A Decade of Development Thinking

Research Department
Inter-American Development Bank

The Office of the Chief Economist of the Inter-American Development Bank was created in June, 1994 and was eventually renamed the Research Department (RES). Two Chief Economists have presided over the Department: Ricardo Hausmann (1994-2000) and Guillermo Calvo (2001-present). RES' mission is to generate new ideas to enrich the knowledge base that supports the policy agendas of the Bank and its member countries for achieving sustainable and equitable development in Latin America and the Caribbean.

RES performs innovative, comparative research on the development issues of greatest concern to the region today. It generates a wide variety of products based on this research and disseminates them to three principal audiences: the Bank, policymakers and the academic community. In addition to a wide range of working papers, RES produces the Economic and Social Progress Report (IPES), a thematically-focused comparative socioeconomic analysis of the countries of the region, and Ideas for Development in the Americas (IDEA), an economic and social policy newsletter. RES also manages seven academic and policy networks that range from the Latin American Research Network to the Latin American Network of Central Banks and Finance Ministries, and the Social Policy Monitoring Network. In addition, RES is responsible for six data monitoring and reporting systems covering macroeconomic, financial and social information. RES also sponsors numerous events ranging from informal policy seminars to high-level international conferences.

Since its inception, RES has striven to remain on the cutting edge of research on Latin America. RES has accompanied the region in its journey through macroeconomic turmoil, fiscal uncertainty and social disappointment, all the while offering its analysis of the problems at hand. Thus, a fitting way to commemorate this first decade of research is to compile a selection of the department's most important contributions to thinking on development in Latin America. In consultation with experts from throughout the region, RES selected 10 of its most influential papers and plans to publish this compilation through the Latin American Development Forum, a joint publications venture among the Economic Commission for Latin America and the Caribbean (ECLAC), the IDB, Stanford University Press and the World Bank. This document is the introduction to that book and the individual papers are available in the accompanying CD. We hope you will find this of interest and join us as we celebrate A Decade of Development Thinking.

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Eduardo Lora, Carmen Pagés,
Ugo Panizza, Ernesto Stein

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Eduardo Lora, Carmen Pagés, Ugo Panizza, Ernesto Stein[1]

Development thinking in Latin America has taken a striking turn since the mid-1990s, when the region was in the midst of huge transformations. Military regimes, the norm in previous decades, had given way to democratic systems. The foreign debt crisis of the 1980s had been left behind thanks to the Brady Plan and the development of a robust bond market for a group of what began to be known as emerging economies. The fiscal disarray that had prevailed in several countries in the previous decade had been eliminated, thereby allowing the specter of hyperinflation to be laid to rest. Every country without exception had to some degree adopted structural reforms geared toward facilitating functioning markets. The changes appeared to be yielding results: several economies enjoyed a number of consecutive years of growth higher than 5 percent, and unemployment and poverty were declining.

This was the backdrop for the creation of the Research Department of the Inter-American Development Bank.[2] The Department had scarcely begun operations, however, when the atmosphere of confidence was shattered by the Tequila crisis in Mexico in late 1994, which quickly spilled over into Argentina, a country that until that time had been viewed as an exemplary model of macroeconomic and structural reforms. The return of macroeconomic volatility to the region raised doubts about the consensus, prevalent until then, on the prominent role of domestic policies in macro stability. In fact, these events led analysts and researchers to question the role of the new international financial order in the crisis and the

[1] Useful background material was also provided by Alberto Chong, Suzanne Duryea and Arturo Galindo. Rita Funaro, John Smith and Carlos Andrés Gómez provided editorial support. The authors wish to acknowledge valuable suggestions and criticisms by Nancy Birdsall, Mauricio Cárdenas, Nora Lustig, Guillermo Perry, Andrés Rodríguez, Mariano Tommasi, and Andrés Velasco.

[2] The Department was originally known as the Office of the Chief Economist.

mechanisms that made other countries vulnerable to spillover effects. These concerns surfaced repeatedly in the ensuing years, when crises erupted in Asia in 1997 and Russia in 1998, and corporate scandals were exposed, beginning with Enron, in 2002.

These events notwithstanding, there could be no question that fiscal discipline was key to fighting inflation and ensuring macroeconomic stability. Unfortunately, in many instances apparent fiscal discipline was actually the product of a momentary growth in tax receipts; this growth resulted from the boom phase of countries' economic cycle, less costly debt service charges because of exchange rate movements reflecting the return of foreign capital to the region, and resources accruing from the privatization of state enterprises. To make matters worse, it was becoming apparent that countries affected by the Tequila crisis were incapable of using fiscal policy to stabilize aggregate demand and to cushion the fall of declining revenues. What was stopping countries from implementing more prudent fiscal policies that would enable them to better weather the storm? Why did some countries tend to take on excessive debt and put at risk their hard-won macroeconomic stability? These were the central questions that led to the study of fiscal institutions and the determining factors of economic policy, issues that prior to the mid-1990s had received short shrift from analysts and researchers of economic development.

Despite the strong growth that some countries experienced in the early 1990s, by the middle of the decade it was becoming clear that, with the exception of Chile and, surprisingly, the Dominican Republic, growth was dropping again to unimpressive levels, and below those typical in the region during the 1960s and 1970s. These levels, moreover, were too meager to close the gap in per capita income with the United States. What good, then, had the reforms been? Ideological positions, more than empirical evidence, tended to guide how this critical question would be answered. This situation should have surprised no one. Even though economic growth had leapt to a position of prominence on the international agenda of academic research, the determinants of growth were identified only tentatively and incompletely. The situation persisted in part during the ensuing years. However, to the extent that certain conclusions were drawn, thinking and practice recognized that properly functioning markets comprise only a single component of the formula for growth; their effectiveness will depend on more complicated factors that lend themselves less to precise definition and modification, such as the rule of law, how public policy decision-making is practiced, and the operations of the machinery of government.

In addition to economic volatility and low growth, employment, poverty, and inequality have been priority development concerns in Latin America. Here, too, thinking and practice have turned sharply since the mid-1990s as analysts and policymakers recognized that expectations for the impact of democratization, macroeconomic stability and trade liberalization on employment, poverty and inequality were unrealistically high. Unemployment reached historic peaks in the late 1990s, while poverty rates and indicators for inequality in the countries of the region at the beginning of the new millennium were essentially unchanged from their levels a decade earlier; notable success was seen in only certain isolated cases. Did this disappointing performance result from a lack of growth, or did it occur because growth was grounded in the market, particularly greater integration with world markets? To what degree was progress impeded by the absence of reforms in labor institutions and mechanisms for social protection?

The Research Department's agenda has been shaped by this heated atmosphere of economic and intellectual change. Below, this introduction will attempt to show the redirection that has taken place in thinking on development in Latin America over the last decade and to place in proper perspective the group of articles produced by the Research Department and selected for this book. The next section sums up the prominent issues concerning research on macroeconomic volatility, its causes, and the policies aimed at curbing it. The subsequent section examines fiscal institutions, the role they play in macroeconomic stability (or in its absence), and the factors that explain their characteristics. The third section looks at the intense debate over the effectiveness of market-friendly reforms and the factors that have conditioned the depth and the outcome of the reforms. Finally, we review advances in research on the effects of economic policies on unemployment, poverty and inequality and on the role that employment and social policies may play in reducing poverty and unemployment.

Volatility, Crisis, and Crisis Resolution

Over the last 30 years, Latin America's macroeconomic performance has proven disappointing. The growth rate of the region's income can be described in two words: low and volatile.

Over the 1970-2000 period, average per capita growth in the region has been just above 1 percent, well below that of Asian countries (that ranged between 3.5 and 6 percent) and also below the performance of industrial countries. Only Sub-Saharan Africa and the Middle East fared worse than Latin America. While moving from 1 to 4 percent may not seem significant at first glance, the difference over the long run is dramatic. At the end of 2000, Latin America's per capita GDP was 40 percent higher than in 1970. The corresponding figures for East Asia and the industrialized countries are 320 percent and 80 percent, respectively.

Not only has Latin America's growth been slow but it has also been characterized by a high degree of volatility. Again, only Africa and the Middle East have been more volatile than Latin America. Studies suggest that this high degree of economic volatility might have contributed to the region's poor growth performance (Ramey and Ramey, 1995). The IDB report on volatility (IDB, 1995) estimated that volatility has reduced economic growth in Latin America by approximately one percentage point per year. This negative effect was due to both a negative effect of volatility on factors accumulation (the report found that volatility has a negative effect on investment in both human and physical capital) and factor productivity.

Given this high degree of volatility and its negative consequences for the growth performance of the region, it is not surprising that documenting this volatility and devising instruments aimed at reducing volatility has been one of the obsessions of the Research Department. Macroeconomic volatility was the focus of the first report on Economic and Social Progress in Latin America produced by the Research Department. The report was published in 1995, just two years after the seminal contribution of Calvo, Leiderman and Reinhart (1993), who forcefully made the point that external factors play a fundamental role in determining the fortunes of several emerging market countries. Initial work by the Research Department recognized the importance of external factors but remained optimistic that domestic policies could by themselves isolate the region from such shocks. The paper by Hausmann and Gavin (1996) included in this volume is representative of this view. While the paper documents volatility and its main external sources, the authors suggest that good policies can play an important role in limiting volatility. In particular, this paper suggested that institutions aimed at increasing credibility (including denominating the debt in foreign currency), ensuring fiscal stability, and granting flexibility (including having a flexible exchange rate) can work as shock absorbers and can help reduce volatility. Consequently, a substantial effort was devoted to research aimed at devising instruments that could limit volatility. The research agenda on budget institutions described in the next section was one of the most visible outputs of this research effort.

