
INCOME DISTRIBUTION, CAPITAL ACCUMULATION AND GROWTH

A. Introduction

As discussed in previous chapters, recent years have witnessed increased polarization both among countries and among various income groups and classes within countries. Rapid and steady growth in developing countries is clearly necessary to close their income gap with the advanced industrial countries and improve standards of living. There may be some scope for raising income through reallocation of existing resources, but restoring rapid growth depends in large part on raising the rate of capital accumulation.

Experience shows that while rapid growth as such may not lead to a significant improvement in income distribution in the short to medium term, it is indispensable for attaining a more balanced pattern of distribution in the longer term. More importantly, as discussed in the preceding chapters, policies can be designed so as to strengthen the forces making for greater equality while promoting growth and absorbing the surplus labour that prevails in many developing countries.

While previous chapters concentrated on the effects of growth on income distribution, this chapter examines the effects of income distribution on capital accumulation and growth. It concentrates on various channels through which personal and functional income distributions influence savings, investment and growth. Chapter VI will then discuss the role of policies and institutions in promoting growth, particularly by influencing the behaviour of classes that absorb a large share of

national income, drawing on the experience of a number of developing countries, especially those in East Asia.

The next two sections examine how inequality in income distribution can slow accumulation and growth, concentrating on various channels of influence. First, it is shown that inequality can trigger political and social pressures that may eventually undermine incentives to save and invest. Second, it can reduce the average skill level of the labour force by making it harder for the poor to finance their education and that of their children.

The proposition is then examined that unequal income distribution is essential for rapid accumulation and growth because the rich save and invest a greater proportion of their incomes than the poor. It is shown that, while the rich may indeed save and invest proportionately more than the poor, the same degree of inequality among countries is often associated with different rates of accumulation, or that a given rate of accumulation is compatible with lower or higher inequality. Thus, accelerating growth does not necessarily require a greater concentration of income in the hands of the rich.

The relationship between inequality and accumulation is greatly influenced by the extent to which profits are saved and invested. An examination of sources of capital accumulation shows that corporate profits are often the principal source of investment in industry, while the contribution

of voluntary household savings to productive investment is relatively small. However, the extent to which profits are saved and reinvested varies considerably among countries. It is argued that high retention and reinvestment of profits foster accumulation and growth at minimal inequality in

terms of personal income distribution. What distinguishes East Asian NIEs from other developing countries is not so much an exceptionally high rate of household savings as a considerably higher propensity of corporations to save and invest from profits.

B. The political economy of distribution and growth

While the evolution of income distribution throughout the process of growth and industrialization has attracted considerable attention, the effect of income distribution on capital accumulation and economic growth has been relatively neglected. A commonly held view is that the rich save proportionately more than the poor, so that greater inequality tends to be associated with higher savings. Consequently, any attempt to redistribute income from the rich to the poor in order to alleviate poverty would be counter-productive over the longer term, since it would slow capital accumulation, income growth and job creation.

The validity and implications of this proposition are examined in greater detail in the subsequent sections. Here, attention is focused on an important aspect of the distribution-growth link which is neglected in this approach; namely, the effect of income distribution on incentives to save and invest. The traditional view assumes that propensities to save of various income groups are independent of how income is distributed among them. However, greater income inequality can reduce incentives to save and invest across the entire spectrum of income groups. Consequently, even if the rich save and invest proportionately more than the poor, a higher degree of inequality may be associated with lower aggregate savings and investment if it has a significant adverse effect on incentives.

Recent work has concentrated mainly on two possible channels through which greater inequality can reduce incentives for accumulation and growth.¹ The first is through the impact of inequality on social and political instability, and of instability on investment. Income inequality and polarization can lead to social discontent, demand

for radical changes, political violence and attempts at an unconstitutional seizure of power. In particular, the absence or weakening of a relatively well-off middle class can be a major factor contributing to socio-political instability, which has an adverse effect on investment and growth. The interaction among income distribution, instability and growth may threaten to set off a vicious circle whereby greater inequality leads to increased instability and reduced growth, which in turn can lead to still greater instability. Consequently, successful redistribution policies could promote growth by reducing social and political instability, provided, of course, that they do not introduce other impediments to accumulation and technical progress.

Placing social and political instability at the centre of the analysis of the link between income distribution and investment provides an important insight into how social and economic phenomena interact. However, the link between inequality and political instability is not a mechanical one. History shows that in most societies there is at any moment in time a notion of a socially acceptable distribution of income, and hence of inequality, which is widely regarded as legitimate. It reflects a long history of class bargains and struggles over income distribution specific to each society. In other words, the degree of socially acceptable income inequality varies among societies. Although, this notion of what is acceptable changes over time as the balance of power among different classes shifts, at any particular moment it sets a limit to the extent to which income distribution and inequality can be changed in either direction without causing serious socio-political dislocations. Thus, just as a sharp deterioration in income distribution often leads to serious socio-political instability and

even to a social revolution, there are also socio-political limits to policies of progressive income redistribution.

The question of legitimacy also relates to specific types and sources of income. Some sources of income are almost everywhere considered illegitimate (e.g. the profits of heroin dealers). Some are legally tolerated in some countries but not in others (e.g. interest on loans). Some are permitted by law, but may not be acceptable to all (e.g. lottery winnings). There is a whole spectrum of what might be called "legitimacy weightings" attached to different types of income. A rise in the "aggregate legitimacy index" can also cause social and political turmoil, as recently in some Central European countries.

The fundamental problem is, thus, that there are two sorts of income inequality, one unacceptable (illegitimate) and the other acceptable (legitimate), and any existing pattern of income distribution embodies both, in proportions that are hard to analyse statistically. To the extent that the inequality of income distribution reflects legitimate inequalities, it is compatible with socio-political stability.

It follows that instability would be greater where high inequality is accompanied by widespread poverty, because in that case the legitimacy of the measured inequality would be lower. Thus, social unrest and political instability can be expected to be less pronounced in economies where a given income inequality is associated with relatively high average per capita incomes and a relatively low level of poverty. For instance, the United States has as high a Gini coefficient as a number of poor countries, but does not have the political instability of many of the latter. Moreover, people often find higher inequality more tolerable if incomes are rising and poverty is diminishing. Thus, inequality does not necessarily lead to greater socio-political instability, unless it is associated with widespread poverty. By the same token, a relatively equitable income distribution may result in instability if the average level of income is low and poverty is widespread. Finally, the impact of inequality on socio-political instability and growth may vary with the nature of the political system.

These various factors shaping the effect of income distribution on political instability differ considerably from one country to another. There is some evidence of a positive correlation between

income inequality and the degree of political instability, and between political instability and investment, suggesting that income inequality is harmful to growth.² It appears that socio-political instability exerts a greater influence on growth than the nature of the political regime itself, and that transition from dictatorships to democracy is often, but not always, associated with increased instability and less growth. However, it cannot be deduced simply from this correlation whether it is political instability that leads to slow growth or slow growth that leads to political instability. Moreover, not all studies linking political stability to growth find a significant relationship between the two.³

Another link between growth and income inequality is through government intervention. It is often argued that a highly skewed pattern of income distribution can generate significant social and political pressure on governments to pursue redistributive policies. Such policies can introduce serious distortions and lead to a reduction in the after-tax return on capital, thereby impeding accumulation and growth. Such outcomes can be expected to emerge more easily in democratic societies, where the poor may vote in favour of redistributive taxes that reduce incentives to invest. However, governments that are more autocratic may also be subject to similar social and political influences.

It is also argued that government intervention is linked to unequal asset distribution as well. On this view, because of imperfections in capital markets, people cannot borrow against their future earnings to finance long-term investment, and they have thus to rely on their own resources, including assets which provide collateral for loans. Unequal asset distribution can generate political pressures on governments to intervene in capital markets, leading to distortions in the allocation of resources and thereby reducing investment and growth.⁴

Political pressures arising from highly unequal income distribution can indeed lead to populist policies which harm investment and growth through their effects on macroeconomic stability or the return on investment. However, such pressures do not necessarily give rise to harmful intervention. For instance, if they lead to policies of taxing the rich to provide better public education, they may both reduce inequality and promote faster growth. Similarly, they could lead to government transfers that may help reduce criminal activities, thereby

alleviating social tensions and instability, and stimulating investment and growth. There is indeed some evidence of a positive relationship between government transfers and growth. It is therefore possible that growth may be low in more unequal societies because they redistribute less, not because they redistribute more.⁵

Indeed, income inequality does not always lead to redistributive policies in favour of the poor. For instance, in most of those developing countries where income distribution is highly unequal taxation is also regressive, suggesting that the link between corrective policy action and income distribution is not automatic. In the same vein, redistributive policies are not always associated with large inequalities; for instance, despite a relatively high degree of equality in income distribution, Japan effectively pursued redistributive policies in the form of conces-

sional lending and technical support in favour of small producers both in industrial and in rural sectors in the postwar era, which also helped accelerate growth.⁶

While various political pressures generated by income inequality may adversely influence investment and growth, the considerations above suggest that the link between inequality and growth is a highly complex one. That is perhaps why empirical studies of the subject covering a number of countries have failed to demonstrate any robust relationship.⁷ In most studies either the two are found to be unrelated, or the relationship loses its significance when other variables are included.⁸ Even where an inverse relationship is found, the impact of inequality on growth is rather small.⁹ Nor is it possible to generalize about how different political systems influence the relationship between inequality and growth.¹⁰

C. Distribution, education and skill acquisition

1. Distribution and education

Another influence of income distribution on growth is through its effect on human capital formation. The degree of educational attainment has come to be considered as a crucial determinant of a country's stock of human capital, as well as of an individual's earnings capacity. Income distribution exerts an important influence on school enrolment, since the financial situation of individuals is an important determinant of their capacity to invest in education. Family income has a direct impact on that capacity because people make most of their investments in education when they are young. Families that are better off financially can more easily finance the education of their children to more advanced levels; they also tend to have lower fertility and fewer children to educate. One part of this investment consists of the direct cost of education, such as tuition fees and the cost of textbooks and other teaching material. The other, and more important, part is the opportunity cost in the form of current earnings that the family unit

forges. The two-way causality between income levels and investment in education points to the possibility that families on the lower rungs of the income ladder, dependent on subsistence earnings, may be caught in a low-education and low-income trap, since they cannot afford to forgo current income and invest in education.

Similarly, the distribution of wealth has a significant effect on investment in education because bequests allow current income forgone and the cost of education to be covered. The initial distribution of wealth can also have long-term effects, since investment in education allows the wealthy to obtain better-paid jobs and to bequeath more to future generations. Moreover, wealthy individuals may form a club which provides private education with a bias towards advanced education for a few rather than basic education for all. Education also provides them with greater exit options by equipping them with skills that enable them to obtain more remunerative employment abroad. Hence, the manner in which society stratifies largely determines who has access to education, what skills are

accumulated and, therefore, the future distribution of income and wealth. Initial inequality in income and wealth distribution can create a low-skill-low-income trap for the poor, while for richer families these variables are constantly on the increase.¹¹ The combination of low skills and low income also tends to be perpetuated, since differences in socio-economic status between families in which children are raised lead to differences in their achievements as students. Consequently, groups or neighbourhoods in deep poverty have great difficulties in overcoming their initial circumstances because their state of poverty tends to be self-perpetuating.

