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Comment Francis T. Lui

The Gordon-Li paper provides a stimulating and insightful analysis on why certain *perverse* economic policies are adopted in developing countries. For instance, why do they adopt possibly harmful inflationary policy, set up high tariffs, pursue state ownership of firms and banks, and tolerate resource-wasting red tapes? In the literature, the rent-seeking approach, or its variants, such as the political economy model advanced by Grossman and Helpman (1994), can be used to address some of these issues. Interest groups, who have different degrees of political influences, can lobby the government to choose policies in their favor. The outcomes are often undesirable from the perspective of efficient allocation of resources.

The Gordon-Li paper proposes a competing hypothesis to the political economy approach. It highlights the difficulties of tax collection in many developing countries. The significant transaction costs involved could induce them to adopt various kinds of second or third best policies for making tax collection more effective.

According to Gordon and Li, their model can generate some outcomes that are similar to those of Helpman and Grossman, but there are also sharply different implications. The more important ones are as follows. First, companies in capital-intensive industries are more likely to pay lower taxes in the Grossman-Helpman model because they are lobbyists that are more powerful. On the other hand, in the Gordon-Li model, they are viewed as those that cannot escape from the tax agencies and therefore are forced to pay more. Second, Gordon and Li believe that the Grossman-Helpman model is not able to explain why governments, especially those in developing countries, adopt inflationary policies. But in the Gordon-Li model, this is taken as a convenient means for governments that lack effective tax agencies to collect revenues. Third, Gordon and Li believe that the Grossman-Helpman model cannot explain why red tape exists. The former

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regard red tape as a means for the government to deter otherwise tax-paying firms to escape into an informal sector, where firms can avoid tax payments more easily.

It is not clear that the two approaches are fundamentally inconsistent. Once we generalize the Grossman-Helpman model by treating branches of the government as interest groups themselves, the phenomena outlined previously can also be accounted for.

Take the example of red tape. Can its existence not be derived from a political economy model? In the literature on corruption, red tape is often treated as an instrument through which corrupt government officials can make profits. Bureaucrats themselves can be powerful lobbyists within the government who want to protect their own interests. This can be done by creating and maintaining red tape that strengthens and justifies the authorities it possesses.

In the Gordon-Li model, red tape is targeted on firms that want to go into the informal sector. This may not always be the case. If a firm wants to hide itself in the informal sector, possibly illegally, why should it bother with the red tape?

I do not see why inflationary policy is incompatible with the political economy approach. Government branches need revenue. If they saw that inflationary tax is effective in protecting their interests, they would support the policy. For instance, in the 1980s, many state-owned enterprises in China tried hard to expand their sizes, but that would require more expenditure. This eventually induced them to force the government to print more money. Thus, inflation could also be the result of a political economy model.

The paper has ranked tax revenue as share of GDP according to the ideological inclination of the country, and has found no obvious relationship between the two. This is regarded as a refutation of the political economy model because countries with different ideologies may face different political pressures. However, one can legitimately ask how ideology is to be measured. For instance, if we define left-wing government as one that favors larger government spending, there will necessarily be a relationship between revenue collected and the *ideology* of the government.

The paper argues that improvement in the financial sector may attract low-quality firms to reenter the formal sector. They could be new competitors for loans and credits. High-quality firms would find it less attractive to stay in the formal sector. These firms might leave, resulting in lower tax revenue for the government. It would be strange if this happened. If low efficiency firms find it profitable to stay, why would good firms be forced to leave?

In short, the Gordon-Li and Grossman-Helpman models are not substitutes for each other. It makes more sense if we regard them as complementary.

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Comment Michael M. Alba

Summary

Why are economic conditions—obviously beside the definitional divide in incomes and living standards—so different between rich and poor countries? In developing economies, why are inflation and tariff rates higher, property rights and the rule of law not well established, red tape rife, and corruption endemic? Why are government-owned or controlled firms—particularly banks—so ubiquitous, tax evasion so pervasive, and the tax base so narrow? In contrast to the political economy literature, which points to government capture by politically powerful groups as the source of these perverse outcomes, Gordon and Li (2005a, 2005b) hypothesize that the culprit is a developing-country government's limited capability to enforce tax laws, due, on the one hand, to informational and monitoring constraints when firms transact business on a cash basis, thus leaving no record, and, on the other hand, to the low and variable productivity gains that firms obtain when using the financial sector, thus providing them little incentive to switch from the tax-evading informal sector to the tax-paying formal sector. Accordingly, firms that cannot do without the financial sector, such as the large or capital-intensive ones, are those that are most highly taxed and that constitute the narrow tax base. In a second-order response, the government then acts to reduce the burden on these firms by providing tariff protection, rationing credit, and subsidizing loans (thus explaining government ownership of banks); at the same time, it can increase the costs of informal sector firms by using inflation as a tax on cash holdings and by imposing red tape, regulatory barriers to entry, and other nontax costs. As an extreme measure, the government may even opt for control of capital-intensive firms to ensure that, although heavily taxed, these firms continue to operate at the appropriate scale and capital intensity.

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