Equity and Development: Political Economy Considerations
François Bourguignon and Sébastien Dessus
Development Economics, World Bank
(This draft, 02/20/07)

Introduction

It has become common to explain the lack of dynamism of Latin American and Caribbean (LAC) countries by the excessive level of income inequality. This is indeed a characteristic that singles out these countries – and increasingly African countries – in comparison with fast growing countries in Asia and in Eastern and Central Europe. Yet, the actual channels through which observed inequality actually acts as a brake on growth are not always clearly stated. The recent World Development Report (WDR06) on equity and development (World Bank 2006) provides an explanation of that relationship. It emphasizes the logical link between (i) the inequality of opportunities - accounting for their various facets, e.g. access to education, credit, infrastructure, public decision making, etc. - and (ii) economic growth. Inequality of opportunities prevents some economic agents, whether individuals, households or firms, to fully express their economic potential, thus reducing economic efficiency and slowing down growth. At the same time, this inequality of opportunities feeds, along with other factors, into the inequality of outcomes. With LAC countries in mind, the story thus seems to be that a common factor - inequality of opportunities – is responsible for both slow growth and high income inequality.2

If inequality of opportunities, which will be referred to as “inequity” in the rest of this paper, is responsible for slower growth, what could be done? The basic problem of promoting the equality of opportunities in a country is that it is most likely to directly harm the interest of some privileged groups. Either more taxes will be levied to fund equity-promoting programs and those taxes might bear proportionately more on these

2 Within this perspective, an exception like Chile exhibiting both satisfactory growth and relatively income inequality would have to be explained by a lower level of inequality of opportunities lying behind the inequality of income. Testing that hypothesis opens an interesting field of research.
groups, or some economic advantages accruing to those groups and the corresponding rents they derive from them will be reduced. In turn, whether such policies will be undertaken or not depends on: a) the overall efficiency gains of these policies and the way they are distributed within the whole population; b) the way in which policy decisions are taken. If everybody is set to gain more or less proportionally to his/her initial level of welfare, envisaged reforms are ‘win-win’ and they should eventually be implemented. If this is not the case, all will depend on the relative weight of the groups of winners or losers in the political decision process. Even though equity may be beneficial to growth, undertaking equity-enhancing policies actually depend in that case on 'political economy' factors.

Ultimately, it may be mostly because of these political economy factors that some countries grow at a slower pace than others. They are inequitable to start with and, therefore, inefficient, and this situation perpetuates because both the economic and political power have been captured by elites, which of course have no interest in relinquishing neither of them. Such a setting is behind many cases of slow or stagnating development. Exogenous shocks have historically been in most cases at the origin of weakening elite’s capture. Hence, there is little that economists and other analysts can do in this regard, but maybe to widen public knowledge of the opportunity costs of such a capture. While not a sufficient condition, improved transparency in this area is nonetheless very much needed to enlighten the various actors in the political economy game about passing reforms that possibly go against the interest of the elite or part of it. We argue that more empirical work needs to be undertaken in this domain, and identify some of the difficulties to which economic analysis is hereby confronted.

The paper, which further elaborates on the WDR 2006, is organized as follows. The first section summarizes the main arguments suggesting that there is a strong long-run complementarity between equity and growth. The second section focuses on the political economy of reforms, and identifies situations where growth- and equity-enhancing reforms are available but actually not undertaken, thus leading to some kind of inequality and under-development traps. The third section reviews a few generic examples of elite’s capture and suggests ways to improve knowledge of its impact on equity. Various implications of this analysis are drawn in the concluding section.
1. The complementarity between equity and development

Latin America countries, including Mexico, have long been stigmatized for their excessively high level of inequality in income or, more generally, economic welfare. Whereas the Gini coefficient, a common measure of income inequality, is around .35 in developed countries, and around .40 or slightly above in Asian countries, it is closer to .5 and often above in most Latin American countries. As this is in sharp contrast with fast-growing Asian countries, it is tempting to attribute LAC countries’ disappointing growth performances to this specific feature of their economies.3

Confirming statistically whether this has actually been the case would require controlling growth rates across countries by all variables likely to affect growth, besides inequality. Unfortunately, the number of such variables is too large, their interaction too complex and the number of observations too limited for such an exercise to deliver reliable conclusions. The ambiguous results obtained in the recent cross-country literature are therefore not surprising.4 Of greater interest is that part of the recent economic literature that focused on the theoretical mechanisms that could explain why inequality may be an obstacle to growth.5 Interestingly enough, the general conclusion of that literature is that it is not so much the inequality of income (or consumption) that is responsible for slow growth as the inequality of endowments – wealth in particular – and access to particular markets, income generating facilities, or public decision making. In other words, both income inequality and slow or stagnating growth would be the consequences of more fundamental inequalities in the areas where individuals within a society find opportunities to generate income and increase their welfare.

---

3 This stylized fact has been emphasized very early in the literature on the relationship between inequality and growth – see in particular Persson and Tabellini (1994), and Alesina and Rodrik (1994). Unlike other East Asian countries, it is interesting that inequality in China has increased quite substantially over the last two decades, with a Gini coefficient now around .45, but without apparent negative effect on growth yet.

4 For a short survey of the cross-country literature on the relationship between inequality and growth and a candid view at available evidence see Banerjee and Duflo (2003).