In linking asset distribution and investment in education, recent work has emphasized the role of assets (noted above) in providing collateral for loans. While there is some evidence that land ownership is a determinant of educational attainment, and that there is a negative correlation between the degree of inequality in initial land distribution and subsequent growth,¹² the precise mechanism linking the two is not clear. On this view, the relationship between land distribution and growth should be especially strong in low-income countries, but this is not always the case. The fact that a number of developing countries with egalitarian land distribution have experienced slow growth (e.g. India, Islamic Republic of Iran, Mali, the Philippines, Senegal and Uganda) suggests that the link between asset distribution and growth depends on a host of other factors, including incentives for individuals to invest in skill acquisition and the provision of public education. More importantly, it does not appear that using land as collateral for educational loans is a common practice in developing countries. Commercial banks are usually unwilling to extend credits to small farmers since farmland is a difficult collateral to handle. It is usually specialized state-owned banks that fulfil this role, but the credits they extend are rarely for purposes other than agricultural activities. It is therefore more likely that land ownership influences investment in education as a source of income rather than as a collateral for credits.¹³

The argument that an individual's or family's capacity to invest in education depends on their own incomes and assets assumes that there is no provision of free education and/or of public credit schemes to cover the costs involved. The provision of government finance for education is required because the value to society of investment in skill acquisition exceeds its value to the individual; it creates positive externalities which are

not captured by the individual concerned. As already noted, educational subsidies for the poor are one of best redistributive policies because they not only help attain greater equality, but also promote growth.

2. Employment, investment and skill acquisition

Investment in education depends not only on the ability of the individual to afford the costs involved, but also on the incentive to do so. The incentive is there if the future flow of income can be expected to rise in consequence. That in turn depends on wage differentials between better educated and less educated labour, and on the probability of finding employment that adequately rewards the skills achieved. In order for higher wages for better educated labour to provide an adequate incentive for investment in education, the wage differential should be large enough to compensate for the costs incurred throughout the investment period. There is strong evidence of such a differential in developing countries. Moreover, it seems to widen as educational levels increase; the difference between the wages of workers with secondary and primary education tends to exceed that between workers with primary education and those with no schooling.¹⁴

The probability of finding employment compatible with increased skills arising from investment in education, and also the extent of wage differentials between better and less educated labour, depend very much on the demand for skilled labour. But in many developing countries, lack of such demand and widespread unemployment among labour with primary or secondary education, or employment of such labour in low-paid jobs not commensurate with their education and skills, is as important an impediment to an individual's or family's investment in education as their ability to afford it.

On the other hand, too fast an expansion of the educated labour force out of line with industrial growth can also be problematic. The high level of education in the early 1960s in the Republic of Korea is often remarked on, but it has also been reported that in 1964, when the per capita income was about \$100 and one in every 289 citizens was in college, college graduates were competing for jobs as municipal streetsweepers

despite a tradition against manual labour. A major policy goal of the Government in the early 1960s was to reduce college enrollments by a third.¹⁵ Unemployment among secondary school leavers has also been important in Malaysia.¹⁶

Demand for skilled labour depends very much on the level of technological development reached, and rises at a pace determined by the speed with which the economy moves up the technology ladder. Since the latter depends on the rate of capital accumulation, investment and technological change are the two most important determinants of the demand for skilled labour. Thus, rapid accumulation and technological change stimulate investment in education by creating high-wage jobs and thereby the ability to finance such investment.

Moreover, capital accumulation, technological upgrading and job creation play a key role in raising the quantity and quality of skilled labour by allowing workers to acquire and develop skills through on-the-job training and learning by doing. From the point of view of workers, incentives to enrol in industrial training programmes are similar to those for schooling. At the same time, the training may benefit employers by developing specialized job-related skills and raising productivity. The acquisition of such skills is a benefit to society as a whole; they can be transferred to other firms or industries while their costs are firm-specific. If skilled labour is attracted by higher wages elsewhere in the economy or abroad, the firm will need to match these levels in order to retain it, thereby incurring additional costs. That is why firms may be reluctant to undertake costly training. One way to overcome this problem is through the public provision of training facilities. A direct subsidy to a firm, linked to the labour force and skill formation, often provides a better alternative.

It is sometimes argued that FDI may also be an important means of skill acquisition because the skill content of production associated with it tends to be higher than that of domestic production. However, the extent to which these benefits spill over to the local economy depends on how strong the linkages are between TNCs and domestic producers and on indigenous capabilities to allow such linkages to develop. Indeed, evidence suggests that positive and significant spillovers occur only when the capability and technology gaps between domestic and foreign firms are moderate. In countries where such linkages are lacking, there are signifi-

cant skill and wage differentials between foreign and domestic enterprises.¹⁷

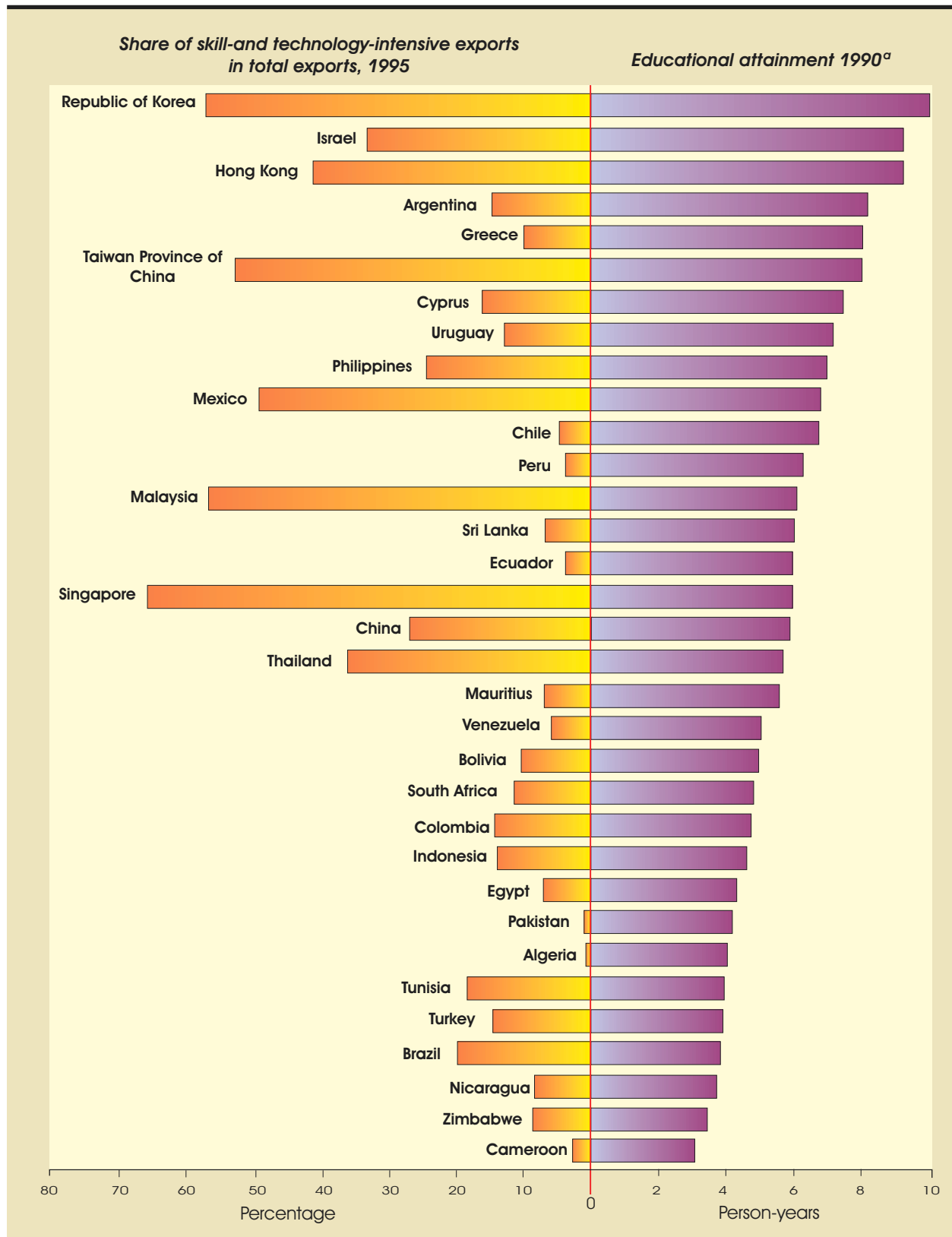
Training and learning by doing during an individual's career are important aspects of human capital formation. For jobs requiring moderate levels of skill, they can indeed be much more effective than providing basic education. In most developing countries, skills acquired through apprenticeship in artisan workshops are often considered superior to those resulting from primary and even secondary education. Thus, the fact that individuals from poor families cannot invest much in formal schooling does not always mean that they are totally excluded from skill acquisition. At higher levels of technology, post-school skill acquisition through learning by doing and training is often an integral part of an individual's skill level, and much training in manual and managerial skills is of an on-the-job nature. General training provided by schools improves adaptability and learning capacity and is an essential complement to on-the-job industrial learning; it is especially vital to an agenda of technological upgrading. However, its contribution to industrialization depends crucially on capital accumulation and job creation.

Chart 13 plots educational attainment in a number of countries against the skill intensity of their exports. Educational attainment is measured by the average number of person-years of schooling of the population aged 15 and above, whereas the share of a country's skill- and technology-intensive goods in its total exports is used as a proxy for the skill intensity of the country's production.¹⁸ Any interpretation of the chart needs to take account of the fact that some of the skill- and technology-intensive exports of a number of countries, such as Malaysia, Mexico and Thailand, have very high skill- and technology-intensive import contents, since a high proportion of such exports comes from assembly operations.¹⁹ Moreover, certain non-traded services can be very skill-intensive. If these sectors are excluded, there results an underestimation of the skill-intensity of production in economies such as those of Hong Kong and Singapore, where the provision of services is important.

However, even allowing for these considerations, chart 13 lends support to the hypothesis that educational attainment is a necessary but not a sufficient condition for skill-intensive production. All countries with a high share of skill-intensive exports also have a relatively high educational attainment, while the evidence for countries such as

Chart 13

SKILL AND TECHNOLOGY INTENSITY OF EXPORTS, AND LEVEL OF EDUCATIONAL ATTAINMENT IN SELECTED COUNTRIES IN THE 1990s



Source: R.J. Barro and J.W. Lee (1996), "International Measures of Schooling Quality", *The American Economic Review*, Vol. 86, No. 2, 1996; United Nations, *Commodity Trade Statistics* tapes.

a Average number of person-years of schooling of the population aged 15 and above.

Argentina, Chile, Peru and Uruguay suggests that relatively high educational attainment does not automatically translate into skill-intensive exports. These countries have educational attainments as high as East Asian NIEs, but their skill intensity is much lower. By contrast, Brazil and Tunisia have lower educational attainment than those NIEs, but their skill intensity is considerably higher. Almost all countries where high educational attainment has translated into skill-intensive exports are those that have sustained a rapid pace of capital accumulation, technological upgrading and productivity growth over many decades, most notably the East Asian NIEs.

These considerations strongly suggest that even when greater equality in income and/or wealth distribution does succeed in stimulating greater investment in education, it will not necessarily also create sufficient skilled jobs to reward the expectations of all who have so invested. Whether that goal can be reached depends on the pace of accumulation and technical progress. Since investment in physical assets plays a crucial role in stimulating demand for education and the supply of job-related skills, the impact of income distribution on the acquisition of education and skills depends very much on its effect on capital accumulation.