Readers familiar with the recent literature on “Original Sin” and the negative consequences of liability dollarization will recognize that, in light of current knowledge, some of the policies recommended in the original Hausmann and Gavin (1996) article seem self-contradictory. In particular, we now know that it is very difficult to have flexible policy instruments (like a floating exchange rate) in the presence of foreign currency debt. While hindsight is always 20/20, the paper reflects the state of knowledge in the mid-1990s, before the Asian and Russian crises of 1997 and 1998. These crises shocked the region by demonstrating that even countries with good policies, fiscal surpluses, and high saving rates were vulnerable, and that a crisis originating in a faraway country like Russia could have disastrous consequences for Latin America, and even hurt a country, like Chile, characterized by stellar policies. From that point on, it became clear that sound domestic policies are a necessary but not sufficient condition for isolating emerging market countries from external shocks. Efforts to understand the origins of the crisis and developing mechanisms to reduce volatility gave rise to two new complementary areas of research. The first emphasizes the role of currency denomination of external debt, and the second focuses on the role of Sudden Stops in capital flows.

The crises of the late 1990s showed that Latin American countries could not follow the example of the more developed European economies and respond to an external shock by depreciating their currencies.[3] It soon became evident that the structure of debt had something to do with a country's inability to freely float its exchange rate, and this was at the basis of the new research agenda on "Original Sin" that was pioneered by the Research Department. In an article presented at the Jackson Hole conference organized by the Federal Reserve Bank of Kansas City, Eichengreen and Hausmann (1999) defined Original Sin as a situation in which a country cannot borrow abroad in domestic currency. The paper by Hausmann, Panizza, and Stein (2002) included in this volume was one of the first attempts to measure Original Sin and show that this phenomenon has important consequences for the conduct of monetary and exchange rate policy. In particular, the paper shows that Original Sin limits the central bank's ability to conduct an independent monetary policy and leads to what Calvo and Reinhart (2000) have called "fear of floating."

[3] This was documented by Gavin, Hausmann, Pagés and Stein (1999).

Subsequent work by Eichengreen, Hausmann, and Panizza (2003a and 2003b) and Hausmann and Panizza (2003) corroborated the original results and showed that Original Sin cannot be fully explained by poor domestic policies or institutions. This later research also expanded the analysis from a relatively small sample of approximately 30 countries, to a sample that includes all countries for which data are available (approximately 80) and showed that Original Sin is a pervasive phenomenon. In particular, it was shown that out of the nearly $1.3 trillion in outstanding securities placed in international markets by countries that do not issue the five major currencies (the US dollar, the Euro, the yen, the pound sterling and Swiss franc) $1.1 trillion was denominated in those five major currencies.

Recognizing that the presence of foreign currency debt limits the ability to conduct a counter-cyclical exchange rate policy led to two kinds of policy responses. The first suggested that countries should abandon any attempt to use the exchange rate as a policy instrument and fully embrace credibility by adopting official dollarization (Hausmann, 1999, Calvo, 2000).[4] This policy proposal generated an intense debate and several authors criticized the adoption of super fixed exchange rate regimes by suggesting that they limit policy flexibility (Sachs and Larrain, 1999, Chang and Velasco, 2000) and increase the incentives to borrow and lend in foreign currency (Burnside et al., 2000).

The second kind of policy response aimed at devising a strategy to "redeem" countries from Original Sin and thus create the conditions under which emerging market countries could conduct counter-cyclical monetary and exchange rate policies. In this setting Eichengreen and Hausmann (2003) formulated a proposal that was not based on domestic policy but would require the active involvement of the international financial institutions (which would be required to issue bonds denominated in a basket of

[4] Panizza, Stein and Talvi (2001) focus on Central America and discuss the condition that would justify the adoption of liability dollarization.

emerging market currencies). While the validity of such a proposal is still under discussion (for a critical analysis, see Goldstein and Turner, 2004, and Reinhart, Rogoff and Savastano, 2003), the Original Sin research agenda is very much at the center of the current policy debate, and it partly explains the Inter-American Development Bank's recent decision to issue bonds denominated in currencies of its borrowing countries.

The crises of the late 1990s, especially the Russian crisis of 1998, also sparked the research agenda on Sudden Stops. The sudden and unexpected interruption in capital flows that followed the Russian crisis forced countries to dramatically adjust their current account deficits to accommodate the shortage of external credit. Calvo and Reinhart (2000) illustrate the destructive power of such drastic changes in capital flows and show that when access to international capital markets is closed—something that occurs with distressing frequency in emerging market countries—the collapse in economic activity is dramatic.

The Russian default of 1998 was a milestone in the development of emerging capital markets because it was hard to imagine how a crisis in a country with virtually no financial or trading ties to several emerging market countries could have such profound effects on them. This puzzle posed serious challenges to traditional explanations of financial crises and led analysts to focus on the intrinsic behavior of capital markets. Thus, it was argued that prevailing rules for capital market transactions may have been responsible for the spread of shocks from one country to other regions. Calvo (1999) suggested that the high leverage of financial intermediaries in margin operations led to a liquidity crunch when Russian bond prices collapsed, which in turn forced massive sales of emerging market assets. In fact, Calvo (2002) suggests that Sudden Stops are not due to the oft-cited temptations of moral hazard, but rather to "Globalization Hazard," whereby limited information on the part of some investors leads to self-fulfilling contagion. As in the case of Original Sin, such a situation cannot be fixed by domestic policies alone (although more openness and less debt can help in preventing the devastating effects of sudden stops). Therefore, Calvo (2000) proposes a global solution based on an emerging market fund that would prevent contagion through purchases of an index of emerging market bonds during crisis periods.

While the Russian Crisis had a negative effect on the whole region, the consequences were disastrous for Argentina, which suffered an economic crisis of unprecedented magnitude and was forced into the largest debt default in the history of emerging markets. The paper by Calvo, Izquierdo and Talvi (2003) included in this volume focuses on the fiscal effects of a Sudden Stop in capital flows and shows that the Sudden Stop that followed the Russian crisis played a fundamental role in the Argentinean crisis.

The main thrust of the paper is that a Sudden Stop in capital flows will require a quick adjustment of a country's current account deficit. While countries with a large and competitive tradable sector can close the current account deficit with a surge in exports, countries with a relatively small tradable sector relative to their absorption of tradables will have to close the current account deficit by reducing the absorption of tradable goods, and this can only be achieved with a depreciation of the real exchange rate.

The real depreciation brought about by a Sudden Stop will have no serious consequences in countries where most of the debt (both public and private) is denominated in domestic currency. However, the consequences can be devastating in countries where most of the debt is denominated in foreign currency. In particular, a real depreciation in the presence of a large amount of dollar-denominated public debt will lead to a sudden jump in the debt-to-GDP ratio and push an economy over the edge of insolvency.[5]

[5] Technically, there will be a negative valuation effect if the share of foreign currency denominated debt is larger than the share of tradable output over total output.

One of the lessons that can be drawn from the analysis of Calvo, Izquierdo and Talvi (2003) is that the negative effects of a Sudden Stop are due to the dangerous mix of large current account deficits, large external liabilities, a small tradable sector and a large share of foreign currency debt.[6] This last factor highlights the complementarities between the Sudden Stop and Original Sin research agendas. In subsequent research, Calvo, Izquierdo and Mejía (2003) show that balance sheet effects, captured by the interaction of liability dollarization and potential changes in relative prices, not only increase the cost of a Sudden Stop, but also make Sudden Stops more likely to happen. It is also interesting to note that the Calvo, Izquierdo and Talvi (2003) analysis can be applied to other types of shocks to the financing of the current account (for instance, a sudden decline in the price of an export commodity or of inflows of remittances) and hence will be key for the development of sustainability exercises that would incorporate the characteristics that are typical of emerging market countries.[7]

The fact that a larger tradable sector reduces vulnerability to sudden stops, provides another argument for policies aimed at increasing trade openness (besides the traditional one that says that openness promotes growth) and is also related to another subject that has been central in the research agenda of the Research Department of the Inter-American Development Bank. In fact, one recent report on Economic and Social Progress in Latin America (IDB, 2002) was exactly on the benefits of economic integration. One chapter of the report focused on the relationship between monetary and trade integration. In particular, the chapter followed

[6] It is worth noting that the real depreciation brought about by a sudden stop could have negative fiscal consequences even if public debt is low or denominated in domestic currency. This is because currency mismatches in the private sector could lead to defaults and create contingent liabilities for the public sector.
[7] For a survey of recent work and an application to Ecuador, see Díaz-Alvarado, Izquierdo, and Panizza (2004).

the seminal work of Rose (2000) and estimated the trade effects of monetary unification.[8]

Another chapter of the integration report focused on the problems that arise when countries have trade agreements but lack coordination in their exchange rate policies. The article included in this volume (authored by Fernández-Arias, Panizza, and Stein) summarizes the main points made in the report and tests whether the negative effects of large real exchange rate misalignments are exacerbated when they originate within regional integration agreements. It shows that the negative effect on exports and FDI flows of an exchange rate misalignment is amplified when the misalignment is among countries that share a regional integration agreement. It also shows that regional integration agreements strengthen the well-established relationship between real appreciation and currency crises.

The findings of the paper are important because they suggest that coordination to achieve real exchange rate consistency within blocs is key for macro stability and, a fortiori, sustainable trade agreements. The paper suggests that policy issues in connection with risks emerging from exchange rate disagreements can be grouped in three classes: (a) unilateral policies countries may choose to make themselves less vulnerable to exchange rate disagreements within regional integration agreements (RIA); (b) macroeconomic policy coordination among RIA members; and (c) adequate international financial architecture to support RIAs.