Following the social justice literature, it seems logical to refer to these inequalities as “inequality of opportunities”. Individuals with limited access to education, credit or various types of infrastructure, those who are discriminated against on the labor market, or those who are muted in local or national political debates simply have limited opportunities to realize their economic potential. In what follows, that particular type of inequality will be referred to as inequity, so as to distinguish it more clearly from the concept of inequality that implicitly tends to refer to outcomes of economic activity – and income in the first place- rather than to the determinants of those outcomes.\(^6\)

It is tempting to consider this definition of inequity as a kind of generalization of the concept of poverty to the space of opportunities rather than income or consumption. There is indeed a strong correlation between the two since poor people tend to lack opportunities at the same time their welfare level is below some threshold. However, the inequality of opportunities also shows elsewhere in society. Elite capture of economic or political power is a case in point. It may occur both at the expense of the opportunities of the poor but also of other groups in society. For instance, barriers to entry into a specific sector of activity are restricting the set of opportunities of potential entrepreneurs or investors in comparison with incumbents. Another instance is that of a group of people controlling, even partially, the political decision process, or influencing the justice system, which prevents other people, poor or non poor, to express their views on the provision of certain public goods or to defend their property rights. The concept of economic inequity is thus much broader than the poor/non-poor distinction. It encompasses all situations where some possibilities, first of all of income generation, are open to some but not to others.

The idea of capture is central to the definition of inequity. De facto, inequality of access to some economic facilities is unavoidable in any society the affluence of which does not permit to make these facilities available to all. However, there would not be inequity in such a situation if access were completely independent of individual characteristics, like social or parental background, ethnicity, gender or age, or in other words if access to limited facilities were purely random. It is the capture of limited facilities by some specific groups, and therefore the exclusion of other groups, that

\(^6\) This distinction owes much to the work of moral philosophers like Rawls, Sen, Dworkin or Roemer.
constitute the source of inequity. Barriers to entry in the financial sector raised by some powerful economic elite, impossibility to get a job without joining a union, access to the best schools reserved to children of economic or cultural elites, or control of local public decision making by politicians acting for their own personal interests are all examples of opportunities being denied to part of the population, and therefore of inequity.

There are three basic channels through which inequity negatively affects economic efficiency and growth. The first has to do with the realization of individual economic potential and the misallocation of talents and resources. The lack of access to income generation opportunities like education or credit prevents talented people to realize their economic potential and reduces incentives to efforts, saving or innovation. It also generates a misallocation of existing resources and lowers their average rate of return. Good investment projects are not undertaken for lack of credit, whereas mediocre projects are launched because their promoters could rely on personal wealth or credit. This mechanism applies at all levels, from the talented child of a poor family unable to attend school to a dynamic innovative entrepreneur unable to enter a sector controlled by a monopoly, to local governments spending on public goods consumed by an elite rather than the majority of citizens.

The second channel is through the persistence of inefficient institutions for public decision making, the regulation of the economy and justice. Unequal political rights, or the capture of political power by a group of citizens, prevent the reform of institutions where there are inefficient. In turn, deficient institutions, and in particular the imperfect protection of property rights due to unequal access to justice, generate disincentives to effort, saving and entrepreneurship in that part of the population that is discriminated against. Economic efficiency and growth are then lower than what they could be with adequate institutions.

The third channel is through political tension and conflict. The permanent exclusion of part of the population from income generation facilities and their lack of voice in public decision making unavoidably lead to social and political tensions. They may be contained by those who have political and economic power, but this comes implicitly or explicitly at a cost which reduces the amount of resources that can be invested in productive activities. From an economic point of view, it is certainly better to
invest in the production of goods and services than in security and political repression. Open conflicts may also result from such a situation with even bigger costs in terms of development.

Through all these channels, inequity is making the economy less efficient and is slowing down growth. It also tends to reproduce itself over time through its impact on the inequality of outcomes. Unequal opportunities indeed feed into the inequality of outcomes and low economic efficiency, which, in turn are likely to generate inequality of opportunities through intergenerational transmission mechanisms. The generation born from the poorest will find limited access to income generation facilities, whereas high incomes permit elites to pay the bribes necessary to maintain their monopoly power over part of the economy or the policy making system. In that sense, one can refer to ‘inequality traps’ where initial inequity generates slow economic development and high inequality of outcomes, both tendencies contributing in turn to the persistence of inequity.7

Evidence about these inequality traps and the various channels through which inequity affects development must be found at the micro- rather than at the macro-level. Indeed, the multiple dimension of inequity make it difficult to summarize their impact on economic efficiency into a single coefficient that could then be related to the pace of economic growth across countries or time periods. In other words, the standard cross-country approach is unlikely to provide reliable evidence of the relationship between inequity and growth. In contrast, there is ample micro-economic evidence on the way limited access to income generation facilities like credit, land or education negatively affects individual economic outcomes and potentially reduces economic efficiency and growth at the aggregate level. This evidence is reviewed in details in the WDR 2006.8 Cross-country evidence about the negative role that weak governance and institutions have on economic growth9 is probably more reliable given the macro-economic nature of examined institutions. To the extent that this weakness is most often the result of the capture of institutions by some elite, this literature provides another confirmation that inequity has a negative impact on development. Finally, the analysis of the causes of

7 For a more formal definition of inequality trap see Bourguignon, Ferreira and Walton (2006).
8 See in particular chapters 5 and 6.
9 See Knack (2006) in particular.
recent conflicts in several countries shows how inequity across ethnic groups as well as a low development level generates fights for the appropriation of existing rents, which in turn are responsible for weak development and the persistence of inequity.10

In the same way as the recent history of some conflict ridden countries provides a good illustration of the negative development impact of inequity, the experience of other countries is consistent with a positive role that equity can play on development. In particular, it is striking that, among the fastest growing Asian countries, several of them started with an extremely equitable distribution of opportunities due to major land reforms as in South Korea or Taiwan (China), or to the legacy of communist regimes as in China (main land) or Vietnam. At the same time, however, equity is clearly not the only factor of growth. It follows that some relatively equitable countries or regions may not have always had the best growth performances whereas more inequitable ones have gone through periods of accelerated growth. The Indian state of West Bengal is an example of the former, whereas the 'Brazilian miracle' of the 60s and early 70s is an example of the latter.