D. Personal and functional income distribution and accumulation

As discussed in the previous chapter, notwithstanding significant differences among countries, a relatively large share of national income in capitalist societies accrues to a relatively small minority. It is, therefore, primarily the spending behaviour of this minority that determines savings and accumulation. This is particularly true for developing countries, where incomes of a large majority of the population are barely sufficient to meet their basic needs, and provides the basis for the view in mainstream economic analysis that there is a trade-off between income equality and growth because the rich have a higher savings ratio than the poor. This view is consistent with various formulations of private savings behaviour.²⁰

However, unlike the standard analysis of the relation between savings and the incomes of rich and poor, an approach different from that of the classical tradition (described in box 7) focuses on the functional distribution of income - i.e. between rents, profits and wages. Each functional type of income is defined as the income source of a particular class: landowners earn rents, capitalists earn profits and workers earn wages. In this analysis, the propensity to save out of profits is greater than the propensity to save out of wages, so that a redistribution of income in favour of profits would raise aggregate savings at any given level of income.

The idea that capitalists save a higher proportion of their profits than workers save out of wages was used by Keynes to justify the working of the capitalist system of the nineteenth century in Europe and North America, already discussed in chapter II. He described the system thus:

Europe was so organized socially and economically as to secure the maximum accumulation of capital. While there was some continuous improvement in the daily conditions of life of the mass of population, society was so framed as to throw a great part of the increased income into the control of the class least likely to consume it. ... Herein lay, in fact, the main justification of the capitalist system. If the rich had spent their new wealth on their own enjoyments, the world would long ago have found such a regime intolerable.²¹

On this view, therefore, inequality is an essential feature of the accumulation and growth process in the capitalist system. Investment provides social as well as economic justification for the concentration of an important part of national income as profits in the hands of a small minority. It indeed acts as a social tax on profits that restricts their use for personal consumption of the capitalists, and thus makes for lesser inequality in consumption than income. Thus, unlike the "so-

GROWTH AND DISTRIBUTION IN THE CLASSICAL AND KEYNESIAN TRADITIONS

A common feature of the classical and Keynesian theories of economic growth is that both link the accumulation process to the functional distribution of income. According to both Ricardo and Marx, profits not only constitute an incentive for investment, but also are the only source of capital accumulation. Over the long term, wages tend to remain at the subsistence level, although they may fluctuate in the short term. Ricardo explained this in terms of the “Malthus Law”, while Marx attributed it to the existence of a “reserve army” of unemployed workers. In both approaches the interaction between accumulation and profits sets off a cumulative downward process whereby accumulation leads to a decline in profits which, in turn, slows accumulation. In Ricardo this happens because diminishing returns in agriculture raise wage costs in industry, increasing agricultural rent at the expense of industrial profits. Marx argued that the increase in capital deepening (rising “organic composition of capital”) associated with accumulation reduces the mass of surplus extracted from workers per unit of capital, thereby lowering profits and slowing accumulation.

The class perspective also dominates the Keynesian approach to income distribution and growth. However, unlike the classical political economists, this approach sees a mutually reinforcing interaction between profits and accumulation. This interaction was first formulated by Keynes and Kalecki in the 1930s, in the context of short-term income determination, and subsequently by Kaldor in the 1950s, in the context of accumulation and growth. Assuming that the propensity of capitalists to save out of profits is greater than that of workers to save out of wages, and that prices respond to aggregate demand faster than wages, it was shown that the share of profits in national income was positively related to the investment rate and inversely related to the propensity to save out of profits. If workers do not save at all, profits are determined entirely by the spending of the capitalists; thus, “workers spend what they earn, capitalists earn what they spend”. If capitalists invest aggressively, aggregate savings and the aggregate savings ratio will be greater as income is redistributed from low-saving workers to high-saving capitalists. By contrast, in an economy where investment is sluggish and/or workers are parsimonious, the share of profits in income tends to be lower.

If workers save, however, they also earn property income (dividends or interest) as they invest their savings and accumulate wealth. This was the basis of a further refinement of the theory in the 1960s. Under these conditions, the shares of wages and profits (but not the shares of workers and capitalists) in national income are independent of the savings rate of workers.

However, all this depends on the assumption that nominal wages would not respond to a rise in prices brought about by increases in investment and aggregate demand. When they do, the redistribution-growth process hits an inflation barrier, as was emphasized by the Cambridge economist Joan Robinson. If there is a limit to how much the absolute level of wages can fall, then inflation sets in whenever investment exceeds the level compatible with the minimum acceptable wage rate, setting a limit to how much the share of profits and, with it, the aggregate savings rate can rise.

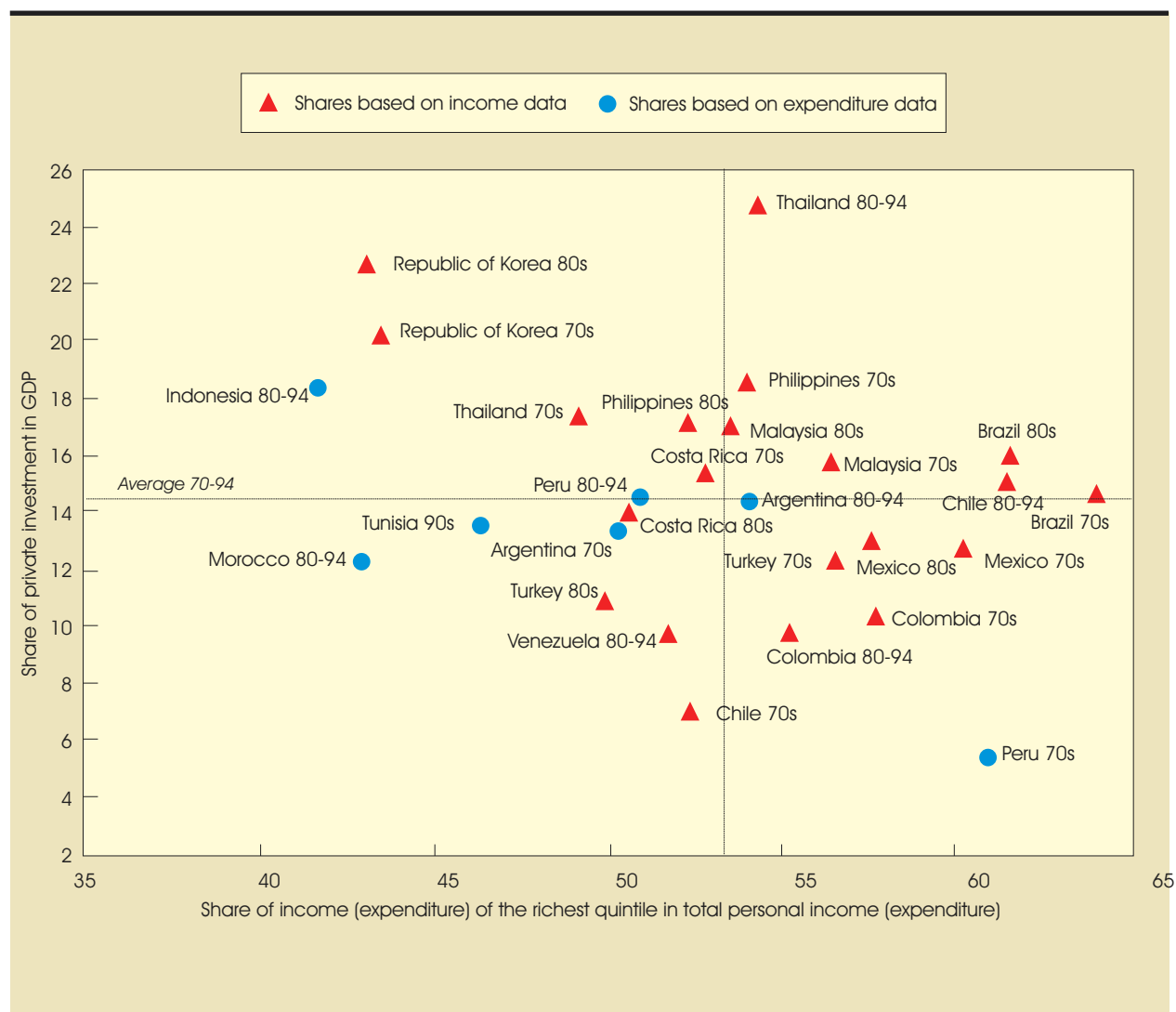
cial instability view” discussed in the previous section, here social cohesion and stability depend not so much on the distribution of income as on the way the rich dispose of their incomes. Inequality can be tolerated if it is associated with accumulation and “continuous improvement in the daily condition of the mass of population”.

However, higher propensity to save from profits than from wages does not necessarily imply that aggregate savings and investment rise with inequality in personal income distribution. Although some empirical studies find a positive correlation between income inequality and aggregate savings, these results are not robust to different specifica-

Chart 14A

LOW-INCOME COUNTRIES: INCOME SHARES OF THE RICHEST QUINTILE IN TOTAL PERSONAL INCOME, AND PRIVATE INVESTMENT AS A SHARE OF GDP, 1970-1994

(Percentage)



Source: F.Z. Jaspersen, A.H. Aylward and M.A. Sumlinski, *Trends in Private Investment in Developing Countries*, IFC Discussion Paper No. 28 (Washington, D.C.: The World Bank, 1995); dataset compiled by K. Deininger and L. Squire (see note 4 to chapter III).

tions and for different country groups. A recent study using the “high-quality” distribution data (discussed in chapter III) for 52 countries, finds no support for the hypothesis that income inequality affects aggregate savings, either in developing or in industrialized countries.²²

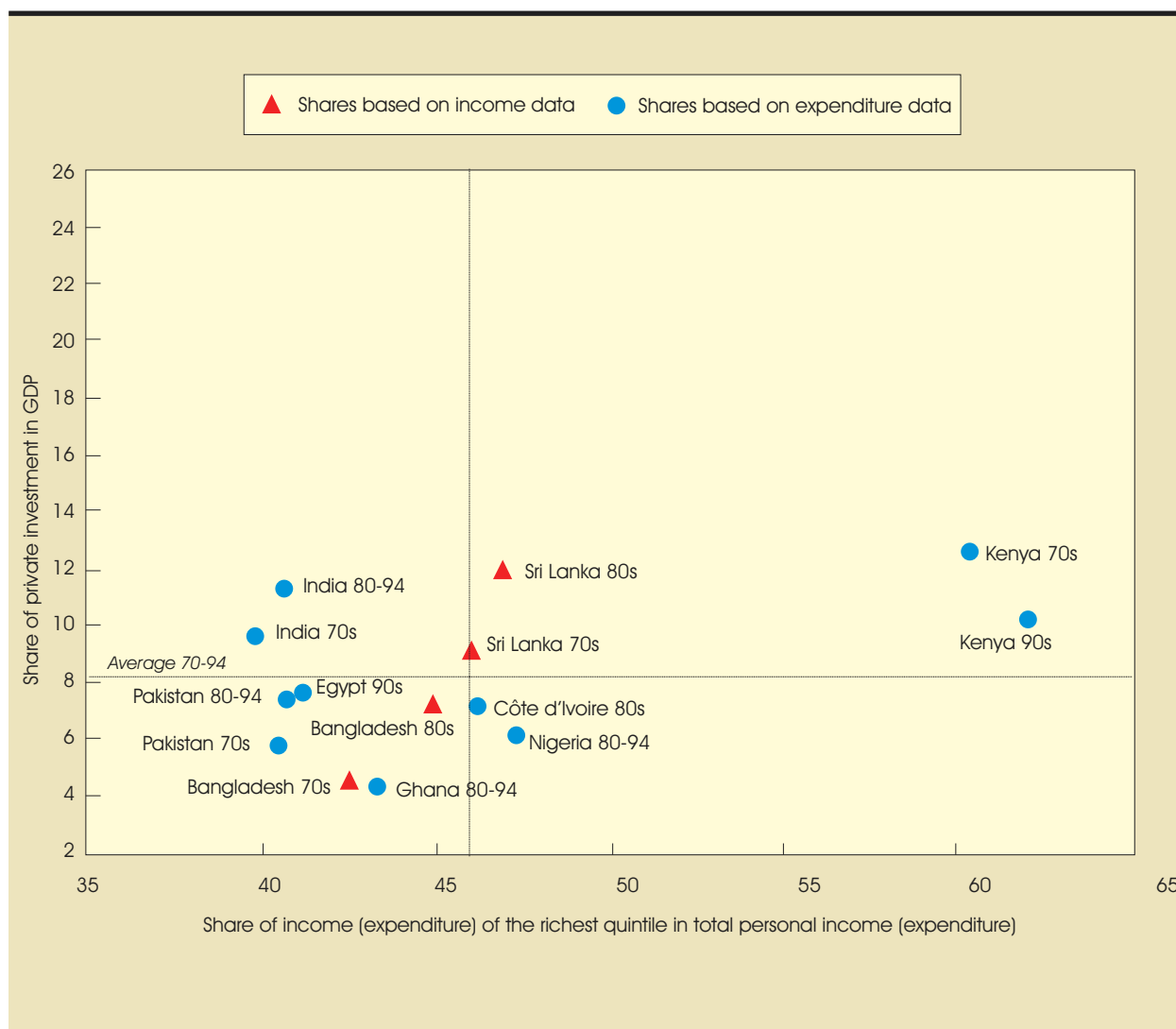
Charts 14 A and B plot the share of private investment in GDP against the share of the richest