[8] While Rose's original work focused on the whole world and was criticized for overemphasizing the role of small and developing countries (see Persson, 2001), the paper that originated from the aforementioned report on integration (Micco, Stein, and Ordoñez, 2004) addresses these criticisms by focusing on the early experience of the European Monetary Union. The results of the research are striking because they show that even in this group of large and developed countries, monetary integration had a sizable effect on trade. In particular, the article shows that a common currency increases total trade because it increases trade among its members and does not generate trade diversions. For these reasons, this article has been at the center of the policy debate in countries that are evaluating whether to join the Euro or not.

A combination of these measures will be key in reducing macroeconomic volatility while maintaining high levels of economic integration.

Budget Institutions and Fiscal Performance

One of the areas in which Latin America had made substantial progress since the 1980s, and before the return of international volatility in 1995, was fiscal accounts. After averaging between 5 and 10 percent of GDP for most of the 1980s, central government deficits in the region had declined on average to less than 2 percent of GDP in the first half of the 1990s. While these developments represented important progress and made deficits as a share of GDP comparable to those of the OECD countries, concerns about fiscal deficits and government debt accumulation remained. First, observed deficits in most countries were substantially lower than structural or permanent deficits due to cyclical factors, appreciated exchange rates and the once-and-for-all proceeds of privatizations. Second, deficits were still very high in comparison to the OECD when normalized by the resources available to finance them, i.e., government revenues, or the size of the financial sector.[9] Moreover, comparisons across countries revealed striking differences in fiscal performance in the region, with deficits ranging from more than 10 percent of GDP in countries like Guyana or Suriname, to surpluses of 2.5 and 3 percent of GDP in Chile and Jamaica. And, finally, as will be further discussed below, fiscal consolidation had not been enough to allow government to use fiscal policies in a counter cyclical manner, in order to cushion incomes and consumption in the event of negative shocks.

[9] In some cases such as Argentina, Brazil or Colombia, an important part of the imbalances were related to subnational government finances. These issues, as well as other aspects of intergovernmental fiscal relations, also played an important role in the research agenda of the Office of the Chief Economist (see in particular the 1997 Economic and Social Progress Report, as well as Stein, 1999)

Fiscal Institutions as Determinants of Public Expenditures and Fiscal Deficits

Differences in fiscal performance across countries—or across states of nature—in OECD countries, which are clearly too large to be explained by purely economic factors, by the early 1990s had already led a number of scholars to explore the potential role of political and institutional factors in explaining such differences. In this context, a number of studies focused in particular on the role of budget institutions. The paper in this volume, "Budget Institutions and Fiscal Performance in Latin America" by Alesina, Hausmann, Hommes and Stein (1999), was inspired by this literature.

What are budget institutions? According to Alesina and Perotti (1996), they are the set of rules, procedures and practices according to which budgets are drafted, approved and implemented. These rules may take the form of numerical limits to some fiscal variable such as debt or deficit; they may take the form of rules on the transparency of the budget; or they may take the form of procedural rules, i.e., the rules of the game in the interaction among the different political actors that participate in the budgetary process.

Although there was some earlier work on the subject, the interest in budget institutions increased substantially, particularly among U.S. scholars, as a result of growing deficits in the U.S. during the late 1970s and the 1980s, which culminated with the Gramm-Rudmann-Hollings Act (GRH) of 1985.[10] The imposition of numerical limits on deficits, which were the centerpiece of GRH, as well

[10] The growth of deficits was partly due to President Reagan's supply side economics, partly to changes in the budget process introduced by the Budget and Impoundment Control Act of 1974, which shifted the balance of power from the executive to the legislative by limiting the power of the President to terminate programs autonomously by simply withholding funds. The Budget Act also created the Congressional Budget Office, and changed important aspects of the internal budget process in the legislature.

as the change in procedural rules involved in the 1974 Budget Act, generated a considerable amount of discussion on issues of budget rules and their potential effects on fiscal performance, including spending, deficits, debt, as well as the capacity to carry out countercyclical fiscal policy.

On the theoretical side the literature, mostly from the formal political science field, focused on the legislative budget process in the American Congress, and on pork- barrel spending in particular. A classic paper by Weingast, Shepsle and Johnson (1981), for example, studied how common practices in the U.S. Congress could lead to excessive spending in programs with concentrated benefits, but which are financed with a common pool of resources.[11] Other authors, such as Ferejohn and Kreibhel (1987), focused on the order of voting in the legislature (in other words, is there a vote on overall budget size before voting for individual appropriations, or does the overall size emerge as a residual?), and its impact on the size of the budget, finding that the sign of the impact was ambiguous. Baron (1989, 1991) and Baron and Ferejohn (1989) studied the distribution of pork-barrel projects in the legislature, focusing on issues of agenda setting powers and the rules by which amendments to the budget may be introduced.[12]

On the empirical side, the literature focused initially on the impact on deficits of GRH, which set a series of targets involving a gradual reduction of the deficits to achieve balance, as well as a number of provisions (such as sequestration procedures that mandated automatic cuts in most government programs) to ensure that actual deficits did not exceed the targets.[13] Gramlich (1990), Hahm, Kamlet, Mowery et al. (1992) and Reischauer (1990) are a few of the papers focusing on the impact of GRH, reaching somewhat

[11] See Velasco (1999) for a dynamic version of this model, leading to excessive deficits and debt accumulation.
[12] For a survey of this literature, see Alesina and Perotti (1996)
[13] Poterba (1996) discusses the debate over the deficit impact of GRH in great detail.

contrasting conclusions about the merits of the deficit limits. Their analysis is not an easy one, given the difficulties in coming up with the right counterfactual.

More recently, research has shifted to the experience of the U.S. states, which provide perhaps a more natural experiment. Forty-nine out of the fifty U.S. States have balanced budget rules, which differ in a number of dimensions, such as the legal rank of the rule (in some states the rule is in the Constitution, in others it is just a law); the coverage of the rule (in some states it covers the whole budget, in others it leaves out capital expenditures); and the stage of the budgetary process at which the rule applies (budget submitted to the legislature, approved budget, or executed budget). While there were some limited earlier efforts to understand the workings of these rules (see the discussion of these efforts in GAO, 1983), the academic literature exploded after the Advisory Council for Intergovernmental Relations (ACIR) compiled in the late 1980s an index of the stringency of the states' balanced budget rules. Studies found that states with more restrictive rules i) tend to have lower deficits (Eichengreen, 1992, Bohn and Inman, 1996) and lower debt (von Hagen, 1991); ii) tend to face lower interest rates, even after controlling for the size of deficits (Goldstein and Woglom, 1992, Eichengreen, 1992, Lowry and Alt, 1995, Poterba and Reuben, 1998); iii) adjust more in response to past deficits (Alt and Lowry, 1994); iv) react by adjusting more during the fiscal year in response to adverse shocks (Poterba, 1994); v) have a less counter-cyclical fiscal policy (Bayoumi and Eichengreen, 1995), but vi) this last fact does not translate into increased output volatility (Alesina and Bayoumi, 1996).[14]

The first studies looking at the impact of budget institutions on fiscal performance using cross-country data were carried out by von Hagen (1992) and von Hagen and Harden (1996) for

[14] For a useful review of this literature, see Poterba (1996). This paper also includes a discussion of the important issue of endogeneity, from which we abstract here due to space considerations.

countries in the European Union. They carefully put together an index of budgetary institutions that goes beyond numerical rules, and focuses mostly on budget procedures, drawing in part on the theoretical literature discussed above. In particular, it is based on the relative power of the finance minister within the cabinet, the structure of the negotiations within the cabinet, the relative power of the executive vis-à-vis the legislature in the budget process, the degree of expenditure control by the budget authority during execution, and the degree of transparency of the budget.[15] They found that more hierarchical (or in their words, centralized) budget institutions, which concentrate budgetary power in the executive branch and, within the executive branch, on the finance minister, tend to reduce deficits and debt without affecting the capacity of governments to stabilize output.

The results of this literature, coupled with the concerns with fiscal indiscipline in a number of countries in the region, led the Office of the Chief Economist to explore this issue for countries in Latin America and the Caribbean. Inspired by the work of von Hagen and his co-authors for Europe, Alesina, Hausmann, Hommes and Stein (1996) developed an index of budget institutions for 20 Latin American countries, based on a questionnaire distributed to budget directors encompassing the stages of budget preparation, approval and implementation. They find that more hierarchical budget institutions lead to smaller primary deficits.[16] Similar exercises, with comparable results, have been done since for the countries in the Middle East and North Africa (see Esfahani, 1999), as well as for the Argentine provinces (see Sanguinetti, Jones and Tommasi, 1998).

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[15] See also von Hagen and Harden (1996) and Hallerberg and von Hagen (1998). This last study brings together political and institutional considerations into the analysis of fiscal performance.

[16] A later paper by Stein, Talvi and Grisanti (1998) shows that the index also has an impact on government debt, although it does not affect the procyclicality of fiscal policy.

The studies discussed above are mostly positive in nature. However, the findings that differences in budget procedures had an impact on the size of debt and deficits, coupled with the concern that the adoption of strict numerical rules would lead to a procyclical response of fiscal policy to output, led some of these authors to recommend the establishment of institutions geared to address the issue of fiscal discipline and procyclicality at the same time. Thus, Harden and von Hagen (1996) suggested the creation of National Debt Boards for the European countries, an autonomous group of notables who would be in charge of setting the maximum allowed limit on debt, taking into consideration the conditions of the cycle. In a similar vein, Eichengreen, Hausmann and von Hagen (1999) proposed the creation of National Fiscal Councils (NFCs) in Latin American countries, where the issue of fiscal procyclicality, coupled with high volatility, was of great concern. The NFCs were similar in nature to the National Debt Boards, but had the added role of setting the macroeconomic assumptions to be used for the purposes of budget preparation and approval, as well as acting as an autonomous scorekeeper in the discussions between the executive and the legislature.

