monograph for the World Bank to educate economists and public sector practitioners in developing countries about the importance of this fundamental equilibrating variable of a country's balance of payments. To a great extent because of his research, teaching, and advising efforts, this field of economic policy has become much better understood by both academics and practitioners.

In recent years, Harberger has turned to another fundamental issue that is the heart of economic development: the determinants and measurement of economic growth. Unsatisfied with the previous explanations of the component of growth not explained by augmentations by the labor force and capital stock (both human and physical), Harberger undertook a major study of the measurement of real cost reductions (a more understandable label than total factor productivity) across firms and industries in the sectors of a number of countries. His two-deflator approach to measuring output changes, and the total labor input component, has enabled him to measure these real cost reductions in a highly disaggregated fashion. He finds that real cost reduction does not apply generally, but are concentrated in certain firms within industries and in certain industries within a sector. The analogy used by Harberger is that real cost reductions pop up like "mushrooms" when the economic climate is favorable, rather than being general "yeast" phenomena that increase the productivity of all activities in an economy on a more or less equal basis.

Furthermore, he finds that a very important determinant of the net contribution of real cost reductions to economic growth for a country is the relative magnitude and frequency of real cost reductions compared to real cost increases among some of the firms and industries. The exploration of this topic continues.

I raise this area of Harberger's research, even though it has not reached the stage of being implemented in public policy decisionmaking, as an illustration of how he goes about trying to understand an issue, that when it is better understood, will lead to public policy prescriptions. Rather than just give this phenomenon a label and then derive numerous implications from theoretical models, Harberger digs into the relevant empirical facts. Anyone who has read his 1998 AEA Presidential address, entitled "A Vision of the Growth Process" (Harberger, 1998b), can easily come to the conclusion that the numbers on this topic are also starting to sing.

In closing, I would like to turn to Harberger the teacher of public policy and Harberger the missionary for the use of good economics. These roles are really just two parts of the same activity. His self-imposed objective is to assimilate within himself a long tradition of work, to distill it, add to it, explore its relevance for analyzing events in today's world, and then to pass on the results to a new generation of economists. For 35 years, Arnold Harberger led the effort at the University of Chicago to train several generations of economists from Latin America in policy economics, and the effort has continued at about the same level at UCLA.

In Latin America alone, he can point to over 300 of his graduate students, and many more than that if shorter courses were included. Out of that total, more than 25 have become government ministers and more than a dozen, central bank presidents. This does not include the large number of graduate students he has supervised from other parts of the world. His students have filled many senior positions of international organizations, such as the World Bank and the International Monetary Fund. Even though it might require him to set new records in terms of airline scheduling complexity or sleep deprivation, I have never known him to turn down an opportunity to lead a seminar or to work on an economic policy issue if one of his students needed his help.

On a personal note, for the past 16 years at Harvard University, I organized a course in cost-benefit analysis for international economic practitioners (the course moved last year to Queen's University). Almost everything that we did when we first started the course has changed, except that Arnold Harberger has never missed a single year in coming to teach these students. In that single

activity, more than 800 students had the opportunity to learn from him about economics in practice. This is in addition to his willingness to work on Harvard's economic advisory projects around the globe whenever he was invited. This is but an example of one former student's demands on his time. I know that his track record is even longer providing assistance to a similar program at the Catholic University in Chile. There are many of us out there, former students, colleagues, and beneficiaries of his advice, who would like to say a huge thanks to Al today.

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