quintile in the distribution of personal incomes (expenditures) for a number of low-income and middle-income developing countries, for the 1970s and for 1980-1994, for which data are available.²³ There are considerable differences among countries in the relationship between inequality, as measured by the concentration of income (expenditure) in the richest quintile, and the share of private investment in GDP. On average, both investment

Chart 14B

MIDDLE-INCOME COUNTRIES: INCOME SHARES OF THE RICHEST QUINTILE IN TOTAL PERSONAL INCOME, AND PRIVATE INVESTMENT AS A SHARE OF GDP, 1970-1994

(Percentage)



Source: See chart 14A.

and income shares of the richest quintile are low in low-income countries (chart 14A). However, it should also be noted that in almost all low-income countries the distribution data refer to personal expenditures rather than incomes, and hence show less concentration. In this group the share of the richest quintile varies from 40 per cent to 50 per cent of total personal income (expenditure) in almost all the countries included in the chart, while

the private investment ratio ranges from 4.5 per cent of GDP (Ghana in 1980-1994 and Bangladesh in the 1970s) to 12 per cent (India, Sri Lanka and Kenya in the 1970s). In Kenya the share of the top quintile is considerably higher than in other low-income countries, apparently because there is a high degree of concentration of privately owned land; one estimate puts the Gini coefficient for land distribution in that country at 0.72.²⁴

Among the medium-income countries, the share of the richest quintile exceeds 50 per cent of total personal income (expenditure) in a large majority of countries, while private investment rates range from around 5 per cent (Peru in the 1970s) to 25 per cent of GDP (Thailand during 1980-1994) (chart 14B). A number of countries with similar investment ratios have widely different concentration ratios. Again, some countries with similar patterns of income distribution have sharply different private investment ratios. In most Latin American countries the investment ratio is lower than the average, but the concentration ratio is higher. Some South-East Asian countries, notably Malaysia and Thailand, have concentration ratios comparable to Latin America, but considerably higher private investment ratios. Indonesia, and even more so the Republic of Korea, also have high private investment ratios, but much lower income concentration ratios.

Private investment/income concentration configurations appear to be relatively stable over time. Two middle-income countries show significant improvements in their private investment ratios in the past decade (Chile and Thailand), associated in both cases with increases in the share of the top quintile. In Chile, however, the decline in the income concentration ratio appears to have been reversed in the 1990s, while the private investment ratio has continued to rise. In some other countries (notably Brazil and Malaysia) the private investment ratio was higher and income concentration lower during 1980-1994 than during the 1970s, but the extent of change was much more moderate.

In interpreting these inter-country variations in the relationship between distribution and investment it is important to bear in mind that there is not a one-to-one correspondence between the distribution of income between wages and profits and among persons. To what extent a high share of profits in value added would be associated with a high degree of inequality in personal income distribution depends on a host of factors. First of all, wages are not always the most important type of labour income in developing countries. In those in the early stages of industrial development, and particularly where agriculture is the principal economic activity, proprietor incomes of small landowners, artisans and shopkeepers, and income from self-employment in the formal and informal sectors, can be more important than wage incomes. They often accrue to the poorest segments of the

population, while wages are earned by people in the middle of the income range. Again, in such economies ground rent, rather than profits, can be the dominant form of property income.

Secondly, the extent to which a high share of profits results in high inequalities in personal incomes depends on the distribution of capital assets. For instance, in the extreme (and unlikely) case where capital is equally distributed among the population, the personal income distribution would be totally independent of the distribution of value added between wages and profits. Ownership of capital assets by workers emerges at a relatively advanced stage in the process of industrialization and development, often in the form of contractual savings in institutions such as pension funds. When workers, in addition to their wage income, obtain income from such assets, the wage-profits distinction no longer coincides with that between workers' and capitalists' incomes, and a redistribution between wages and profits would not necessarily be associated with large changes in personal income distribution. Moreover, both theory and empirical evidence suggest that workers save more out of profits and profit-related incomes than from wages (see chapter VI), so that a redistribution of profits from capital to labour would not necessarily lead to a considerable decline in aggregate private savings.²⁵

Finally, personal incomes do not add up to functional incomes because an important part of private incomes (such as the contractual savings mentioned in the preceding paragraph) is retained in institutions, and thus does not appear as personal income. In this connection a distinction has to be made between insurance premiums paid by employees to private pension funds, which are treated as household incomes and savings; and payments into public social security schemes, which are treated as income taxes.²⁶ Since government pension schemes are traditionally much more common than private schemes in developing countries, much of the institutional savings of households take place before labour incomes are paid out. More importantly, retained corporate profits are not included in personal incomes. If profits are largely retained, a high share of profits in value added is not necessarily associated with high inequality in personal incomes; a greater equality in personal income distribution may simply reflect a higher propensity to retain profits rather than a lower share of profits in value added. Thus, a high share of profits in value added can

coexist with a high or a low degree of inequality in personal income distribution, depending on the propensity of corporations to retain profits for investment. For any given profit share in value added, a higher propensity to save and invest by corporations would generate not only a faster growth, but also a more equal personal income distribution.

There can be little doubt that the importance of corporate retentions tends to increase with economic development and industrialization. For this reason, international comparisons of income distribution often lead to an overestimation of the difference in inequality between developing and developed countries, since corporate business and retained profits are less important in the former. However, it should also be noted that in developing countries with per capita income of \$300 or more, companies already play an important role, often in the modern sector, and their retained profits can constitute an important share of value added.²⁷ Consequently, the extent to which profits are retained in corporations can also influence the comparison of personal income inequality among developing countries.

The inter-country variations in the relationship between personal income distribution and capital accumulation also suggest that, unlike Keynes's description of capitalism in 19th century Europe and North America, economic and social life in developing countries is not always so organized "as to secure the maximum accumulation of capital". Indeed, the extent to which the rich save and invest their incomes in productive assets appears to vary considerably among countries and plays a key role in relative economic performance.

Property income, including rents and profits, constitutes the principal source of earnings of the rich. There is no direct evidence on savings and investment by the recipients of such incomes in developing countries. For a small number of such countries data exist on the contribution of retained corporate profits to capital formation, and these will be examined in the following section. A procedure that makes it possible to study a larger number of developing countries, as well as other income than profits received by the rich, is to compare the share of the richest quintile in personal income distribution with aggregate private invest-

ment, drawing on the data presented in charts 14 A and B. In developing countries most of the private investment can be expected to be undertaken, directly or indirectly, by this income group, although it may be financed in part by savings of persons below this income level or by transfers from abroad. The share of private investment in GDP is thus only a proxy measure of the extent to which the rich use their incomes for investment. The richest quintile can also be expected to embrace all major recipients of property income, including profit earners and rentiers.

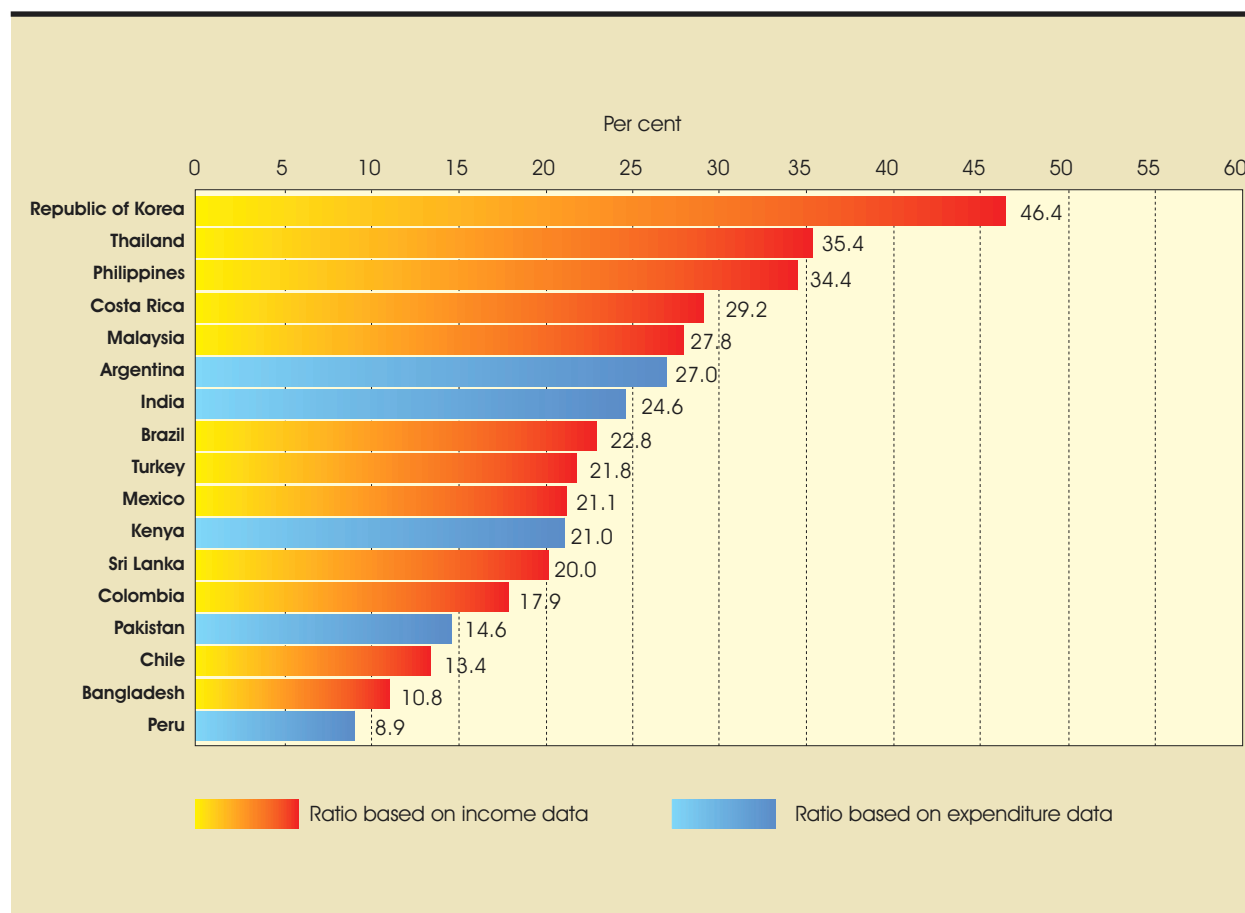
As noted in chapter III, for some countries the data on personal income distribution is based on shares in consumption rather than in income. In such cases, which include most low-income countries, the ratio of the share of private investment in GDP to the share of the richest quintile (i.e. the accumulation/concentration ratio, or ACR) is an indicator of the extent to which the rich spend their incomes on investment rather than personal consumption. Even when the distribution data refer to personal incomes, the ACR measures the same relationship, since the evidence presented in the subsequent section suggests that property-owning classes save primarily through corporate retentions, and use their personal incomes mainly for consumption.