Although none of the countries adopted these recommendations, the region has witnessed a great deal of budgetary reform during the last five years. Partly inspired by the literature cited above, and partly by budget reform in other regions (most notably the Fiscal Responsibility Act of 1994 in New Zealand), a number of countries have been adopting fiscal responsibility laws, in each case with different characteristics. Argentina and Peru were the first countries to adopt such laws in 1999 and 2000, respectively, incorporating a mix of numerical rules, stabilization funds, changes in procedures and increased transparency.[17] The numerical rules were later relaxed in both cases, and in neither case have the rules met with compliance. Brazil has implemented the most comprehensive fiscal responsibility law in the Americas, specifying limits to debt, as well as

[17] In New Zealand, the reform does not involve numerical rules, and focuses instead on procedural rules and transparency.

expenditures in personnel, which apply not only to the central government, but also to each level of government. Unlike those in Argentina and Peru, it was enacted after much consultation with civil society. Also in contrast to Argentina and Peru, it is a special law, which cannot be undone by a normal law. In addition, it includes automatic mechanisms to correct imbalances when the numerical limits are approached, as well as severe penalties (including jail) for non-compliance. Although the early results are quite encouraging, it still may be too early to reach definitive conclusions on its merits. Other countries that have reformed their budget institutions in recent times include Chile, which adopted a structural surplus rule in 2001 and, more recently, Colombia and Ecuador. The recent flurry of activity surrounding the budgetary institutions in Latin America clearly suggests that the topic remains, more than ever, a worthy one for further research.

Procyclical Fiscal Policy in Latin America

As mentioned, fiscal institution reform has not only been aimed at curtailing excessive deficits and public indebtedness, but also at creating room for fiscal policies to operate countercyclically in order to smooth incomes and consumption. As discussed above, Latin America is one of the most volatile regions in the world. Average GDP volatility, measured by the standard deviation of growth rates, had been on the order of 4.7 percent during the previous 30 years, more than twice the level of OECD countries. In such a volatile context, fiscal policy should play an important stabilizing role. Yet, in contrast to the experience of the OECD countries, fiscal policy in Latin America is highly procyclical. The paper in this volume, by Gavin, Hausmann, Perotti and Talvi (1996), was the first one to document this important fact.

The question of how fiscal policy should be managed over the cycle has received a great deal of attention over the years. A neoclassical approach to optimal fiscal policy, based on the tax-smoothing model of Barro (1979), suggests that fiscal policy should remain neutral over the business cycle. This would entail keeping tax rates, as well as spending programs, stable over the cycle. As a result, revenues should fall during recessions, and deficits should increase in order to allow expenditures to remain fairly constant. A Keynesian approach would imply that fiscal policy should be countercyclical. Within this framework, deficits would increase during bad times, but expenditures would increase as well, and taxes decline, in order to reduce the magnitude and duration of recessions.

This discussion suggests that, depending on the framework the policymaker has in mind, expenditures should either remain stable or behave in a countercyclical manner. This is exactly what one observes in the OECD countries, where fiscal policy benefits from a number of automatic stabilizers. In contrast, in Latin America expenditures are procyclical, a response that seems to be at odds with the principles of economic theory. To make matters worse, procyclical behavior appears to be particularly strong during bad times, when even deficits tend to decline in response to recessions. As argued by Gavin, Hausmann, Perotti and Talvi (1996), this means that, rather than being used for stabilization purposes in the context of intense volatility, fiscal policy in the region has the exact opposite outcome: it exacerbates macroeconomic volatility.

The stylized facts regarding the differences in fiscal response in Latin America, compared to the OECD, have been complemented by Gavin and Perotti (1997), De Ferranti, Perry, Gill et al (2000) and, most recently, by Braun and Di Gresia (2003). The latter focuses in particular on the procyclicality of social expenditures, precisely the type of expenditures one would want to protect during bad times. The evidence presented by the authors shows that, in most Latin American countries, social spending is less procyclical than total expenditures. However, expenditures in the social sectors still tend to fall in response to declines in GDP growth.[18]

[18] Other papers discussion procyclicality of social expenditures in Latin American countries include Hicks and Wodon (2000), and Wodon, Hicks, Ryan et al. (2000).

Given these stylized facts, a key question is why would fiscal policy be procyclical? And, in particular, why is it procyclical in Latin America, while it is stable or countercyclical in the OECD? A number of arguments have been advanced in this regard. Giavazzi and Pagano (1990) have suggested that fiscal adjustment during recessions may be an optimal response if governments are nearly insolvent, as a fiscal expansion may create fears of a fiscal crisis and a collapse of confidence. Caballero and Krishnamurthy (2004) argue that the difference in the cyclical behavior of fiscal policy observed in industrial versus developing countries is due to differences in financial depth. They show how lack of financial depth can constrain fiscal policy in a way that can overturn standard Keynesian fiscal policy prescriptions.

A related argument, advanced by Gavin, Hausmann, Perotti and Talvi (1996), is that countries in Latin America, as opposed to those in the OECD, have limited creditworthiness, and their access to financial markets tends to be diminished precisely during bad times, when they most need it. Countries would like to respond to recessions countercyclically but do not have access to sources of finance during bad times. This limited creditworthiness, in turn, may be partly attributed to the underlying volatility of these economies. In this way, volatility, procyclicality and limited creditworthiness are all part of a vicious cycle that severely complicates the management of fiscal policy in Latin America. These arguments suggest that fiscal retrenchment during bad times may actually be the best response available to governments given the constraints they face. The key to avoiding procyclical fiscal behavior may be, instead, to avoid entering recessionary periods in a precarious financial condition.[19] One obvious way to do so is saving during good times—which begs the question of why countries do not do so.

A few papers have explored precisely this issue. Talvi and Végh (2000) develop a theoretical model in which the procyclical nature of

[19] See Gavin and Perotti (1997).

fiscal policy in the region arises from governments' inability to save during good times, due to political pressures to overspend. These pressures to overspend, they assume, are an increasing and convex function of the size of the surplus. Countries with higher volatility would require larger surpluses during good times, which make it increasingly difficult to withstand the political pressures to spend the boom's revenues, given the convexity of the political pressure function. Thus, underlying GDP volatility again takes center stage in this paper in order to explain the differences in the cyclical behavior of fiscal policies in Latin America vis-à-vis the OECD.[20]

Tornell and Lane (1999) advance an alternative explanation. They argue that industrial and developing countries differ in the extent to which they suffer from political pressures to overspend during good times as a result of common pool problems in the allocation of fiscal resources. To a greater extent than is the case in industrial countries, fiscal resources in developing countries are a common pool from which interest groups try to appropriate as much as they can. During booms, each group tries to push for a larger share, knowing that if they do not appropriate the resources and spend them, other groups will. Thus, exercising restraint during good times is not the rational response of the interest groups when the government is known to have little ability to withstand spending pressures. In this regard, the key difference between industrial and developing countries is that, in the former, the ability of powerful groups to appropriate resources is effectively limited by political institutions and budget procedures, while in the latter it is not. Interestingly, this argument brings us full circle back to institutions.

So what can be done in terms of budget institutions in order to help countries save during good times, and thus avoid the problem posed by procyclical fiscal policy?[21] Unfortunately, there

[20] Braun and Di Gresia (2003) present empirical evidence of a very tight correlation between volatility and procyclicality.
[21] See Braun and Di Gresia (2003) for a more complete discussion of different options to deal with procyclicality.

are no easy solutions. Two obvious candidates for dealing with the problem of procyclicality are fiscal rules and stabilization funds. While numerical rules specifying the size of the deficit or surplus may complicate countercyclical management of fiscal policy, other rules, if properly designed and enforced, may help in this regard. Such is the case with the structural surplus rule in place in Chile, and one can think of expenditure rules that are not contingent on actual revenues that would also help in this regard. In fact, any of these rules would, in essence, be very similar to stabilization funds. The problem in this case is enforcement. The same political pressures that make it difficult to save during good times, in the absence of rules and funds, may complicate their enforcement during good times. In Chile, the structural surplus rule seems to be working quite well, but Chile was able to save during good times even before the adoption of the rule. Other countries are likely to have problems doing so, with or without such rules.

Beyond these rules, one could think of more hierarchical/centralized budget institutions, which may contribute to put a check on the commons problem and, more generally, may contribute to a more responsible fiscal behavior. But in the end, even these budget institutions have to be traced back to the more fundamental political institutions, which determine which are the players that participate in the fiscal decision-making process, distribute the power among the different actors involved, and determine the rules of the game in their interactions.

Economic Thinking on Structural Reforms in Latin America

In 1994, when the Research Department was created, there were good reasons to be optimistic over Latin America's prospects. Renewed access to international capital was encouraging governments to embrace the set of policies summarized five years earlier by John Williamson in the "Washington Consensus." By 1994, all the countries in the region were riding the wave of pro-market reform, reducing import barriers, and relaxing interest rate controls within the financial system, while many of them were taking steps to privatize state enterprises.

Two other important events occurred in 1994. First, the successful implementation of the Real Plan in Brazil soon lowered inflation in Latin America's largest economy to levels seen in most countries only after several years of fiscal discipline and independent monetary authority. Second, Mexico signed the North American Free Trade Agreement (NAFTA) in partnership with Canada and the United States, laying the foundation for quadrupling its exports over the course of the next six years.

This momentary optimism would be shattered in December, 1994 with the outbreak of the Tequila crisis in Mexico, which had a particularly pernicious effect on Argentina. Nevertheless, these events failed to undermine the confidence in pro-market reforms prevailing among international organizations and top economists. In 1996, Dani Rodrik remarked, "Faith in the desirability and efficacy of these policies unites the vast majority of professional economists in the developed world who are concerned with issues of development" (Rodrik 1996, p. 9).