2. Political economy of equity enhancing reforms

If equity is conducive to growth and inequity an obstacle to it, a policy issue of importance is that of the means to promote equity, or in other words to equalize opportunities among citizens. Identifying reforms to make progress in that direction is not difficult, from equalizing access to education, credit, infrastructure, or justice to regulating competition or fighting corruption. The difficulty lies in convincing the various heterogeneous groups that form a society to adopt those policies, or to free the resources needed to implement them. If most inequitable situations in a society have to do with the capture of part of the economic and political power by a specific group, correcting those situations implies going against the interests of that group. This is clearly impossible if the group has the political power of opposing the reform that is being considered and its short-run losses are not compensated by the overall efficiency gains of the economy in the long-run.

As mentioned earlier, here lies one of the important explanations for the existence of 'inequality traps' that locks some countries in the vicious circle of inequity and low development. An important cause for slow growth in a country is the existence of elites with limited appetite for the development of the country because of their own high level of income and wealth, and ability to resist at low cost pressures for reforms that would in one way or another reduce the control they have on society and threaten the source of their income.

Under what conditions is it possible to get out of this kind of trap and to promote reforms that are both enhancing equity and development? The schematic representation of the costs and benefits accruing to stylized aggregate actors of a potential reform in Table 1 will help examine this question.

* A simple representation of the political economy of equity-enhancing reforms

The table describes the choice faced by a society between the status quo, where three groups of citizens keep the same level of income over time, and a reform where each group registers changes in current and future incomes. It is assumed that the three groups are ranked by decreasing order of affluence. The policy reform implies an immediate loss for the richest group (-T₁), the 'middle class' (-T₂), and the poorest group (-T₃). In the second period, all groups benefit from the reform, the net difference with their gains in the status quo being respectively g₁, g₂ and g₃.¹¹

This simple setting allows for an interesting review of political economy issues that arise when trying to implement equity-enhancing reforms. It indeed permits to represent various types of initial inequity and various policies that can correct for them. Suppose to start with that the reasons why the three groups have different levels of income is because they face unequal opportunities, group 1 being the most advantaged, and group 3 the most disadvantaged. Suppose also that enhancing equity through improving some specific opportunities of group 3 – say access to education - may be

¹¹ Note that the short-run cost of an equity-enhancing reform may actually be nil, or even negative, for some groups, as for instance when abolishing privileges accruing to the richest group or equalizing access to some facility initially restricted to the richest group. Note also that the net gains, g, in the second period are net of the losses that the reform may entail after the first period.
done through raising taxes that will be paid by the three groups, but proportionally more by the richest groups. For instance, access to secondary or tertiary education may be improved in group 3 by raising taxes in some progressive way, so that groups 1 and 2 end up being the main contributors to the expansion of the educational system. In the second period, all groups enjoy some returns from the reform either directly, as for group 3 benefiting from an easier access to secondary or tertiary education, or indirectly for the other groups, for instance because a more skilled labor force contributes to higher profits in the businesses run by people in those groups.

The preceding reform can also be interpreted more in terms of privileges than in terms of additional educational spending. For instance, the reform may consist in making the whole recruitment process into secondary and tertiary education more merits-based, thus reducing the privileges that groups 1 and 2 initially enjoy. The losses $T_1$ and $T_2$ have thus to be interpreted as the monetary equivalent of the loss of privileged access to college and university, whereas the loss $T_3$ can reasonably be assumed to be nil. As before, the gains $g_1$ and $g_2$ correspond to the benefits for capital owners in those two groups to rely on a labor force of higher quality.

Still another reading of the reform is the partial or complete abolition of some economic capture by groups 1 and/or 2. Say that group 1 enjoys some monopoly power in a specific sector of the economy – finance for instance. The reform then consists of opening up that sector to competition. Group 1 will then lose the monopoly rent it was enjoying before, the amount of that rent being $T_1$, whereas $T_2$ and $T_3$ are nil, or possibly negative if groups 2 and 3 directly benefit from cheaper financial services. The result of that reform is to increase the efficiency of the economy so that the income of all groups increases by different amounts depending on how they are directly or indirectly affected by the expansion of the sector opened up to competition – i.e. through lower prices and higher employment in that sector but also in other upstream and downstream sectors.

Many of the monopoly situations in Mexico that are analyzed in this volume resemble that case. Making the telecom sector more competitive would reduce the rent of the owners of that sector who presumably belong to group 1, and generate immediate gains among users in groups 2 and 3 ($T_2$ and $T_3$ being thus negative). Second period gains, $g$, would then be the long-run efficiency gains due to expanded use of all services.
emanating from the telecom sector. In the case of the reform of the pension system managed by the Mexican Social Security (IMSS), the monopoly power is located in the union of IMSS employees. Bypassing this power and reforming the pension system would correspond to a loss for part of the middle class (T2), to a gain for another part of the same class, under the form of better social services, and potentially a gain for business owners because of reduced social security contributions due to a lower effective cost of IMSS employees. In the long-run, group 3 would also gain because of the lesser degree of informality of the economy and all groups would enjoy faster economic growth.

Various other situations lead to the same simplified representation of the costs and benefits of an equity-enhancing reform. The rent T1, or T2, in the preceding examples may come from other sources than monopoly power. It may arise through the sheer appropriation by some groups of some resources available in the economy, public or private. It may also come from corruption. The size of losses T1, T2 and T3, and benefits g1, g2 and g3 will depend on the kind of privilege being lost and the effect of this reform on overall efficiency. In the case of corruption, for instance, T2 and T3 are the payments that groups 2 and 3 cease to make to group 1 – they thus are negative – whereas the gains g1, g2 and g3 describe the way in which the efficiency gains arising from the disappearance of corrupt practices are distributed in the economy.