In charts 15 A and B developing countries are ranked according to their ACRs for the 1970s and for 1980-1994, respectively. The successful East Asian countries are generally at the top of the list, followed by North African, Latin American and sub-Saharan African countries. The ranking of countries is much the same in both periods, with the notable exception of Chile and Peru, which move significantly up the scale in the latter period.

For the reasons noted above, the ACR is only a proxy for measuring how the property-owning classes allocate their incomes between consumption and investment. However, the ranking of countries by the ACR broadly conforms to that by the contribution of corporate profits to capital accumulation and growth, discussed in the next section. It thus confirms that success in growth and industrialization depends very much on how the capitalist class divides its income between the two types of expenditure.

Chart 15A

**SELECTED DEVELOPING COUNTRIES: ACCUMULATION/CONCENTRATION RATIO^a,
1970-1979**



Source: See chart 14A.

a Share of private investment in GDP expressed as a percentage of the share of the richest quintile in total income or consumption.

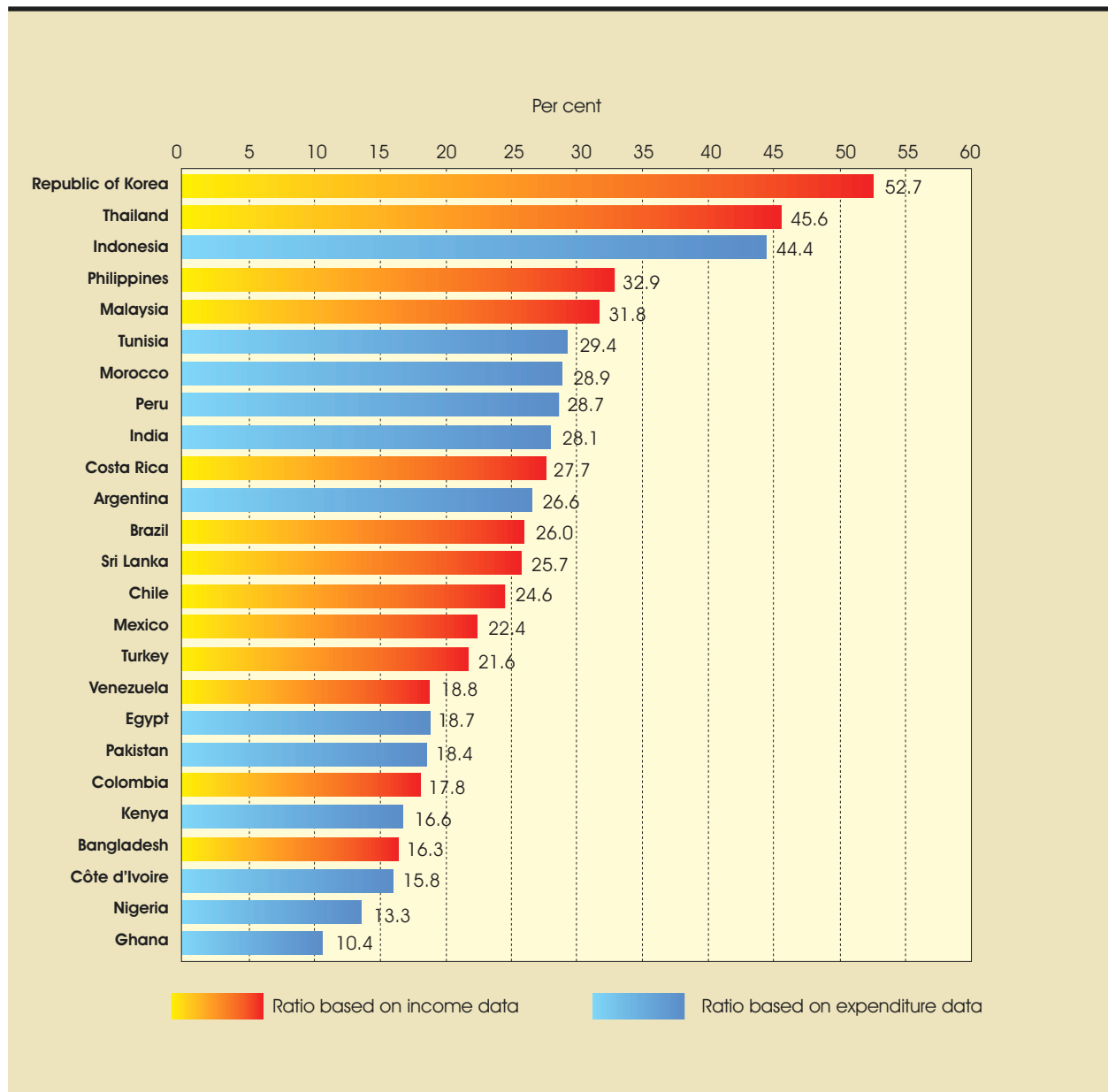
E. Profits and accumulation

Both theory and evidence suggest that capital accumulation in industry is financed primarily by savings out of profits, and such savings generally take the form of corporate retentions rather than household savings from dividends. Capitalists save primarily through undistributed corporate profits, while personal dividends are largely devoted to consumption. Shareholders tend to make allowance for undistributed profits in their saving decisions, since such retentions increase the mar-

ket value of corporations and hence the wealth of the shareholders, which, in turn, stimulates personal consumption.²⁸ However, the marginal propensity to consume out of retained earnings is smaller than the marginal propensity to consume out of distributed income, so that an increase in corporate saving is not compensated by an equivalent decrease in household savings. Therefore, household and enterprise savings are not perfect substitutes; corporate retentions raise total savings

Chart 15B

**SELECTED DEVELOPING COUNTRIES: ACCUMULATION/CONCENTRATION RATIO^a,
1980-1994^b**



Source: See chart 14A.

a Share of private investment in GDP expressed as a percentage of the share of the richest quintile in total income or consumption.

b The ratios for the Republic of Korea, the Philippines, Malaysia, Costa Rica, Brazil, Sri Lanka, Turkey, Bangladesh and Côte d'Ivoire are for 1980-1989; those for Tunisia, Egypt and Kenya are for 1990-1994.

out of profits and are the main reason for the existence of a higher propensity to save from profits.

The decision of corporations as to what proportion of profits should be retained is not independent of their decisions on investment. Over

the long term, a high rate of corporate retention is almost always associated with a high rate of corporate investment. In this sense, a high propensity to retain profits is an indication of a strong accumulation drive and corporate dynamism. This dynamism and the division of profits between sav-

ings and consumption vary considerably from one country to another, and play a crucial role in the overall pace of accumulation and industrialization. It is also an important determinant of inequality in personal income distribution. Indeed, greater propensity to save and invest from profits in East Asia has been a key factor in achieving not only a more rapid pace of accumulation and growth, but also a more equitable personal income distribution than in most other developing countries.

1. Evidence from industrial countries

Table 42 gives for selected OECD countries total private savings and investment, and their distribution between the household and corporate sectors, as a percentage of GNP during the past three decades. There are considerable differences in these total private savings and investment ratios; the highest ratios (Japan in the 1960s and 1970s, at about 30 per cent of GNP) were twice those of the lowest ones (Sweden and the United Kingdom).

In most countries the contribution of retained corporate profits to total private savings is often as high as, and even higher than, that of the household sector, especially so in Japan in the 1960s and Germany, the United Kingdom and Sweden throughout the entire period. It is notable that corporate savings in Japan were particularly high during the 1960s, when the average annual growth of total and industrial output was about 10 per cent and 13 per cent, respectively. The only country where household savings are considerably greater than corporate savings is Italy. However, this largely reflects the fact that unincorporated enterprises are included in the household sector in the national accounts. In all countries, the contribution of household savings to corporate capital formation is less than that of retained corporate profits.

It is generally recognized that, for a number of reasons, national income data tend to overstate the contribution of households to productive investment, and that, if appropriately measured, "pure" household savings would be much smaller.²⁹ A study on the United States for the period 1947-1991 found that household gross savings did not significantly exceed household gross capital formation. In cumulative terms the latter was equal to 99.8 per cent of household gross savings, while gross savings by enterprises exceeded their gross

capital formation in all but 11 of those 45 years.³⁰ Similarly, a study on the United Kingdom for 1952-1984 found that, when properly measured, voluntary household savings were just sufficient to meet household investment. Enterprise investment came from retained profits and mandatory pension fund contributions.³¹ Finally, a number of studies in Japan have pointed out that, if various biases in the estimates of household savings are removed, such savings are not as high as official figures suggest, either absolutely or compared to other countries, notably the United States. However, these studies also suggest that the surpluses generated by households for investment in the public and corporate sectors are bigger in Japan than in other countries.³²

The results for the United States and the United Kingdom have been interpreted as a confirmation of the classical view that household savings do not supply funds for productive investment.³³ The greater contribution of household savings to capital formation in the business sector in Japan can be explained by a number of factors, including the greater role played by banks in its financial system, exceptionally high rates of corporate investment, as well as a number of institutional arrangements, such as profit-related pay, that raise household savings, which are discussed in the next chapter.³⁴

While corporate savings from profits are the main source of productive investment in the major industrial countries, there is considerable variation in the amount of investment thus financed, reflecting partly differences in corporate retention ratios and partly variations in the share of profits in value added. Corporate retention tends to be higher in countries such as Japan, where inside shareholding through interlocking ownership among firms and banks belonging to large business groups is important, than in the Anglo-American system, where widespread individual shareholding and active secondary markets result in considerable pressures on corporate managers to distribute dividends; according to one estimate, individuals in Japan owned only 20 per cent of total shares in 1987, as opposed to 65 per cent in the United States.³⁵ However, since depreciation allowances account for a large proportion of gross corporate profits, inter-country differences in corporate gross savings rates are relatively small.