As the pace of structural reforms in Latin America was increasing, belief in their ability to spur productivity and growth was so strong that development economists were asking why these reforms had not been adopted earlier. This question provided the foundation for the literature on the political economy of the reforms, which culminated in the mid-1990s with a plethora of theoretical models geared toward explaining the timing (when and why reforms take place), sequencing (why they are sometimes implemented in several areas simultaneously and sometimes not) and pace of reforms (why some countries implement reforms in one fell swoop and others incrementally). According to these models, the key players are the distinct interest groups that interact in a distributional struggle in varying contexts. The anticipated benefit of adopting certain reforms will change in the presence of a crisis that upsets the balance of power among them, or because new information comes to light either on the distributional effectiveness and impact of these reforms or on their future stability.[22]

The activism of governments, the optimism of practitioners and the vigor of debate among theoreticians were defining traits in the panorama of structural reforms in the mid-1990s. Among other segments of the population, public opinion ranged from expectant to tolerant. Although observable improvements were not forthcoming in social or employment conditions, the central tenets of market economics and of liberal reforms were not rejected.

Ten years later, the situation is quite different. Reforms have bogged down in practically every country, and in several cases there has been a pronounced retreat. Among international organizations and practitioners, the prevailing attitude is one of less certainty and greater pragmatism, and in academic circles, faith has been lost in the explanatory or normative capacity of the theoretical perspectives in vogue a decade earlier. For its part, public opinion believes that many reforms have not been beneficial and that social problems have returned (Lora, Panizza y Quispe, 2004).

Still, in many senses, these changes do not imply a rejection of the Washington Consensus. In the first place, the objectives that the reforms initially pursued have been broadened, not cast aside. The almost exclusive emphasis on efficiency and growth has been rounded out with a more explicit consideration of the objectives of macro stability, on the one hand, and the reduction of poverty and inequality, on the other (Williamson, 2003, and Birdsall and de la Torre, 2001). Secondly, the market instruments that were envisioned to achieve growth have not been abandoned; rather, recognition that their efficacy depends on the quality of government institutions has been growing. Institutional reforms or "second-generation reforms," to use the term coined by Naím (1994) are now center stage in the amended versions of the Washington

[22] These theories are reviewed in Tommasi and Velasco (1996) and Rodrik (1996). For a succinct summary, see IDB (1997, Part Two, Charts 1.1 and 1.2).

Consensus currently making the rounds (Birdsall and de la Torre, 2001, Rodrik, 2002, Williamson, 2003). Thirdly, opportunities to fuel pro-market reforms continue to be seized when they are available, even in the face of contravening political ideologies (Brazil under the Lula government) and occasionally at great political cost (Bolivia under Sánchez de Losada). In other cases, anti-neoliberal rhetoric has been strident, but there have been few decisions to beat a retreat (Peru under Alejandro Toledo, Argentina under Néstor Kirchner, Ecuador under Lucio Gutiérrez). Finally, public opinion does not appear to be turning left or making an about-face toward a political activism that would demolish the "neoliberal model" (Lora, Panizza and Quispe, 2004).

Pro-market structural reforms have settled from an initial phase of inflated expectations to a more modest phase of adaptation. Something similar has occurred with economists' thinking on the effects of the reforms and the importance of the factors of economic policy identified in the literature. The empirical evidence produced over the last ten years has lent support to most of the theoretical predictions, even as it has shown that the factors prominent in theory are of less importance than originally proposed.

The Magnitude of the Reforms

Empirical studies of pro-market reforms in the mid-1990s were guided by attempts to quantify the impact of reforms. Quantification efforts made by Lora (1997, 2001), the most recent version of which is published here,[23] show that reforms were (and continue to be) much less uniform among different areas of reform and among the countries that supposedly adopted the Washington Consensus *en masse*. In fact, whereas virtually all countries concentrated their reform efforts on opening up trade and liberalizing the mechanisms for domestic finance, reforms in other

[23] Using various methodological adaptations, since 1975, these indices have been broadened to cover most countries in Latin America (Morley, Machado and Pettinato, 1999) and have also been applied in some African countries (Bonaglia, Goldstein and Richaud, 2000).

areas were far more disparate and less comprehensive. In the area of privatizations, Argentina, Bolivia and Peru set forth an ambitious strategy to be followed in every area of infrastructure, whereas in Mexico, Costa Rica and Uruguay, several sectors—ranging from electricity to telecommunications—remained closed. Likewise, the reforms to simplify tax structures envisioned under the Washington Consensus led to the adoption of sales tax systems and large reductions in the maximum tax rates of businesses and individuals in almost all countries, but only in a few were appreciable improvements made in collections systems and structures to fight tax evasion. In the area of labor reforms, legislation in few countries has allowed for more flexibility, and no uniform trend has emerged. Thus, there has been broad divergence in the depth, timing, sequencing, and pace of the reforms.

As for the impact of reforms on economic growth (see, in the section below, the discussion concerning employment and distributional effects), the tenor of economic research has clearly shifted from optimism to moderation. The first studies (Easterly, Loayza and Montiel 1997, Fernández-Arias and Montiel 1997, Lora and Barrera 1997) concluded that reforms accounted for about two points of economic growth in Latin America. Given that the reforms were (and continue to be) an incomplete process, it was assumed that stepping them up would lead to significant additional benefits. But more recent studies point to less encouraging effects. Escaith and Morley (2001), who use a modified version of the same indices for 1970-95, also find a positive effect, although smaller in magnitude and less robust than those reported in previous articles. By using the same indices for 1985-99, Lora and Panizza (2002) make new estimates of the effects of the reforms on growth. They find that the effects were more modest and of a transitory nature because they seemed to be diluted after the reforms were in place for some time. For example, during their high point (1991-93), the reforms increased annual growth by 1.3 percentage points. When the reform period began to slow down, the growth effect declined considerably, and in 1997-99 it engendered only 0.6 percentage points of additional growth (compared with a hypothetical situation with no further reforms). Loayza, Fajnzylber, and Calderón (2002) also find more modest effects of the reforms in their update of the estimates of Easterly, Loayza, and Montiel (1997).

A growing body of research has aimed at understanding why growth effects have turned out to be modest and what can be done to make market reforms more effective. Research efforts have focused on the three most important reform areas, namely trade liberalization, domestic financial liberalization, and privatization.

The Effects of Trade Liberalization

The area of structural reform whose effects on growth have been the subject of most debate is international trade liberalization. Most evidence from cross-country and panel regression analyses indicates that openness is positively correlated with growth (Dollar 1992; Sachs and Warner 1995; Frankel and Romer 1999; Ben-David 1993; Edwards 1998; Dollar and Kraay 2000; for a recent survey see Berg and Krueger 2003). Studies of domestic experiences point to the same conclusion but are less consistent since disentangling the numerous factors that affect growth is difficult on a case-by-case basis (see summaries in Srinivasan and Bhagwati, 1999, and Berg and Krueger, 2003). Although this body of research points towards the positive effect of trade liberalization on growth, measurement problems and the inability to separate the effects of openness with those of other growth determinants weaken this conclusion. The issue of measurement stems mainly from the fact that in many of these studies openness is measured by an outcome variable, such as the ratio between imports and exports to GDP, and not by a policy variable, such as the level of effective protection or the anti-export bias of the system of policy interventions.[24] Therefore, even if they

[24] Since policies are difficult to measure directly, some studies attempt to measure them as a residual, by isolating the influence of other factors (such as income levels and geographic features) on openness. For a discussion on this topic see Berg and Krueger 2003.

lend support to the hypothesis that trade is good for growth, those studies cannot provide strong results about the impact of trade liberalization policies. Although several papers do use indicators of policies, the measures built for that purpose have also been subject to criticism. Harrison and Hanson (1999) and Rodríguez and Rodrik (2001) have found that due to a variety of methodological problems and data errors, the results of the most quoted papers that use policy indicators are not particularly solid. Nevertheless, Wacziarg and Welch (2003) find that Rodríguez and Rodrik's criticisms are valid for cross-country analyses, from which it cannot be concluded that opening helps growth, but not for time-series panel results, which demonstrate the high and robust effects of liberalization on growth. Using a dichotomous measure of liberalization that only captures discrete shifts in trade policy, they find that trade liberalization produces growth surges on the order of 1.5 percentage points.

The issue of correlation between openness and other growth determinants, such as institutional quality, has led to several recent papers. The issue arises because it is difficult to separate the effects of these variables since their exogenous components that can be identified with the use of instrumental variables (such as the distance from trading partners and historical determinants of institutional quality) are highly correlated with each other. Thus, while Easterly and Levine (2002), and Rodrik et al. (2002), find that institutions trump openness when both are instrumented, Dollar and Kraay (2002) using similar methods show that their separate effects cannot be distinguished. Dollar and Kraay (2001) avoid this problem by looking only at differences in openness through time in a panel of roughly 100 countries in the 1980s and 1990s. Their basic result is that changes in trade volumes are strongly correlated with changes in growth. Although their results are robust to the inclusion of several institutional and policy variables, they cannot say much about the impact of trade policy, since they use outcomes, not policy indicators. Therefore, although much evidence points towards the beneficial effects of trade on growth, it is less clear to what extent (exogenous) trade liberalization policies promote higher growth, and whether the effect is transitory or permanent. Studies focused on Latin America (Lora and Barrera 1997; Stallings and Peres 2000; Loayza, Fajnzylber, and Calderon 2002), which also find a positive relationship between liberalization and growth are subject to similar criticisms.