Table 1. Schematic representation of the distributional impact of an equity-enhancing reform (Income under status quo or reforms)

<table>
<thead>
<tr>
<th></th>
<th>Group 1</th>
<th>Group 2</th>
<th>Group 3</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Status quo</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Period</td>
<td>Y1</td>
<td>Y2</td>
<td>Y3</td>
</tr>
<tr>
<td>Future</td>
<td>Y1</td>
<td>Y2</td>
<td>Y3</td>
</tr>
</tbody>
</table>

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Reform</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Period</td>
<td>Y1-T1</td>
<td>Y2-T2</td>
<td>Y3-T3</td>
</tr>
</tbody>
</table>

12 The extent of competition in the Mexican Telecommunication sector is assessed in del Villar (2006).
The argument made in the previous section about a complementarity between equity and economic efficiency is equivalent to assuming that the sum of benefits derived from the reform, $g_1 + g_2 + g_3$, is greater than the costs, $T_1 + T_2 + T_3$. In other words, the reform is more than mere ‘zero sum game’ redistribution across groups. The reduction of the privileges of the elite – group 1 and/or group 2 – increases the total income of the community. If $B$ be is the overall increase in income, it is the case that:

$$B = (g_1 + g_2 + g_3) - (T_1 + T_2 + T_3) > 0$$

The equity-enhancing reform being considered would thus be acceptable by all groups if it were possible to redistribute the total gain among all groups in a lump-sum fashion, that is, in a way that is independent of economic activity - so that no one would lose. From a simple accounting point of view, this is possible since the overall surplus, $B$, is positive. In effect, things are much more complicated that what this simple arithmetic suggests. Practically, redistribution of the overall benefit $B$ may be difficult to achieve for economic or political economy reasons. On the one hand, lump-sum redistribution is never easy. Redistributing on the basis of arbitrary rather than economic criteria like income may be opposed because considered unfair, and possibly “inequitable”. In the case where $T_1$ corresponds to the elite losing some privilege, for instance, it might not be socially or politically acceptable to have it fully compensated for that loss. Yet, at least

---

14 Logically, one should introduce a time discount factor to compare the costs and the benefits. This discount factor may be implicit in the benefits, $g$’s. Taking it into account explicitly would not modify the argument.

15 The case where $B$ is negative but the reform is nevertheless imposed by one of the political actors, either within an autocratic regime or even through democratic processes, is also important, but of no direct interest for the issues discussed in this paper.
full compensation is required for the elite not to oppose the reform. On the other hand, there is an issue of time consistency. If compensation or redistribution is to take place in the future, and if group 1 is the main or only loser, it would not accept losing its privileges for an amount equal to $T_1$ without a commitment by the two other groups to compensate it for that loss in the future. But strong political institutions need to be in place for such a commitment may be credible? In the (most frequent) absence of such institutions, no guarantee can be offered that beneficiary groups will not renege in the future on their initial commitment. For these two sets of reasons, that the reform being considered yields a positive overall net gain is no guarantee that it will be accepted unanimously.

The basic fact that a positive overall surplus is a necessary but not a sufficient condition for a reform to be unanimously accepted is often overlooked by economic analysis. Appropriate redistribution or compensation mechanisms must also be in place for the reform to be adopted and to be successful. Trade liberalization is one of the most obvious examples. In accordance with economic theory, advocacy in favor of this reform emphasizes that, together with an improvement in the functioning of domestic factor markets, it will produce an overall gain in efficiency which could benefit to all. Yet economic theory also suggests that some people will lose in this process. If the appropriate channels to redistribute income and to compensate the losers, at the time the overall gain of the economy will turn positive, are not available or are costly\(^{16}\), adopting the reform or not becomes a difficult decision.

Of course, these distribution issues should not arise in the case of a win-win reform where all groups actually benefit from the reform ($g_i - T_i > 0$ for $i=1,2$ and 3). Even in that case, however, some groups might try to block the reform if they feel their gain is proportionally much lower than the others’. In matters of policy reform, the question of interest thus is that of the trade-off, which arises when some groups gain while others lose (whether in absolute or relative terms). If compensation commitments are momentarily ruled out for the reasons above, either for economic reasons or because

\[^{16}\text{It is even possible that the cost of redistribution exceeds the overall gain of the reform, making thus impossible that it could benefit all. See Guesnerie (2001) extending earlier treatment of that issue by Dixit and Norman (1986).}\]
of the difficulty to find time consistent arrangements, then the issue is essentially that of the way public decision is made.

Various cases are to be considered, depending on the political institutions in place. To simplify the discussion, consider the case where only the elite group 1 is losing in the reform, so that $g_1 < T_1$, whereas $g_2 > T_2$ and $g_3 > T_3$. A first case is when political power has been captured by group 1. Within such an autocratic state, the reform will clearly not be undertaken, thus reducing the efficiency and the pace of growth of the economy. Development-enhancing reforms that harm the ruling elite are simply ignored. Development in such a society takes place only if it is beneficial to the elite. There are many examples of such inequality traps, beginning with Mobutu's Zaire, although other factors often have to be taken into account. Of course, such a situation may seem rather trivial. Surely the elite will not adopt a reform that benefits other groups in society but is against its own interest. More fundamentally, however, would such an autocratic state be compatible with anything left by the elite to other groups in society? If the elite has all the power, why doesn’t it simply expropriate other groups? The answer to that question is that there is a rational limit to such a predatory behavior. In the case where the elite live on a rent levied on the non-elites, it comes from the necessity to maintain sufficient incentives for the latter to invest and produce. More generally, it also comes from the possible rebellion by other groups, the fact that the probability that it would succeed and the cost of repression that it entails for the elite increase with the degree of predation. Being somewhat extreme, this case will not be explored further, even though it clearly is of historical relevance in many countries and is unfortunately still relevant today in some countries under some form of dictatorship.17