The share of gross profits in gross value added varies considerably (table 43). However, there is

Table 42

Country/sector	1960-1970		1971-1980		1981-1990	
	Saving	Investment	Saving	Investment	Saving	Investment
United States						
Total	17.7	16.1	19.1	17.3	19.4	16.9
Households	9.2	7.1	10.7	7.5	10.3	7.0
Corporate	8.5	9.0	8.4	9.8	9.1	9.9
Japan						
Total	28.3	30.7	30.4	28.2	26.2	23.6
Households	13.3	8.0	17.9	10.3	14.9	7.5
Corporate	15.0	22.7	12.6	17.9	11.3	16.1
Germany						
Total	21.1	22.7	20.4	19.5	20.8	17.6
Households	6.9	..	8.7	..	7.9	..
Corporate	14.2	..	11.8	..	12.9	..
France						
Total	..	..	22.2	21.8	18.8	17.3
Households	..	..	13.6	10.0	9.8	7.4
Corporate	..	..	8.6	11.8	9.0	9.9
United Kingdom						
Total	14.8	14.7	15.3	15.7	15.5	15.7
Households	5.4	3.0	6.1	3.9	5.9	4.9
Corporate	9.4	11.7	9.2	11.8	9.6	10.8
Italy						
Total	26.0	16.8	31.2	16.6	28.1	17.7
Households	..	..	24.5	7.2	21.7	9.9
Corporate	..	..	6.6	9.4	6.4	7.8
Sweden						
Total	..	..	14.3	17.0	15.0	16.6
Households	..	..	4.9	4.5	3.0	3.3
Corporate	..	..	9.4	12.5	12.0	13.3

Source: OECD, *National Accounts*, various issues.

considerable variation among countries in the relationship between the share of gross profits and that of corporate savings as a proportion of GDP, partly because of differences in various charges

on gross operating surplus, such as corporate taxes and interest payments, and partly because of differences in the propensity of corporations to retain profits.³⁶

Table 43

PROFIT SHARES IN SELECTED OECD COUNTRIES^a				
<i>(Percentage)</i>				
<i>Country</i>	<i>1960</i>	<i>1973</i>	<i>1980</i>	<i>1990</i>
United States	30.9	28.8	32.1	37.2
Japan	50.1	46.7	42.0	43.4
Germany	40.8	32.7	29.0	31.9
France	..	35.1	30.4	38.8
United Kingdom	31.7	31.8	31.3	36.2
Italy	..	34.1	45.3	47.7
Sweden	..	32.5	29.0	31.1

Source: OECD, *Historical Statistics*, various issues.

a Gross operating surplus (as defined in note 36 to the text) as a percentage of gross value added in industry, transport and communication.

2. Corporate savings in developing countries

The orthodox analysis of industrialization and growth in developing countries typically concentrates on household savings and explains savings performance in terms of macroeconomic fundamentals. Such explanations are also given for East Asian economies, such as those of the Republic of Korea and Taiwan Province of China, where domestic savings rose at unprecedented rates, from less than 10 per cent of GDP in the 1950s to more than one third in the 1990s.³⁷ According to this view, macroeconomic stability, together with the exceptional efficiency of those economies in using their physical and human resources, gave rise to rapid accumulation and growth which, in turn, resulted in a rapid increase in the savings rate.³⁸

Clearly, economic growth exerts a positive influence on savings, but it is less clear how savings and macroeconomic stability are related. The causality may indeed run in the reverse direction; often a high rate of saving is needed to maintain a high rate of accumulation without running into inflation and balance of payments difficulties. On

the other hand, evidence on the relationship between growth and stability shows that “low inflation and small deficits are not necessary for high growth, over even quite long periods”.³⁹ More important, while rapid income growth is essential for savings to rise, since it also allows consumption to rise, income growth is not translated automatically into higher savings growth. For instance, the average savings rate in some of the middle-income countries of Latin America failed to show a significant increase from the 1960s to the 1980s despite a relatively rapid growth of per capita income. During 1968-1977 in Brazil, for example, GDP grew at an average rate of 7.5 per cent per annum, but the gross domestic savings ratio was constant at around 20 per cent of GDP and the ratio of private savings at around 16 per cent.⁴⁰

This emphasis on household savings is one of the main reasons why the high savings rates in East Asia have not been properly understood. UNCTAD research on East Asia has taken a different route and concentrated on the link between profits and savings. It has revealed that the success of East Asian industrialization has depended very much on the role of government intervention in accelerating capital accumulation and growth, and that government policy achieved this objective by animating the investment-profits nexus that is constituted by the dynamic interactions between profits and investment: profits are simultaneously an incentive for investment, a source of investment and an outcome of investment. This thesis was based on three basic propositions. Firstly, high rates of investment played a major role in the exceptionally rapid growth of successful East Asian economies and this investment was, after an initial period, supported by high rates of domestic saving. Secondly, profits increasingly became the main source of savings and capital accumulation. Thirdly, government policy accelerated the process of capital accumulation by creating rents and pushing profits beyond what could be attained under free-market policies. Some evidence was provided in *TDR 1994* and *TDR 1996* in support of these propositions.⁴¹ This section introduces additional evidence from the region and compares it with other developing countries for which data are available, and relates profits and savings to income distribution.

Data on sectoral savings and investment are not readily available for developing countries, and hence it is not easy to account for the respective roles of corporate and household savings in inter-country differences in capital accumulation. Table

Table 44

SECTORAL SAVINGS AND INVESTMENT IN SELECTED COUNTRIES
(Percentage of GDP)

Country	Period	Households		Business		Memo item: Profit shares in manufacturing ^a
		Savings	Investment	Savings	Investment	
China	(1982-1986)	12.5	5.5	14.1	22.1	..
Republic of Korea	(1980-1984)	10.3	5.3	8.3	20.0	74.1
Malaysia	(1980-1986) ^b	19.7	2.9	9.1	16.3	70.3
Taiwan Province of China	(1980-1984)	13.7	..	12.0	..	..
Thailand	(1981-1983)	10.4	3.6	8.7	13.2	75.8
Japan	(1960-1970)	13.3	8.0	15.0	22.7	..
Philippines	(1983-1985)	10.0	1.0	3.3	10.2	80.3
India	(1978-1982)	16.6	10.0	1.9	3.1	52.7
Colombia	(1980-1984)	8.6	5.1	5.4	10.4	80.3
Ecuador	(1980-1984)	9.6	5.0	3.6	11.1	63.5
Paraguay	(1980-1984)	5.9	..	1.8	..	..
Peru	(1980-1984)	16.7	..	4.2	..	81.0
Uruguay	(1980-1984)	9.2	..	3.3	..	73.7
Venezuela	(1980-1984)	3.8	..	3.2	..	75.0
Cameroon	(1980-1984)	4.4	0.4	9.2	18.7	63.0
Côte d'Ivoire	(1974-1978)	4.1	3.0	3.3	12.3	73.0
Tunisia	(1980-1984)	6.7	4.3	5.9	20.4	53.0
Turkey	(1977-1981)	12.1	4.5	3.9	16.1	74.5

Source: UNCTAD secretariat estimates, based on national and international sources; World Bank, *World Development Report*, various issues.

a Manufacturing value added less total gross earnings of employees.

b Average of the three years 1980, 1985 and 1986.

44 assembles data from various sources on corporate and household savings and investment in a number of developing countries for the late 1970s and early 1980s, as well as corresponding data for Japan for the 1960s. These figures are not based on a common methodology and their margin of error is likely to be large, since the difficulties noted above in obtaining accurate estimates of household and corporate savings are even more serious for developing countries. Moreover, they do not all

refer to the same period, or reflect long-term tendencies.

Even allowing for these problems, however, table 44 strongly suggests that the exceptional savings-investment performance of East Asian economies has been due not so much to household as to corporate savings. Compared to most other developing countries, the East Asian NIEs have significantly higher business savings, while their

Box 8**COMPULSORY SAVING SCHEMES IN SINGAPORE AND MALAYSIA**

Singapore is the only country among the first-tier NIEs where household savings account for a large proportion of gross domestic investment. A large part of these savings is accumulated in the Central Provident Fund (CPF) established in 1955 as a compulsory social security programme. The contribution rates were initially set at 5 per cent of the employee's remuneration and a matching contribution of another 5 per cent by the employer. These rates were gradually raised to 25 per cent by the mid-1980s. They were subsequently lowered, but the total contributions by employers and employees never fell substantially below 40 per cent. Use of these funds by the employees is allowed primarily to purchase housing built by a public Housing Development Board or, to a lesser extent, to finance education, but otherwise the participants have a limited ability to withdraw their balances, even upon retirement. A very large proportion (about 95 per cent) of the Fund is invested in government securities. The contribution of gross CPF savings to gross national savings rose from around 10 per cent in the second half of the 1960s to over 20 per cent in the second half of the 1970s. At its peak in 1985, CPF contributions amounted to 36 per cent of gross national savings or almost 15 per cent of GNP. This state-managed fund is run extremely efficiently: in 1990, its administrative costs amounted to 0.5 per cent of total contributions, against 15 per cent in the privately-run Chilean scheme. Moreover, it is distributionally progressive: workers earning less than a specified minimum wage are exempt from contributions while deriving benefits.

In Malaysia, an important part of household savings appears to consist of forced or contractual savings, accumulated in the Employees Provident Fund, established in 1951. Total contributions to the Fund amount to 20 per cent of the wage bill, of which 11 per cent is paid by employers and 9 per cent by employees. These funds are directed primarily towards financing long-term development projects initiated by the public sector, although recently they have been increasingly invested in private sector assets. As in Singapore, withdrawals are allowed for housing purposes. The reserves of the Fund stood at over 45 per cent of GDP in 1994.

household savings are not exceptionally high, except in Malaysia and Singapore, where they are due mainly to compulsory saving schemes (see box 8). On average, business savings as a proportion of GDP are almost three times higher than in other developing countries, whereas the difference in household savings is much smaller. To put it differently, on average the business sector in East Asia appears to save 7 percentage points of GNP more than the business sector in other developing countries for which data are available, and the East Asian investment ratio is also higher by a similar margin.

The contrast between the East Asian NIEs and Latin American economies for which the data are available is particularly striking. For the Latin American countries, the average corporate savings ratio as a proportion of GDP is almost a quarter that of East Asian NIEs. Since the share of profits in Latin America is no less than in East Asia

(see also chart 16), this suggests that the low rate of accumulation in Latin America is not the result of insufficient capacity to generate investible resources, but of the high propensity to consume of property-owning classes. Moreover, this feature is not of recent origin; it was already noted as far back as the 1950s in respect of Chile:

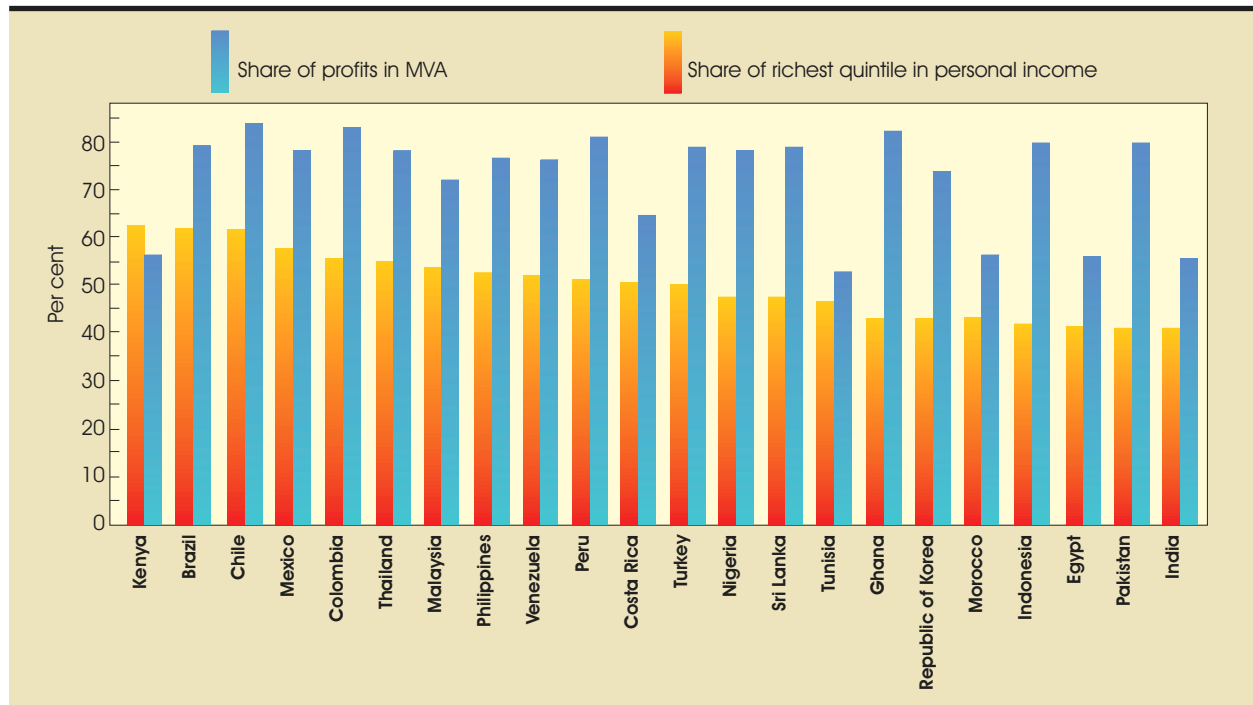
The percentage of net undistributed profits in total net profits was remarkably low in Chile throughout the period [1940-1954]; companies tended to distribute much the greater part of their increase in earnings. ... The extremely low estimates of national savings, despite the high ratio of both profits and dividends to the national income, are thus to be explained by the high propensity to consume of the capitalist classes.⁴²