Trade liberalization policies in Latin America were much more effective in raising imports than exports. While import-to-GDP ratios went from an average of 22.6 percent in 1983-85 to 36.2 percent in 1998-2000, export ratios increased much less, from 23.3 to 29.6 percent (IDB, 2003). Only a few countries made important inroads in world markets, most notably Mexico. In most other countries, export increases were a result of deeper regional trade, while exports to other regions grew little and became more concentrated in primary products. Although econometric evidence is still wanting, this may help explain why increased trade penetration failed to deliver the promise of higher growth rates, especially during the second half of the nineties. At any rate, the experience of the 1990s indicates that trade liberalization by itself is no panacea. A modicum of complementary policies are needed, among them better access to international markets, policies to address key competitiveness weaknesses (such as transportation infrastructure, export promotion and R&D support), and an exchange rate and macroeconomic policy regime consistent with outward orientation (Bouzas and Keifman 2003). Even smaller changes in policy could spark export growth in several countries, as has been argued in a very recent study by Hausmann and Rodrik (2004). A system of incentives to encourage the discovery of new investment opportunities may prove effective in small, low-to-medium income economies.

The Effects of Financial Liberalization

Empirical research on the effects of financial liberalization has shown that while it does not contribute to an increase in savings

(Bandiera et al., 1999), it does increase financial deepening that, in turn, is associated with growth (Levine, 2001).[25]

Two transmission channels from financial liberalization to growth have been identified by the empirical research. First, under certain conditions financial liberalization is associated with deeper credit markets. When institutions are properly set, financial market liberalization, particularly in both the domestic banking system and stock markets, can be a growth-promoting policy. Using an econometric methodology that allows the effects of financial liberalization to be identified in a context of multiple reforms, Galindo, Micco and Ordoñez find that, on average, financial liberalization boosts the growth rates of industries that, for technological reasons, rely more on external financing than others. Their results suggest that, after liberalization takes place, sectors with higher external dependence grow 1.33 percent faster than industries with low external financing requirements. Financial liberalization promotes development and tends to reduce the cost of funds, and to foster the growth of sectors dependent on external capital.[26] These results strongly depend on the quality of underlying institutions such as the degree of creditor protection, the efficiency of courts and the rule of law.

Second, there is evidence that financial liberalization also leads to efficiency gains in financial intermediation. That is, it not only increases the size of credit markets but also the efficiency with which funds are allocated. Country-level studies for Ecuador, Mexico, Chile, and Indonesia also indicate that financial liberalization leads to a more efficient allocation of capital and relaxes credit constraints faced by small firms (Harris, Schiantarelli and Siegar 1994; Jaramillo, Schiantarelli and Weiss 1996; Gelos and Werner 1999; Gallego and Loayza 2000).[27] In a cross-country panel

[25] Reforms that eliminate negative real interest rates seem to have the largest impact on growth.
[26] Rajan and Zingales (1998) provide the framework from which this analysis stems.
[27] Laeven (2000) supplies cross-country evidence for the fact that financial liberalization relaxes financial constraints but affects small firms more than large firms.

of 14 emerging markets, Galindo, Schiantarelli and Weiss (2002) show that financial liberalization improves the allocation of investment.

However, research has also shown that financial liberalization may lead to crisis. This is because the previous system of interest rate controls and directed credit may have created weak bank portfolios and not promoted a good "credit culture." This suggests that post-liberalization financial crises are due less to the liberalization per se than to the pre-liberalization environment, the sequencing of financial reforms and the legal, regulatory, and supervisory structures (Caprio and Hanson, 2001). Demirguc-Kunt's and Detrigiache's (1998) research on financial crises has shown that when basic institutions that govern credit markets are weak (i.e. when rule of law is weak, creditors are unprotected, and regulation is deficient) liberalization increases the likelihood of a crisis. This presumption is corroborated by Arteta et al. (2002) by interacting a capital account liberalization index with financial depth with an index of law and order. Note that these are the same preconditions under which financial liberalization has shown to have little effect on growth.

Although much evidence indicates that good institutions improve the odds of developing deeper and more stable financial systems, two major criticisms are in order. First, the indicators used for these tests often are too general to derive specific policy implications. For instance, the usual indicators of rule of law or contract enforcement are based on subjective opinions on things as varied as the respect for contracts and the use of criminal methods for solving conflicts. Second, as pointed out in an influential paper by Glaeser et al. (2004) it is hard to find quantitative measures of institutional quality that reflect permanent and durable institutional features, such as the protection of property rights and contracts. The usual indices of institutions fluctuate with the economic and political situation. Much research is still needed to pinpoint which institutions do really matter and what factors affect their effectiveness. A recent example of the type of research needed in this area is the study undertaken by Galindo and Micco (2004) included in this publication, which analyses, on theoretical and empirical levels, the influence of effective legal rights of financial creditors on the supply of credit. The results of this research indicate that this institutional aspect has an enormous impact on financial depth and credit volatility, and therefore, indirectly, on the efficacy of reforms to liberalize the financial sector with a view toward spurring greater economic growth.

The Effects of Privatization

In recent years, public opinion and policymakers in Latin America have turned against privatization, unleashing a large political backlash to privatization that has been brewing for some time. This has occurred despite the lack of hard evidence to actually assess the privatization record in the region. Recent research on privatization at the Research Department sets the record straight by analyzing systematic evidence emerging from comprehensive studies in the region that take into account typical flaws in previous research in the region and elsewhere, in particular, small, inaccurate, and biased samples. In accordance with earlier worldwide evidence (for instance, Megginson, Nash and van Randenborgh, 1994; Boubakri and Cosset, 1998; D'Souza and Megginson, 1999), Chong and López-de-Silanes (2004) find that when taking into account most of the criticisms and flaws of previous studies, the empirical record shows that privatization leads not only to higher profitability, but also to high output and productivity growth, operating efficiency, fiscal benefits, and even quality improvements and better access for the poor. These increases are typically accompanied by reductions in unit costs, boosts in output and lower or constant levels of employment and investment. The evidence suggests that higher efficiency, achieved through firm restructuring and productivity improvements, underpins profitability gains. The results on firm performance are robust to whether the calculations are performed with raw data or industry-adjusted information.

Who pays for the profitability gains? The evidence suggests that although labor cost reductions and price increases account for part of the gains, the bulk of the profitability improvement lies in deep firm restructuring and productivity growth. In fact, countries that privatize have benefited, and the gains are not only kept by firm owners, but also distributed to society as a whole. These findings do not mean that failures do not occur, but rather that they are not the norm. Most instances of failure can be explained by three factors. First, opaque processes with heavy state involvement open the way to corruption and opportunistic behavior. Second, poor contract design and regulatory capture are linked to a lack of deregulation and inadequate re-regulation. Third, deficient corporate governance institutions raise the cost of capital and hamper restructuring efforts; they may even throw firms back into the hands of the state. In short, it is clear that instances of failure exist, but in light of the overwhelming evidence, this should not be turned into an argument to stop privatization, but rather into an additional reason for identifying institutional failures and addressing them.

Therefore, as in the case of financial liberalization, a successful privatization process requires an adequate regulatory framework and political and social institutions that direct and supervise the activities of the regulatory boards (World Bank 2001; IDB 2001). Thus, reforms in the financial and infrastructure sectors have had positive effects when the reforms have generated a climate favorable to competition and an adequate regulatory system. When these conditions are met, the effect on growth of the financial reform and the privatization of key infrastructure sectors can be substantial (Mattoo, Rathindran, and Subramanian 2001).

Despite the differences between the various studies, the conclusion that can be drawn is that the reforms have had a positive, but modest, effect on growth. Even considering the more optimistic calculations, which place the effect at close to 2 points of additional growth, the reforms by themselves could not have raised per capita growth from -0.7 percent in the 1980s to rates around 3 percent, like those seen in the 1960s and 1970s. One of the reasons for the modest impact of the reforms may have been that they were incomplete, did not have enough internal institutional support, and took place in an unstable international environment, especially in the realm of financing, which in turn may have compromised national macroeconomic policies. This debate suggests that the reforms changed the operation of the economy less than is generally assumed, and hence their impact on productivity was muted. This view has inspired the extension of the Washington Consensus to several other areas of reform, as mentioned above. Such an approach, however, remains open to serious criticism; it calls for reforms that are beyond the political and practical possibilities of any government, and it fails to convey any sense of priorities or even direction. According to Rodrik (2003), jump-starting growth and sustaining growth are two separate enterprises. The former seldom requires such a wide array of policy changes, and it is unclear that the latter must necessarily be based on that combination of policies. He notes that several celebrated cases of economic success, most notably in Asia, seem to defy the standard policy prescriptions of either the Washington Consensus or its extended version. Both South Korea and Taiwan relied upon public enterprises and utilized industrial policies including directed credit, trade protection, export subsidization, and tax incentives, while China grafted a market system onto its planned economy.

The Political Economy of the Reforms

Empirical evidence has shown that the political economy factors identified in theory are quite limited in their capacity to explain the intensity, timing, pace, and impact of the reforms. Lora (1998) and Lora and Olivera (2004a) tested some of the hypotheses of the theoretical literature and found support for several of them. In particular, they found that the depth and characteristics of crises influence the timing and the combination of reforms. Nevertheless, the authors reached the conclusion that these hypotheses explain only the slimmest proportion of reforms that did in fact take place. Similar conclusions have been reached in regard to other factors that are less prominent in economic theory but noted by political scientists, such as the administrative cycle of government in which reforms are attempted and the availability of international financial resources. No econometric studies exist on the explanatory capacity of these factors in the case of second-generation reforms, but the ad hoc evidence mustered by Navia and Velasco (2003) suggests that they are scarcely significant. These authors observed: "All this intellectual activity... was exciting... [but] it all seems like *much ado about little*" (p. 274, emphasis in the original).