A second case is where the political decision process is under the joint control of groups 1 and 2, with some dominance by group 2. Several situations fit that case. An extreme situation is that of an autocratic regime controlled by group 2. Within that setting, there actually are two elites in society, with divergent views. The economic elite, group 1, controls part of the economic power and draws rents from it. The political elite, group 2, controls the public decision process and can impose reforms to group 1. In other

---

words, there is a potential conflict within the elite between those who control the economy and those who control the politics. The conflict can be avoided by the collusion of the two elites, in which case group 1 is likely to bribe group 2 so as to block the reform. The outcome of that situation is the same as the autocratic regime controlled by group 1 and development is slowed down. But, collusive arrangements are known to be unstable. Group 1 will always have an interest in minimizing the bribe given to group 2 and hide income from it, whereas group 2 will always have an interest in passing the reform. The conflict between the two elites may thus reappear at some stage, and the reform can eventually pass.

The same outcome would be obtained if public decisions were taken according to an imperfect democratic process where only elite groups 1 and 2 would participate, under the assumption that group 2 has a majority – and indeed has political power. Within that limited democratic regime, the reform would be adopted because group 2, playing the role of a kind of middle class, gains with the reform. Of course, this would not be the case if the interest of the middle class did not coincide with that of the mass in group 3.

There are numerous examples of this type of 2-group situations where one group controls the natural resources or is the wealthiest sectors of the economy and the other group controls political power. The later may hold its power from the legacy of some form of autocratic regime, but it may also have acquired it through apparently democratic processes completely dominated by patronage and corruption. The two group structure may also come from the split of a single elite group following some fight for power, with one side being able to mobilize the rest of the population in its favor. The Perestroika undertaken by Gorbachev in the Soviet Union in the mid 1980s and the ensuing confrontation with the Nomenklatura may be interpreted as such a split of initially homogeneous elites.

The third case is indeed that of a fully democratic regime where group 3 has a majority. As its gain is positive, the reform will be adopted, thus boosting economic efficiency and growth. Note, however, that this outcome is not necessarily the result of the sole numerical dominance of group 3 over the other groups. Decisions in democratic regimes also depend on political participation and activism, which may actually be weaker in poorest and less educated groups. For that group to be able to actually express
its view and to be decisive in the adoption of the reform, previous steps may have to be taken, which may be themselves part of an equity-enhancing package. In that perspective, it may be somewhat artificial to separate the adoption of equity-enhancing reforms and the structure of political decision-making.\(^\text{18}\)

In presence of some trade-off of the gains from reform across population groups, the preceding simple analysis thus suggests that the final decision will essentially depend on the joint structure of political and economic powers. Who controls the rents or the privileges that the reform wants to abolish and who controls the decision process about reforms are the key parameters that determine whether an equity-enhancing policies will be adopted with positive effects on the long-run growth of the economy. Autocratic regimes are likely not to adopt such policies, except in the case of conflicting interests within the elite. On the contrary, a democratic regime, even with some limitations in the democratic process, might move ahead with equity- and development-enhancing reforms.

*The importance of information*

The preceding schematic presentation of the political economy of equity-enhancing reforms relies on an important assumption, which is that of perfect information. In order for political decision-making mechanisms to possibly lead to the desired reform, it is essential that all actors identify with some precision the losers and the winners of the reform and know how much they lose or gain. Practically, this is not always the case. Group 3 may be aware of the gains it would get from having better access to secondary and university education and that this must be somehow paid for by the upper classes in society. They may thus be in favor of a more merits-based recruitment in higher education and/or a heavier and more progressive tax system. But they may not be aware that they stand to gain possibly much more from abolishing some of the rents and privileges of the elite through overall efficiency gains and that these efficiency gains might partly compensate the loss in other groups. In the absence of such information on the full distributional effects of a reform that would reduce the capture of

\(^{18}\) For the clarity of the argument, this simultaneity between equity-enhancing reforms and changes in the structure of political decision making will not be discussed here. See for instance, Bourguignon and Verdier (2000).
part of the economy by the elite, the distribution of political power among the various
groups is biased and, if they do exist, democratic mechanisms are likely to be weakened
and fail to achieve equity- and efficiency reforms of the type discussed here.

This lack of information may be the reason why democratic mechanisms that
could lead to equity- and development-enhancing reforms are not triggered. At the same
time, it is clearly in the interest of the losing groups to retain the information or to
disguise the truth so as to avoid specific reforms being adopted. At the borderline
between democratic and non-democratic decision systems, public information on all the
implications of equity oriented reforms may itself be the object of a complex political
game. This is an area where third parties, think tanks, NGOs and international agencies
can play an important role, through the disclosure of information highlighting the
opportunity costs of status quo, through a strong reputation of objectivity, and also
through the building and promotion of independent analytical capacities and free press.

Several papers in this volume on equity and competition in Mexico provide good
illustration of the potential power of information in promoting equity-enhancing reforms
and the need for rent-extracting agents to curb it. In his analysis of the way regulation
works in the Mexican telecom sector, del Villar (2006) insists on the secret nature of the
productivity gain factor entering the determination of cap prices for telecom services. The
figures he quotes suggest that the productivity gain taken into account in the negotiation
with the regulatory authority is much below what has been observed in other countries.
Another example is provided in the chapter by Levy (2006) on the reform pension system
and the apparent oligopolistic power of pension funds which could serve a rate of return
on pensions below market rates. Information now seems to have begun to spread as more
mobility is observed of workers towards the pension funds offering the highest return.
Studies like that this, and, in effect, most chapters in the present book are essential for the
diffusion of information and the promotion of equity-enhancing reforms.