It was estimated that the capitalist class in Chile spent on personal consumption more than two

Chart 16

SHARE OF PROFITS IN MANUFACTURING VALUE ADDED, AND SHARE OF THE TOP QUINTILE IN TOTAL PERSONAL INCOME, 1970-1992: A COMPARISON FOR SELECTED DEVELOPING COUNTRIES

(Percentage)



Source: World Bank, *World Development Report*, various issues; K. Deininger and L. Squire, *op. cit.* (see chart 14A).

thirds of their gross income, or three quarters of their net income - i.e. after tax, absorbing more than 20 per cent of national resources, as opposed to less than 8 per cent in the United Kingdom:

In comparison to other countries, the luxury consumption of the property-owning classes appears to take up an altogether disproportionate share of national resources, part of which would be automatically released for investment purposes if a more efficient system of progressive taxation were introduced and/or if effective measures were taken to encourage retention of profits by enterprises.⁴³

From the mid-1970s to the mid-1980s private savings in Chile never reached even 10 per cent of GDP. In the past decade, however, they have risen sharply, exceeding 20 per cent in the first half of the 1990s. This increase in private savings was a major factor in the recovery of the national sav-

ings rate, which has averaged some 26 per cent since 1990 - a very high rate in Latin America even though modest by East Asian standards. While reliable data on the respective contribution of the household and corporate sectors are not available, it is generally agreed that much of this rise in private savings has been due to corporate retentions. Some estimates indeed put corporate savings as high as 20 per cent of GDP - a level exceptional even by East Asian standards. Whatever its actual value, there can be little doubt that corporate savings are now the main source of capital accumulation in Chile. Adoption of the kind of policies advocated by Kaldor three decades ago, together with a strong investment drive in the traded goods sectors, appears to have played a major role in this respect (box 9). By contrast, the contribution of private pension funds to the rise in Chilean national savings is relatively small (around 3.2 per cent in the first half of the 1990s, compared to 2 per cent in the 1980s) and, on some estimates, not suffi-

Box 9**TAX REFORM AND CORPORATE SAVINGS IN CHILE**

Taxation of corporate profits in Chile during the 1970s was designed to encourage dividend distribution in order to help promote the stock market and allow firms to tap household savings. However, following the outbreak of the debt crisis, a new tax reform was introduced in 1984 which encouraged profits to be kept in corporations. The new law effectively replaced the corporate tax with an income tax. A 15 per cent tax is levied on corporate profits, but is in the nature of a tax credit. If profits are retained in corporations, the tax is reimbursed to the shareholders. Since the marginal income tax rate is quite high (around 45 per cent), this provides a strong incentive to profit retention. Moreover, because this tax exemption applies to undistributed profits of all types of corporations, it encourages households to rearrange their unincorporated business activities in corporations. It is perhaps for this reason that household savings appear to be very low and corporate savings exceptionally high in Chile.

cient to offset voluntary dissavings by households, even though there is not yet an important pension withdrawal from the system.⁴⁴

However, the tendency to spend capital income on consumption rather than investment appears to have continued in the rest of Latin America. Evidence available for a number of Latin American countries (Colombia, Ecuador, Paraguay, Peru, Uruguay and Venezuela) suggests that in the early 1990s the recipients of property and entrepreneurial income consumed, on average, more than 85 per cent of their incomes, and such spending absorbed up to 40 per cent of national income.⁴⁵ Despite many reforms and the end of the debt crisis, for the region as a whole the ratio of gross private investment to GDP during the 1990s has been even lower than during the difficult period of the 1980s.

3. Profits, savings and distribution

To what extent do variations among developing countries in the importance of corporate savings reflect variations in the share of profits in value added? Cross-country evidence shows that the correlation between the two is weaker in developing countries than in mature industrial economies, suggesting significant variations in corporate retention ratios among the former. In countries such as Colombia, Peru, Philippines, Tunisia, Turkey, Uruguay and Venezuela, the share of gross profits

in manufacturing value added (MVA) is as high as or higher than in the East Asian NIEs, but the contribution of gross corporate savings to gross capital formation in these countries is much smaller (see table 44). Similarly, aggregate national savings are not always correlated with the share of profits in MVA. There can be little doubt that factors other than the propensity to save from profits play an important role in differences in the extent to which corporate profits are retained for investment, including variations in the burden of interest charges on corporate debt, the level of corporate taxation and depreciation allowances. As discussed in the next chapter, most of these factors are influenced directly by government policy.

The previous section has shown that a high share of profits in value added may be associated with greater or smaller inequality in income distribution, depending on the extent to which profits are retained in corporations. Chart 16 compares the share of profits in MVA with the share of the richest 20 per cent in personal income distribution in 1980-1992 for countries for which data are available. The relationship between income equality and profit shares is indeed rather weak. A number of countries with similar profit shares have widely different income concentration ratios. In Kenya, Costa Rica, Tunisia, Morocco and Egypt profit shares are all lower than the average for the countries in the table, but the income concentration ratios vary considerably, from 62 per cent in Kenya to about 40 per cent in India.

More important, some East Asian NIEs, such as the Republic of Korea and Indonesia, have profit shares as high as Latin American countries, but they have considerably lower income concentration ratios. These differences can be explained, at least partly, in terms of corporate retentions, since, as noted above, retained profits are not included in personal incomes. A similar functional distribution of income between wages and profits results in a more equal distribution of personal incomes in East Asia than in Latin America, to a large extent because a much greater proportion of profits is retained and reinvested in corporations in the former than in the latter. To put it differently, a more equal personal income distribution in East Asia is a reflection of higher corporate savings rather than lower profits.

The difference between East Asian NIEs and other developing countries in the degree of equality of income distribution and the concentration of income at the top narrows down significantly if undistributed profits are added to household incomes. It is common practice to impute these to the top quintile in studies seeking to derive internationally comparable income distribution measures.⁴⁶ The same procedure can also be applied to East Asian NIEs since, unlike for land, there is no evidence that corporate ownership of capital assets is particularly evenly distributed in these countries. For instance, contrary to conventional wisdom, wealth is highly concentrated in Japan. It was estimated that during the early 1970s the top income decile held almost one half of total private wealth and that in 1988, the richest quintile had stock holdings that were nearly 14 times greater than that of the poorest.⁴⁷ Again, as noted in chapter III, the Gini coefficient for the distribution of financial assets in the Republic of Korea in 1988 was as high as 0.77. Comparable estimates are not available for other countries, but it is notable that this ratio is higher than the Gini coefficient of the distribution of bank deposits in Turkey noted above (0.70), where such deposits account for a large proportion of household financial assets.

If it is assumed that the sum total of personal incomes falls short of GDP only by the amount of retained corporate profits, a measure of the adjusted

share of the richest quintile can be estimated for a number of countries for the early 1980s by adding such profits to the personal incomes of that quintile. Clearly, for all countries this measure is higher than the share of the top quintile in personal income, but more so for East Asian NIEs because of higher retained corporate profits. The inclusion of retained profits narrows the difference between the latter countries and other developing countries. For example, the richest quintile income shares in the first half of the 1980s would rise from 42.7 per cent to 48.1 per cent in the Republic of Korea and from 42.0 per cent to 48.6 per cent in Indonesia. They would rise from 57.4 per cent to 59.7 per cent in Colombia; from 47.2 per cent to 48.9 per cent in Venezuela; from 47.4 per cent to 49.1 per cent in Côte d'Ivoire; and from 53.2 per cent to 55.0 per cent in Turkey.

When the share of profits in value added is high, even if profits are retained and invested, wealth concentration will increase over time with the accumulation of capital unless the initial distribution of corporate ownership is relatively equal. In other words, the relatively benevolent effect on present income distribution is obtained by a worsening of the distribution of wealth, which will certainly influence income distribution in the future. The question then arises how to avoid such an outcome without slowing down accumulation and growth. A redistribution from profits to wages over time as incomes rise can prevent a worsening of income distribution without slowing accumulation, provided that household savings gradually replace corporate savings. That is what appears to have happened in Japan in the past three decades: corporate savings as a proportion of GDP fell alongside the share of profits (in gross value added) and the increase in household savings largely made up for the decline (tables 42 and 43). As discussed in the next chapter, certain factors appear to have played an important role in this process. Reliance on excessive profits (rent creation) needed to build up infant industries gradually declined as industrialization progressed. The fall in the share of profits in value added coincided with the development of the bonus system, which promoted household savings. ■