The limited explanatory capacity of the hypotheses on the political economy of the reforms may stem from the difficulty of gauging such factors as the fragmentation of classes or the benefits expected from the reforms among the different social groups involved. Nevertheless, several case studies and econometric analyses, undertaken from a political science perspective, suggest that the problem more likely arises because the models are too general to capture the specific characteristics of the political contexts in which reforms take place. For example, ideologies and party affiliations are considered only vaguely in these models, yet they may be crucial in explaining the course of reforms. Voters choose candidates who reflect their ideological preferences and who may be expected to adopt policies consistent with their expectations should they win election. The combination of political parties without a clear ideological identification, voters who identify little with the parties, and independent candidates who have never had a political career may attenuate this connection and make the "surprise reform" strategy more viable, as was seen in Latin America in the early 1990s (Stokes, 2001). The econometric evidence shows in fact that the ideology of the president's party is a poor predictor of the direction of a government's economic policies. Nevertheless, the ideological orientation of legislators is a clear predictor of reform policies whose effectiveness depends on legislative willingness and authority with which to adopt reforms (Johnson and Crisp, 2003).

Moreover, econometric evidence lends support to the hypothesis that not only are Latin American voters responsive to economic outcomes (in particular, inflation and, to a lesser degree, growth), but that they are also highly responsive to the direction of economic policies (Lora and Olivera, 2004b). Even though there has been a general rejection of pro-market reforms, disapproval has been mitigated when the economy is launched from a situation of crisis, when growth accelerates, and when the reforms adopted correspond better to the ideological direction of the governing party. In any event, the central conclusion drawn from this evidence is that party reformers have paid a high cost for the adoption (whether incomplete or not) of the Washington Consensus. During the early stages of reform, these political costs were not evident because many pro-market reforms were made in tandem with a package for macroeconomic stabilization that produced considerable political benefits. But this opportunity has now passed.

The time of major pro-market reforms has drawn to a close. On the other hand, research on the economic, political, and social effects of the reforms has just begun. As has been shown, the academic discussion during the last decade on the impact of reforms on productivity, investment, and growth has been fluid but inconclusive.[28] It is apparent that the economic effects are not uniform among countries and may depend on the quality of institutions. However, much work remains to be done in order to delineate the channels of influence and the specific institutional aspects that influence the efficacy of reforms. Much less is known about processes to transform government or institutions in general, and more specifically about the factors that influence the success of attempts to undertake institutional reform. Clearly, the results of these attempts at reform depend on the rules and practices of the political game and the strategies employed by the executive, legislators, political parties, interest groups, and social organizations to influence deci-

[28] As the following section will discuss, the assessment of social effects remains similarly inconclusive.

sion-making processes and implementation. Given that the results of these political interactions are difficult to anticipate in a general way, specific knowledge is needed of the institutions, processes and practices of policy-making and implementation in each country and in each policy area in order to improve our understanding of government reform processes and their influence on the efficacy of economic and social reforms.

Employment, Poverty and Inequality

Latin America is afflicted by high levels of inequality and poverty and this situation did not improve much during the nineties. Even when average per capita growth rates increased relative to the meager growth rates observed in the 1980s, poverty and inequality hardly declined. The share of the population living in moderate poverty (on less than approx. $2 per day) fell on average by only 4 percentage points from a level of 43 percent to 39 percent, based on calculations for 17 countries (Székely, 2001).[29] Moreover, the percentage of the population living in extreme poverty (on less than approx. $1 a day) fell by less than one percentage point, from 16.8 percent to 15.6 percent (Ravallion and Chen, 2000). In comparison, the share of extreme poor in China fell from 49 percent to 6.9 percent from 1981 to 2002. Reductions in poverty would have been greater if the tendency in inequality had been to decrease rather than to increase slightly as was observed for most countries. Székely (2001) notes an average increase in the Gini index of 2.4 points among the 17 countries, with a full 15 countries registering an increase in income inequality over the period. This lackluster performance was compounded by increasing unemployment rates. The average unemployment rate in the region increased from 7 percent in 1990 to more than 10 percent in the year 2000 and some indicators of the quality of jobs, such as the proportion of workers that are covered by labor laws (a measure of formality), declined from already very low levels.

[29] Ravallion and Chen (2003) using a slightly different approach find a small decline in the overall level of poverty in Latin America from 1990 to 1998.

Many have argued that the market-oriented reforms implemented in the 1990s—trade and financial liberalization, together with tax reform and privatization—explain the region's poor performance in terms of inequality, poverty and employment. In contrast, others have noted that, while the region went through extensive reforms in the product and capital markets, reforms in the labor market have lagged behind. In this view, the *lack of reforms* has allowed rigid labor market institutions and regulations to persist, and this would explain the poor performance of employment and inequality in the region. Given the importance of these questions, it is not surprising that a substantial share of work at the IDB Research Department has been devoted to ascertaining the effects of economic reforms, or the absence of reforms, on employment and distribution outcomes. The two papers included in this volume, and the papers reviewed in them, are leading examples of this work: both studies try to determine the effect of policies and institutions on social outcomes. In addition, both papers make use of increasingly available micro data to investigate these issues.

In the rest of this section, we place the papers included in this volume in the context of the policy debate and the literature. We first review the debate and findings regarding the effect of reforms and institutions on employment and unemployment performance. We then assess the findings relating economic policies and institutions with the evolution of inequality and poverty. Of course, these concepts are not unrelated: the availability of more and better-paid jobs is the main route to escape poverty, while countries with more efficient labor markets tend to exhibit lower levels of wage inequality.[30] [31]

[30] In a very interesting study, Székely (2004) describes the results of a survey conducted among the poor in Mexico. The poor cite increased employment opportunities as the main route for escaping poverty.

[31] IDB (2003) shows that within Latin America, countries with more efficient labor markets, measured by low unemployment levels, low unemployment gaps between women and men, adult and young workers, and skilled and unskilled labor as well as low wage differentials across sectors, and good labor relations, exhibited lower levels of wage inequality.

The Effects of Trade and Trade Policies on Employment Outcomes
As mentioned above, both the unemployment rate and the share of unregistered workers increased during the 1990s. How much of these developments were the result of market reforms, relative to other possible factors, such as macroeconomic volatility or financial crisis? Perhaps because it was widely argued that trade liberalization would bring a painful reduction in jobs, the attention of researchers focused primarily on trade reforms. The promoters of reforms expected that, while the new economic environment would bring opportunities for job creation, increased competition would also imply the closure or downsizing of some firms, resulting in job losses and transitional unemployment. The detractors predicted major job losses, particularly in small and medium firms, which employ a large proportion of workers. In addition, they argued that increased competition would force firms to engage in cost-reduction strategies, such as reducing the quality of jobs, in order to survive in a more competitive environment.

Economic research assessing the impact of such reforms on employment has yielded quite surprising results, although given the paucity of studies available, such results should be taken very cautiously. In some countries, trade reforms were associated with net job losses in the manufacturing sector, but the effects on aggregate employment are seemingly very small or negligible. Perhaps because there is better data for manufacturing activities, most studies measure the effects of trade reforms in the industrial sector. While Rama (1994) and Casacuberta, Fachola and Gandelman (2004) find sizeable effects in manufacturing employment in Uruguay, Feliciano (1994), Revenga (1997) and Hanson and Harrison (1999) find very small effects on manufacturing employment as a result of trade liberalization in Mexico. Outside of Latin America, Currie and Harrison (1997) find no significant effects of a reduction in tariffs and quotas for the average firm in Morocco.

Only two studies examine the effect of reforms on aggregate employment rates (Márquez and Pagés, 1998, and Stallings and Peres, 2000). Both studies find that, controlling for the level of output, employment rates declined with the decline in tariffs. Yet, Márquez and Pagés (1998) find that once the effects of reforms on output are taken into account, the effect of trade reforms on aggregate employment is not different from zero. This implies that, as a whole, economies reacted to changes in trade openness by increasing productivity per worker and increasing the level of production. While the increased productivity tended to reduce the number of jobs required, this effect was outweighed by increased production. As a result, trade reforms had very little effect on aggregate employment. Márquez and Pagés (1998) also find no discernible effects on unemployment. Perhaps even more surprisingly, the distribution of employment across sectors was not greatly affected. Although one of the predictions of trade theory is that trade reforms should cause employment to reallocate from formerly protected sectors to other sectors of activity, the evidence suggests that reductions in tariffs and other trade barriers did not result in substantial increases in sector reallocation.[32]

At this point it is rather unclear why the measured effects of trade reforms on employment and reallocation levels are so small. It may be too early to tell, as there are still relatively few studies available. So far, some studies have raised the hypothesis that stringent labor regulations prevent firms from dismissing workers and in consequence slow down employment reallocation across firms and sectors (Feliciano, 1994). Other studies have shown that firms reacted to increased levels of international competition by reducing profit margins and increasing job productivity rather than by cutting jobs (see for instance Hanson and Harrison, 1999, or Currie and Harrison, 1997). Revenga (1997) also found substantial wage losses associated with the reforms in Mexico. It thus seems that constraints on labor adjustment, as well as the ability of firms to adjust on other margins such as profits, wages and productivity, reduced the need to cut jobs.

[32] Haltiwanger et al. (2004) find a positive but small effect of trade reforms on employment reallocation while IDB (2003) reports no correlation between the level of sector reallocation and measures of market reforms.

What about the quality of jobs? Were firms forced to reduce workers' benefits to sustain increasing levels of competition? The evidence here is even sparser, and therefore the existing results should be taken only as suggestive. The findings so far indicate that if the race to the bottom effect exists, its effects are very small. In Colombia, trade liberalization was associated with only a small decline in the share of workers affiliated with social security, while the evidence for Brazil and Ecuador suggests no relation between trade liberalization and social security affiliation.[33]

In short, while in some countries, such as Uruguay, trade liberalization had a large impact on manufacturing jobs, the results so far suggest that in most countries and sectors the effects of trade on employment and job reallocation levels were surprisingly small and therefore cannot account for the rising unemployment rates. Moreover, while the share of unregistered (informal) employment has increased in many countries, such effects do not seem to be associated with increasing trade openness. It is surprising that other reforms, such as privatization of state-owned firms, financial liberalization or tax reforms, which could perhaps explain unemployment and informality outcomes, did not catch the eye of researchers.[34] The only other large institutional change that has been examined in detail is the effect of changes (or lack of them) in labor market legislation and institutions, which many consider a major source of problems in the labor market.