Information may be an important factor of change and it tends to be neglected.
The arguments developed earlier in this section are those which lie behind the fast
growing economic literature on the relationship between institutions and development.19
However, this literature is essentially descriptive, not prescriptive. It tells us about the

19 See for instance Acemoglu and Robinson (2006).
consequences of inequity or the structure of political power for development. It does not
tell us what to do about it. In effect, economists and analysts equipped with this
knowledge but confronted to institutions on which they are powerless seem to be in front
of a wall. Institutional equilibria in a society can only change under the pressure of
exogenous shocks in some fundamental parameters within the economy or its
environment. This is true as long as one assumes that all actors in society have perfect
information on the implications of reforms that promote equity and, indirectly,
development. If that information is imperfect, however, then there is considerable scope
for all parties to interact in a public debate on the impact of particular reform so as to try
to learn from each other about its distributional effects and for credible and neutral third
parties to influence reforms. Casual observation suggests that this debate does not always
take place – as for instance in strongly autocratic societies - or is not as transparent and
informed as it should be, sometimes because the information is not available and
sometimes because the information made public is biased in the interest of some parties.
Better information might not be sufficient to unlock political equilibria, which are often
persistent given the inequitable initial distribution of powers and the ability of elites to
maintain their dominance over non-elites. As mentioned earlier, exogenous shocks have
historically been in most cases at the origin of weakening elite’s capture. But while
shocks occur, highlighting the evolution of parameters which had so far been
underpinning the equilibrium might be instrumental to unlock it. Take the example of a
society were rents stemming from the exploitation of a natural resource are captured by a
political elite, which redistributes only part of it in the form of social services to the
population. As the resource is depleting – i.e. the 'exogenous' shock - the elite might
progressively look for alternative means of rent extraction over the population, most
likely through increased taxes, or the creation of monopoly situations. In the transition
though, the elite might find itself particularly vulnerable to the disclosure of information
revealing the distributional effects of the reforms envisaged to protect its privileges. The
disclosure of that information may be necessary for the exogenous shock on natural
resources to actually trigger institutional changes.

It must be recognized that identifying all the distributional effects of a reform is
not a simple matter. This may be the reason why much of the economic literature and
political debate about reforms that promote competition and weaken rent-seeking behavior in an economy focuses on the aggregate rather than disaggregated benefit of doing so. The argument in this section has shown that it is not only the overall benefit, \( B \), of an equity-enhancing reform that matters, but the whole distribution of the individual – or group – net gains, \( g_i - T_i \). The issue of the way to determine these net gains is taken up in the next section.

3. Identifying the distributional effects of reforms

A cursory examination of the literature reveals there have been many attempts at determining the full distributional impact of unequal opportunities in fields like education, health care or access to specific infrastructure.\(^{20}\) The literature on the distributional impact of obvious cases of elite capture is much more limited. It is most often circumscribed to the analysis of monopoly situations, leaving aside general equilibrium and dynamic effects. Yet, this is precisely where the arguments presented earlier suggest that much of the action is.

One may easily understand the difficulty of identifying the distributional effects of monopoly situations within a dynamic general equilibrium framework. Such identification cannot indeed rely on ex-post observations of an economy with and without a monopoly in some specific area. Instead, it must rely on ex-ante counterfactual analysis based on some kind of economic modeling approach.\(^{21}\) As a systematic review of those few studies which have tried to take that route was beyond the scope of this paper, the present section is devoted to the main mechanisms that such studies should take into account and existing general evidence where available. Three situations will be analyzed: a) standard monopoly situations with non-negligible general equilibrium effects; b) oligopolistic behavior in the financial sector; c) corporatist monopoly power exerted by trade unions.

---

\(^{20}\) See for instance van de Walle (1998) and World Bank (2005). Note that this analysis is often incomplete because essentially static and based on debatable assumptions – see Bourguignon and Rogers (2006) for education.

\(^{21}\) Though, most general equilibrium analyses of monopoly power in some key sectors are based on a single representative consumer and do not permit analyzing distributional effects.
a) Distributional effects of monopoly power in markets for goods and services

The direct effects of monopoly power are well known. Those enjoying such a situation get extra income on top of the normal profit rate in the economy, whereas their customers pay a higher price, get less to buy and possibly face a lower quality than under conditions of perfect competition. The size of these distortions essentially depends on the elasticity of demand. For instance, an elasticity of demand equal to 1.5 leads to a price margin of 3 with respect to marginal cost. In other words, consumers pay three times the price they would pay under perfect competition. At the same time they reduce their demand in a proportion of two thirds, which of course weakens the effect of the monopoly on their overall welfare.

Some of these effects can be easily quantified when monopoly situations are well identified. However, as noted by Creedy and Dixon (1999) a few years ago, there are not many studies of the distributional effects of monopoly situations, even though the identification of direct effects does not seem conceptually difficult. Analyzing the distributional impact of a change in price of specific services due to monopoly power can be done in a simple way using household surveys with information on expenditures on the service supplied by a monopoly. It is sufficient to figure out the mark up of the monopoly with respect to the competitive price and the distributional effect of the monopoly may be evaluated in the same way as the incidence of indirect taxes. A good example of this approach is the analysis of introducing more competition in the British utility sector by Waddams Price and Hancock (1998). However, this kind of analysis ignores the possible difference in the quantity (or quality) of the service delivered by the monopoly in comparison with a more competitive market. In the field of infrastructure, on the other hand, the issue is not so much that of the quantity being consumed and the corresponding cost as that of unequal access.

Work done on the effects of privatization tries to take access into account as well ad household consumption and expenditures on a privatized service before and after privatization – see for instance the various studies in Nellis and Birdsall (2005) and

\[22\] Guerrero et al. (2006) suggest that lack of competition in the Mexican electricity and telecommunication sectors is a major reason behind the poor quality of service delivery, affecting overall productivity levels of industries and preventing the installation of modern equipment.
McKenzie and Mokherjee (2002). However, this approach has some drawbacks. First, it is ex-post, whereas decision making in the field of competitive regulation calls for an ex-ante perspective. Second, the before-after comparison does not always correct for the effect of other phenomena contemporaneous but independent of the reform being analyzed. An analysis of the distributional impact of a reform that changes the competitive structure of a sector must rely on some kind of counterfactual. But it is not always a simple matter to define such a counterfactual.