Notes

- 1 For a discussion of these channels see T. Persson and G. Tabellini, "Growth, distribution and politics", *European Economic Review*, No. 36, 1992; A. Alesina and D. Rodrik, "Distributive Politics and Economic Growth", *The Quarterly Journal of Economics*, Vol. CIX, No. 2, May 1994; A. Alesina and R. Perotti, "The Political Economy of Growth: A Critical Survey of the Recent Literature", *The World Bank Economic Review*, Vol. 8, No. 3, 1994; T. Persson and G. Tabellini, "Is Inequality Harmful for Growth?", *The American Economic Review*, Vol. 84, No. 3, June 1994; A. Alesina and R. Perotti, "Income distribution, political instability, and investment", *European Economic Review*, Vol. 40, 1996.
- 2 The evidence is based on cross-country regressions, where instability is measured in terms of an index combining the number of politically motivated assassinations, the number of people killed as a result of domestic mass violence, the number of *coups d'état*, and a variable indicating whether the country is a democracy (free competitive elections) with universal franchise, a semi-democracy (some form of elections, with severe restrictions on political rights), or a dictatorship. For details see Alesina and Perotti, "Income distribution, political instability, and investment", *op. cit.*
- 3 For one such study that failed to find such a relationship see Douglas Hibbs, *Mass Political Violence: A Cross-Sectional Analysis* (New York: Wiley and Sons, 1973).
- 4 See O. Galor and J. Zeira, "Income Distribution and Macroeconomics", *Review of Economic Studies*, Vol. 60, 1993; M. Bruno, M. Ravallion and L. Squire, "Equity and Growth in Developing Countries", *Policy Research Working Paper* No. 1563, World Bank, Jan. 1996; and K. Deininger and L. Squire, "New Ways of Looking at Old Issues: Inequality and Growth" (mimeo), World Bank, Washington, D.C., July 1996.
- 5 See, for example, G. Saint Paul and T. Verdier, "Education, democracy and growth", *Journal of Development Economics*, Vol. 42, 1993; G. Saint Paul and T. Verdier, "Inequality, redistribution and growth: A challenge to the conventional political economy approach", *European Economic Review*, Vol. 40, 1996; and X. Sala-i-Martin, "Transfers", *Working Paper* No. 4186, National Bureau of Economic Research, Cambridge, MA, 1992.
- 6 See K. Goto, K. Hayashi, and K. Tsuji, "The 'East Asian Miracle' as Intellectual Public Property", in UNCTAD, *Proceedings of the International Conference on East Asian Development: Lessons for a New Global Environment, Kuala-Lumpur, Malaysia, 29 February - 1 March 1996* (a forthcoming United Nations publication).
- 7 The procedure is typically to examine whether initial inequality exerts a negative influence on subsequent growth, often over two or three decades. The data used generally include both developing and developed countries. As noted in chapter II, such growth regressions suffer from a number of serious methodological shortcomings.
- 8 See J.D. Sachs and A.M. Warner, "Natural Resource Abundance and Economic Growth", *Working Paper* No. 5398, National Bureau of Economic Research, Cambridge, MA, Dec. 1995; A. Fishlow, "Inequality, Poverty and Growth: Where Do We Stand?", in M. Bruno and B. Pleskovic (eds.), *Annual World Bank Conference on Development Economics* (Washington D.C.: The World Bank, 1995); and Deininger and Squire, *op. cit.*
- 9 For instance, according to one study, if in 1960 the Republic of Korea had had Brazil's level of inequality, Korean per capita income in 1985 would have been lower by 15 per cent, representing a loss of about two years' growth (N. Birdsall, D. Ross, and R. Sabot, "Inequality and Growth Reconsidered: Lessons from East Asia", *The World Bank Economic Review*, Vol. 9, No. 3, 1995, p. 496. It is, however, noted that there is also an indirect effect of inequality on growth through lower investment in education). See also G.R.G. Clarke, "More evidence on income distribution and growth", *Journal of Development Economics*, Vol. 47, No. 2, 1995.
- 10 In some studies (e.g. Persson and Tabellini, *op. cit.*), income inequality is found to be bad for growth only in democracies, while in others (e.g. Alesina and Rodrik, *op. cit.*, and Clarke, *op. cit.*), no difference could be detected between democracies and other regimes. Yet, according to another study, the link between initial income inequality and subsequent growth is much weaker in democracies (Deininger and Squire, *op. cit.*).
- 11 See R. Bénabou, "Human capital, inequality, and growth: a local perspective", *European Economic Review*, Vol. 38, 1994.
- 12 Deininger and Squire, *op. cit.* See also Bruno, Ravallion and Squire, *op. cit.*
- 13 However, in the studies mentioned above, the correlation between land and income distribution is

- weak, possibly because the income-earning capacity of land depends on a host of factors, including its quality and agricultural policies, which are not accounted for in such studies. A plot of land which does not earn much income does not provide a good collateral.
- 14 See, for example, *World Development Report, 1995* (New York: Oxford University Press for the World Bank, 1995), p. 39.
- 15 See I. Adelman and S. Robinson, *Income Distribution Policy in Developing Countries: A Case Study of Korea* (Oxford University Press, 1981).
- 16 See D. Mazumdar, *The Urban Labour Market and Income Distribution: A Study of Malaysia* (Oxford University Press, 1981).
- 17 See UNCTAD, *World Investment Report, 1995* (United Nations publication, Sales No. E.95.II.A.9, New York and Geneva, 1995), chap. III; A. Kokko, R. Tansini and M. C. Zejan, "Local Technological Capability and Productivity Spillovers from FDI in the Uruguayan Manufacturing Sector", *Journal of Development Studies*, Vol. 32, 1996; and B. Aitken, A. Harrison, and R.E. Lipsey, "Wages and foreign ownership. A comparative study of Mexico, Venezuela, and the United States", *Journal of International Economics*, Vol. 40, 1996.
- 18 For the definition of skill-intensive goods see *TDR, 1993*, Part Two, chap. IV, sect. B.
- 19 See *TDR 1996*, Part Two, chap. II, sect. C.3.
- 20 For a review of these formulations and their implications for the relationship between inequality and savings see K. Schmidt-Hebbel and L. Servén, "Income Inequality and Aggregate Saving. The Cross-Country Evidence", *Policy Research Working Paper No. 1561*, World Bank, Washington, D.C., Jan. 1996.
- 21 J. M. Keynes, *The Economic Consequences of the Peace* - Vol. II of *The Collected Writings of John Maynard Keynes* (third edition) (London: Macmillan, 1971), p. 11.
- 22 See Schmidt-Hebbel and Servén, *op. cit.*, which also contains a survey of the empirical studies on the relationship between savings and income distribution.
- 23 The private investment figures include FDI and hence overestimate domestic investment. Deducting FDI from these figures would, however, result in an underestimation of domestic investment since FDI includes purchase of existing assets as well as greenfield investment.
- 24 See A. R. Khan, "Reversing the Decline of Output and Productive Employment in Rural Sub-Saharan Africa", *Issues in Development, Discussion Paper No. 17*, ILO, Geneva, 1997, table 5.
- 25 L. O. Taylor, "Saving out of Different Types of Income", *Brookings Papers on Economic Activity*, No. 2, 1971; and E. Malinvaud, "Pure Profits as Forced Saving", *Scandinavian Journal of Economics*, Vol. 88, No. 1, 1986.
- 26 A. Dean, M. Durand, J. Fallon, and P. Hoeller, "Saving Trends and Behaviour in OECD Countries", *Working Paper No. 67*, OECD, Paris, June 1989, p. 79.
- 27 See J. Lecallion, F. Paukert, C. Morrisson and D. Germidis, *Income Distribution and Economic Development. An Analytical Survey* (Geneva, ILO, 1984), p. 50.
- 28 See Malinvaud, *op. cit.*
- 29 For a discussion of this issue see R. Ruggles, "Distinguished Lecture on Economics in Government. Accounting for Saving and Capital Formation in the United States, 1947-1991", *Journal of Economic Perspectives*, Vol. 7, No. 2, Spring 1993; and A. Dean *et al.*, *op. cit.*
- 30 Ruggles, *op. cit.*
- 31 C. Pitelis, *Corporate Capital. Control, Ownership, Saving and Crisis* (Cambridge: Cambridge University Press, 1987).
- 32 See C. Y. Horioka, "Is Japan's Household Saving Rate Really High", *Review of Income and Wealth*, Series 41, No. 4, Dec. 1995, and the references therein.
- 33 See F. Guy, "Correspondence: Unhooking Household Saving and Business Investment", *Journal of Economic Perspectives*, Vol. 9, No. 2, Spring 1995. The results are also taken as further evidence against the orthodox theory that household and enterprise savings are perfect substitutes.
- 34 On corporate investment, savings and leverage see A. Singh, "Savings, Investment and the Corporation in the East Asian Miracle", Study No. 9 prepared for the UNCTAD project on "East Asian Development: Lessons for a New Global Environment", sponsored by the Government of Japan (Geneva: United Nations, March 1996).
- 35 J. Bauer and A. Mason, "The Distribution of Income and Wealth in Japan", *Review of Income and Wealth*, New Series, 38, No. 4, December 1992, p. 419.
- 36 Gross operating surplus is defined as gross value added *minus* compensation of employees *minus* indirect taxes paid by the producer net of subsidies received. By contrast corporate savings are calculated as gross operating surplus *minus* various charges, including particularly corporate taxes and interest on debt, *minus* dividends; see T.P. Hill, *Profits and Rates of Return* (Paris: OECD, 1979).
- 37 For the evolution of savings in East Asia see *TDR 1996*, table 31.
- 38 See, for example, *The East Asian Miracle* (New York: Oxford University Press for The World Bank, 1993). The claim of exceptional productivity is highly controversial. For a summary of various views see Y. Akyüz and C. Gore, "The Investment-Profits Nexus in East Asian Industrialization", *World Development*, Vol. 24, No. 3, 1996; and Singh, *op. cit.*
- 39 S. Fischer, "The role of macroeconomic factors in growth", *NBER Working Paper No. 4565*, 1993, p. 21.
- 40 See M. R. Agosin, "Savings and investment in Latin America", *UNCTAD Review, 1995* (United Nations

publication, Sales No. E.95.II.D.23), New York and Geneva, 1995.

41 This approach was subsequently further developed in Akyüz and Gore, *op. cit.*

42 N. Kaldor, "Economic Problems in Chile", *Essays on Economic Policy II* (London: Duckworth, 1964), p. 256.

43 *Ibid.*, p. 266.

44 See M. R. Agosin, G. Crespi and S.L. Letelier, "Explicaciones del Aumento del Ahorro en Chile" (mimeo), IDB, Washington, D.C., August 1996; and G. Palma, "Whatever happened to Latin America's savings? Comparing Latin American and East Asian savings performances", Study No. 6 prepared for the UNCTAD project on "East Asian Development: Lessons for a New Global Environment", sponsored by the Government of Japan (Geneva: United Nations, March 1996). While agreeing on the importance of corporate savings, these studies give different figures for the division of private sav-

ings between the household and corporate sectors. The corporate savings are obtained as a residual and thus depend on the figure adopted for household savings. On the other hand, while the above studies give a negative figure for household savings for 1983-1985, according to a flow-of-funds study this sector had a financial surplus during that period; see P. Honohan and I. Atiyas, "Intersectoral Financial Flows in Developing Countries", *Working Paper, WPS 164*, March 1989, World Bank, Washington, D.C., p. 32.

45 These estimates are based on CEPAL national accounts data; see Palma, *op. cit.*

46 See Lecallion *et al.*, *op. cit.*; and Wouter van Ginneken and Jong-goo Park, *Generating Internationally Comparable Income Distribution Estimates*, A World Employment Programme Study, ILO, Geneva, 1992, pp. 4-8.

47 See Bauer and Mason, *op. cit.*

PROMOTING INVESTMENT: SOME LESSONS FROM EAST ASIA

A. Introduction

As noted in the previous chapter, accumulation and growth depend largely on the spending behaviour of the classes that take a very large share of national income, particularly the capitalist class. Historical and cultural factors play an important role in the emergence of a dynamic capitalist class with a high propensity to save and invest from profits. It was also noted that income distribution itself can have an important influence on incentives to save and invest. However, experience shows that government policies play a key role in promoting “animal spirits” among business, not only by securing certain basic conditions such as political and economic stability and property rights, but also through appropriate use of fiscal, financial, industrial and trade policy tools and institutional arrangements that enhance the effectiveness of government intervention.

This chapter discusses the key policy instruments and institutions used in the East Asian countries in animating the investment-profits nexus and attaining a rapid pace of growth and industrialization without widening inequality. The next section examines the policies and institutions designed to encourage savings and investment from profits, and is followed by a discussion of specific policies aimed at discouraging luxury consumption, focusing on how trade and development strategies can be designed to link investment and production to exports rather than domestic consumption. The final section examines the role of profit-related pay in reconciling distributional and growth objectives. While the chapter draws primarily on the East Asian experience, comparisons are also made with other countries.

B. Animating the investment-profits nexus

All the East Asian governments have generally succeeded in guaranteeing certain basic conditions for investment by maintaining political stability, ensuring the respect of property rights and creating a pro-investment macroeconomic cli-

mate. “Pro-investment” is a better description of East Asian macroeconomic policies than “stable” or “low inflation”, because some of these governments were willing to tolerate a fair degree of inflationary pressure for the sake of boosting in-