Labor Market Institutions and Regulations

Labor market institutions and regulations govern the way transactions are made in labor markets. For some, this wide body of rules and actors increase workers' welfare and make the labor market more humane. For others, they are at the root of unem-

[33] See Goldberg and Pavcnik (2003) and Martínez and Pagés (2004).
[34] A notable exception is the work of Chong and Lopez-de-Silanes (2003) on the effects of public sector restructuring programs around the world.

ployment and inequality, causing large welfare losses for society and workers. In Latin America, policy debates in this area have been extremely contentious, often fuelled by a lack of hard evidence on the effects of such institutions on outcomes. Fortunately, in the last ten years a large body of research is beginning to emerge. This research shows that Latin American labor markets tend to be highly regulated by international standards. Hiring and firing restrictions tend to be very stringent relative to industrial countries, or any other region of the world. In addition, regulations regarding employment conditions or social security benefits and contributions are also very protective of workers relative to other developing countries.[35] The findings in Heckman and Pagés (2004) as well as those from the studies reviewed and assessed in their work suggest that, while regulations and institutions were created with the objective of protecting workers, they often have unintended and collateral adverse effects on labor market outcomes. There is strong evidence that job security regulations reduce turnover in the labor market and bias employment opportunities against the young and the unskilled and towards older and more skilled workers.[36] The evidence also suggests adverse employment effects of social security regulations.[37] Instead, the evidence of the effect of hiring and firing restrictions on employment and unemployment rates is less conclusive. Thus, while some studies find that reforms that reduce firing constraints would increase employment (and reduce unemployment), others find no evidence that that is the case.[38] The evidence also indicates a possible negative effect of minimum wages on employment rates, especially for

[35] Heckman and Pagés (2000) showed that labor market regulations in Latin America are very stringent relative to industrial countries. IDB (2003) shows that they are also very stringent relative to other developing countries. Compliance levels are low relative to developed countries, but probably higher than in other developing nations.
[36] See Micco and Pagés (2004), Kugler (2004), Saavedra and Torero (2004) and Pagés and Montenegro (2004).
[37] See Botero, Djankov, La Porta and López-de-Silanes (2003), IDB (2003) and Heckman and Pagés (2004)
[38] See Saavedra and Torero (2004) and Mondino and Montoya (2004); see also Heckman and Pagés (2000, 2004)

young and less skilled workers, although a consensus on the size of such effects has not yet been achieved.[39]

The evidence illustrates that institutions matter and that policymakers should be careful when designing labor market institutions. Yet it also indicates that rising unemployment rates probably cannot be explained by either the rigidity in firing regulations or the (scarce) labor market reforms that made labor markets more flexible. In addition, while many countries underwent substantial pension reforms, which caused an increase in the social security contribution rate, such increases do not seem to be enough to explain the large increase in unemployment experienced by many countries.

What then, can explain the behavior of unemployment in the 1990s? At this point the causes are still speculative. Figure 1 shows the evolution of unemployment during the 1990s. It also shows that most of the increase in unemployment started after 1994, coinciding with periods of low economic growth, so that cyclical rather than structural factors would seem to underlie this phenomenon. It also appears that unemployment rates are reacting more dramatically to changes in economic activity than during the debt crisis of the 1980s. González (2002) and IDB (2003) find evidence that wages (employment) might be becoming less (more) responsive to the business cycle, and therefore firms may be shedding more labor in periods of low economic activity. Loboguerrero and Panizza (2003) show that in Latin America the high wage flexibility of the 1980s was the product of two bad outcomes: high inflation and poor enforcement of labor market regulations. As inflation has dropped to single digits, less adjustment via wages may have implied more adjustment via employment, causing a larger increase in unemployment for a given size of a shock. Better enforcement of strict

[39] See Maloney and Nuñez (2004) for a review of minimum wages in Latin America, Cowan, Micco and Pagés (forthcoming) for an analysis of the effects of recent changes in minimum wages in Chile, Bell (1997) for Mexico and Colombia and Lemos (forthcoming) for Brazil.

labor market regulations also produces the same effect. While the way this mechanism works is still unknown, the implications for unemployment are large. As Latin American economies emerge from the last recession, joblessness will likely subside. However, to the extent that unexpected and unavoidable shocks will continue to occur, unemployment will continue to react strongly unless policies and institutions facilitate such adjustment.

Policies, Institutions, Poverty and Inequality

As in the case of employment, many studies examining the effect of market reforms on distribution outcomes focused on identifying the effects of trade reforms on wage differentials. One important exception is the study by Behrman, Birdsall and Székely (2001) included in this volume, in which the authors analyze the effect of market reforms on earnings, inequality and poverty.

By the mid-1990s, it became apparent that returns to higher education were increasing in a number of countries.[40] This finding was at odds with the predictions of standard trade theory and with the expectations of reformers. According to the standard two-country trade theory, developing countries undergoing a process of trade liberalization should experience an increase in the production of goods that require low skilled workers and a decline in the production of goods produced with skilled labor. The driving force is that, as countries open themselves to the international market, they tend to specialize in the production of goods for which they have a comparative advantage, that is, goods produced with relatively abundant unskilled labor. This theory implies that trade liberalization should increase the demand and the wages of the unskilled and reduce the demand and the wages of skilled labor, leading to a reduction in wage inequality. What was happening? An extensive literature seeking to address this puzzle ensued.

[40] See, for example, Cragg and Epelbaum (1996) for Mexico; Beyer, Rojas and Vergara (1999) for Chile; Robbins (1996) for Colombia; and Robbins and Gindling (1999) for Costa Rica.

One potential explanation for the increase in the skill premium is that the pattern of tariff protection in Latin America and the Caribbean differed from that predicted by standard trade theory. Studies have found that rather than protecting their scarce factors, many countries had higher levels of protection in industries abundant in less-skilled workers.[41] The subsequent lowering of tariffs thus had greater adverse effects on low-skilled workers, with the rising skill premium reflecting the initial pattern of protection rather than a contradiction in the application of standard trade theory.

Another potential explanation for the apparent contradiction is that Latin America is not relatively abundant in less-skilled workers. With the emergence of India and China on world markets, Latin America may have lost a comparative advantage in less-skilled workers.[42]

A third hypothesis states that trade has fueled the adoption of technologies intensive in skilled labor increasing the demand for this factor relative to unskilled labor.[43] IDB (2003) shows that there has been a decline in the relative price of capital goods. However, this trend responds more to secular reasons (the decline of the relative price of capital goods in developed countries, which has been occurring for decades) than a decline in the tariffs to capital goods (which have been rather low and constant) casting some doubts on the trade-technology channel.

Trade liberalization is one of the reforms examined in a novel approach by Behrman, Birdsall and Székely (2001 and in the chapter by these authors in this volume), hereafter referred to as BBS. In these two papers, the authors link indices of policy reforms to a series of household surveys for 18 countries covering the decade

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[41] Hanson and Harrison (1999), Revenga (1997), and Robertson (2001) describe these patterns for Mexico. Porto (2002) finds a similar pattern for Argentina and Attanasio, Goldberg and Pavcnik (2002) in Colombia.
[42] See Wood (1997) and Spilimbergo, Londoño, and Székely (1999).
[43] See de Ferranti, Perry, Gill et al. (2003), and Sánchez-Páramo and Schady (2003) for evidence supporting this view.

of the 1990s. In BBS (this volume) the authors examine the effects of trade liberalization and financial reforms on poverty and inequality using data from 18 Latin American countries. They find that trade liberalization has had no discernible effect on poverty or inequality.[44] However they find that financial liberalization increased poverty and inequality over the period, asserting that capital inflows may be complementary to skill, boosting the demand for skilled workers. In this view, the acquisition of capital goods is not driven by lower tariffs, but by the amelioration of credit and financial constraints.

While BBS (this volume) examines the distribution of family level income (per capita household income), BBS examines the distribution of individual earnings. The authors also expand their explanatory variables to include privatization and tax reform. They find that policy reforms have contributed to an increase in wage differentials, although this effect is found to fade over time; their findings at the individual level are consistent with those examining family income. The disequalizing effect on wages is mainly attributed to financial reforms while trade liberalization is found to have no effect on wage differentials. Tax reform was found to have contributed to the widening gap between skilled and less-skilled workers, while privatization was found to narrow the gap.

In sum, the evidence indicates that—perhaps with the exception of the privatization of formerly state-owned firms—reforms have not contributed to reducing poverty and inequality. However, there is still an intense debate as to what the underlying causes of the increasing skill premium actually are. While most of the evidence suggests that trade-based explanations cannot account for this phenomenon, it is too early to say. Perhaps a more convincing hypothesis is that skill-biased technological change (SBTC) rather than trade is the cause of the rising skill premium. However, IDB (2003) indicates that SBTC does not appear to be driven by the

[44] Trade liberalization is measured as the mean of the average level and average dispersion of tariffs per Lora (1997).

incorporation of automation technologies or induced by trade liberalization, as some have suggested. Instead, the increasing penetration of information technologies seems to be a better candidate for explaining the increasing demand for skill. It is likely that the structural reforms did not improve the poverty and inequality situation because they did not address their underlying structural causes, i.e., the poor's lack of access to credit and to productivity-enhancing assets. Policies to reduce poverty and inequality need to focus on unlocking the growth potential of the poor, facilitating their acquisition of productive assets, insuring such assets in times of economic crises, and increasing their assets' returns.[45]

[45] See Birdsall and Székely (2002) for an excellent survey of challenges and strategies for poverty and inequality reduction.

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Inter-American Development Bank
1300 New York Ave, NW
Washington, D.C. 20577