A complete identification of the distributional effects would require going beyond price and quantity effects. It should take into account the impact of the monopoly situation on sectors upstream and downstream of it, as well as overall impact on factor markets, and on employment in particular. When dealing with some major infrastructure, for instance, or sectors with tight links with the rest of the economy (e.g. transports), ignoring general equilibrium effects may lead to a severe under-estimation of the impact of monopolistic situations.

Many applied general equilibrium models today include imperfect competition features and can be used to determine the impact of introducing more competition in some specific sectors of the economy. However, fewer models do explicitly take into account the heterogeneity of the household population and permit a distributional analysis of monopoly power. A good example of such a model is the analysis of the effects of privatization and regulation in Argentina by Chisari et al. (1999). In addition to taking explicitly into account distributional factors, the general equilibrium model should also be dynamic so as to account for the possible effect of monopolies on labor participation, investment, innovation\(^{23}\) and growth.\(^{24}\) Conventional static and partial equilibrium analysis using the famous Harberger triangles suggest the aggregate welfare loss of a single representative agent due to monopolies is small. Things may be quite different when considering various population groups, the linkages of the sector under monopoly with the rest of the economy and the dynamic effects of monopoly. However,

\(^{23}\) The conventional Schumpeterian view defends the idea that some market power (either on product markets or in the form of intellectual property rights) is necessary for enterprises to innovate, and that social welfare unambiguously increases as a result. Yet, this proposition also necessitates assuming that monopolies only gain transitory competitive edge from innovating, and not continued market dominance.

\(^{24}\) The recent paper by Dessus and Ghaleb (2006) on the effects of monopoly power in the Lebanese economy is based on a dynamic applied general equilibrium model. It does not incorporate distributional effects, but analyzes changes in factors’ incomes, labor and capital.
models combining all these features are very rare and it is thus not surprising to see that only a few estimates of the distributional and development effects of monopolies are available in the literature.

b) Evidence on the effect of barriers to entry in the financial sector

General equilibrium and dynamic effects are likely to be especially important when monopoly or oligopoly power is exerted in the financial sector, because of the impact of that sector on practically all productive sectors and on their development. Interestingly enough, the existing economic literature provides some aggregate evidence of the effect of the lack of competition in the banking sector on access to financial services and on economic growth. It also gives evidence of the impact of the underdevelopment of credit on the degree of income inequality, other things being equal.

Using firm level survey data for 74 countries, Beck, Demirguc-Kunt and Maksimovic (2004) study the impact of bank regulations, concentration, ownership and institutions on access to external finance. They find that bank regulations that impede competition – such as entry and activity restrictions – result in higher financing obstacles for firms and decrease the likelihood of receiving bank finance, this effect being exacerbated for small firms. A case study confirms these findings. Cetorelli (2004) presents evidence on the effect of changes in banking structure on average firm size in 27 manufacturing sectors in 29 OECD countries over time. The results show that in sectors where incumbent firms are more in need of external finance, these firms are also of disproportionately larger size if they are in countries whose banking sector is more concentrated. The results also show that this effect of bank concentration is substantially weakened in EU-member countries where the banking system is much more competitive due to implementation of pro-competition deregulation.

Empirical evidence also suggests that financial development, as measured by access or the ratio of credit to GDP, is associated with higher growth, lower poverty and reduced income inequality. There is now an important literature on the first result. As for the others, Beck, Demirguc-Kunt, and Levine (2004) find that higher financial depth leads to the income of the poorest 20 percent growing faster than average GDP per capita
and therefore declining income inequality. Honoan (2004) finds that a 10 percent change in private credit over GDP is associated with a 3 percentage point drop in the headcount poverty index. Burgess and Pande (2005) find that a one percent increase in the number of rural banking locations in India reduce rural poverty by 0.3 percent. Last but not least, the success of micro-credit institutions reminds us how access to credit is effective for poverty reduction, even if the emergence of such institutions is not necessarily linked to lower financial repression.

Interestingly, there is also a healthy body of literature looking at the political economy of financial development. For instance, using panel data for 26 countries over the period 1973-1999, Girma and Shortland (2005) find that it is predominantly fully democratic regimes that have liberalized their financial systems. Using a panel of 24 countries over the period 1913-1999, Rajan and Zingales (2003) suggest that financial systems get liberalized as they become ineffective to shield elites-controlled industries from competition after trade and capital account liberalization. Haber (2006) in this volume defends the view that high barriers to entry in the Mexican banking sector were erected in compensation for the high risk of expropriation by authoritarian political institutions, thus reflecting collusion between a business and political elite.

All this evidence is consistent with the theoretical considerations in the preceding section of some kind of elite capture preventing the extension of the financial sector to small and medium enterprises and to households and micro-firms, thus slowing down the pace of growth and contributing to a higher level of income inequality. The problem is that most of this evidence is based on cross country comparisons and might be difficult to use at the country level to feed the debate on reforms aimed at making the financial sector more competitive. More work is needed at the micro level to identify those agents that are rationed on the credit market because of barriers to entry in the financial market, the loss they incur because of this and the lack of efficiency and economic growth that results for the whole economy.

c) The effect of restrictive corporatist unions

22
Capture does not necessarily result from the power of the elite. It may also occur in some sectors or professions dominated by groups belonging to the middle class which have been able to erect barriers to entry or to regulate part of the labor market in their favor. Trade unions may play a positive role for equity by preventing some workers in a given profession to be exploited by employers for lack of bargaining power. In some cases, however, their equity impact is debatable because they simply tend to protect incumbents from outside competition, harming potential outsiders and contributing to a loss of efficiency in some part of the economy.

This is particularly the case in monopolistic or oligopolistic sectors where trade unions have the ability to capture a significant share of the rent arising from imperfect competition.25 In this case, unions will obtain above market wages, extending the inequity originating on the product market to the labor market.26 By doing so, though, they also tend to reduce the advantages granted to firm owners who benefit from monopolistic positions, and the net effect in terms of equity is hence generally more difficult to establish. On the one hand, unions reduce the rent accruing to monopolists and oligopolists in the sectors they control, but on the other hand they contribute to worsening the labor-market for non-union workers outside these sectors.

The public sector is a particular case in this respect. It enjoys a monopoly position in most of its activities and the implicit rent it generates – the difference between a monetary equivalent of its impact on social welfare and the wages paid to civil servants - normally accrues to people at large. In this setting, powerful trade unions can enjoy sizable monopolistic advantages and may have substantial effects on the rest of the economy. By setting a wage higher than the market wage, they reduce the implicit rent accruing to the population from the activity of the government sector and they contribute to lower the wage of workers in the private sector. In the case of Mexico, the analysis of the IMSS pension system by Levy (2006) gives a rather good illustration of the way a union in the public sector is able to indirectly reduce the welfare of IMSS affiliates in the

---

25 See for instance Borjas and Ramey (1995) and Blanchflower et al. (1996). Tzannatos and Aidt (2006) conclude that resource and efforts unions will eventually devote to rent-seeking depend on the legal (nature of collective bargaining, cost of militant actions) and economic (degree of product market competition) environment in which they operate.

26 See Spector (2004), for a theoretical discussion on this aspect. The author suggests that general equilibrium effects of product market deregulation on consumers’ welfare might not be sufficient to compensate for the elimination of rents accruing to workers in protected sectors.
private sector and, more generally, the size of GDP. Note also that the negative impact of this lack of competition on both equity and efficiency may not be so much due to the higher wage that union members are able to secure in comparison to the competitive segments of the labor market than in lower efforts and a lower quality of the services delivered. 27

Although difficult to measure formally, there is considerable anecdotal evidence on the inefficiency of social service delivery in many countries where those services are managed by the central government, which implicitly or explicitly has to face organized civil servants. Absenteeism or weak performances of teachers, or health care workers when they directly depend on a central, or even regional government is well documented in a number of countries – see World Bank (2004). Whether in education or in health care, the consequences of such a situation for equity and efficiency are sizable. Whereas the elite is able to substitute public schooling and health care by private services, the poorest people suffer from the low quality of these services and human capital does not accumulate in the economy proportionately to the money that is spent on these public services.28 Interestingly enough, numerous experimentations show that these problems tend to disappear when the delivery of services is supervised directly by the users as for instance by local governments and parent association in the case of teachers.

Conclusion

Inequity – the inequality of opportunities – is a severe deterrent to economic development. In many instances, it mirrors the capture of economic opportunities by some powerful groups or elite, thanks to their ability to control directly or indirectly the

27 On efficiency, empirical studies conducted on the impact of trade unions generally conclude to the existence of a minor negative welfare impact. See Rees (1963), Johnson and Mieszkowski (1970) and Freeman and Medoff (1984). Note also that public sector trade unions can also prefer to raise employment (and membership) above efficiency levels rather than wages. Their impact on the rest of the economy is then different. They move the allocation of resources in favor of the public sector but they now contribute to improving the situation of workers in the private sector.

28 Another dynamic consequence of poor social service delivery might warrant attention. Workers in formal sectors who consider that the value for money of the service they receive is not worth its implicit price (in the form of social security contributions for instance) might prefer to move to informal sectors to improve their welfare (Levy, 2006). In turn, growth will suffer (compared with the first best situation where social services are worth their price) if informality is synonym for lower productivity or slower human and physical capital formation.
public decision-making process and to shape institutions to their advantage. In turn, the persistence of inequity and slow development can often be explained by the interest from the elites in not relinquishing their economic or political advantages and their lack of interest for overall development.

Historically, external or technological shocks have often been at the source of a shift in relative powers across groups, which have weakened elites and encouraged the development of institutions preventing future elite capture. Rarely though, was it the result of an endogenous process, and in many countries the persistence of inequity and slow development can hence be seen as a low but stable equilibrium.

In the face of it, improved transparency and widespread economic information is probably the best possible vehicle to foster equity- and development enhancing reforms. A better understanding by the population and competing elites of the welfare and distributional impact of status quo vs. reform is an indispensable instrument to create the space for reform. Although probably not sufficient, public awareness is a necessary condition to forge coalitions for changes – especially in vertical political structures where programmatic parties are absent.

This calls for greater efforts in this domain. Little work of this type is available so far and analytical difficulties are obvious. Even though precise quantification of the distributional effects of selected reform is difficult to obtain, it should be possible to get rough orders of magnitude in a number of cases. As only those reforms with large potential impact do matter, it may be sufficient to work with schematic counterfactuals yielding plausible orders of magnitude of gains and losses of relevant population groups.

At a minimum, it should be possible in many instances to get some consensus on the basic economic mechanisms at work, who the losers and the winners are, and whether their losses or gains are “large” or not. This should be enough for improving the transparency of the public debate and, depending on initial political institutions, to lead to more development effective decision making. It is to be hoped this will be the impact of the present book which offers several impressive examples of the distributional effects of various types of monopoly power in Mexico.
References


Bannon, I. and P. Collier (2003), Natural Resources and Violent Conflict: Options and Actions, World Bank, Washington D.C.


Nellis, J. and N. Birdsall, eds (2005), Reality check, the distributional impact of privatization in developing countries, Center for Global Development, Washington D.C.


