

The Political Economy of Latin American Economic Growth^{*}

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1. Introduction

Latin America's experience with economic growth has been a disappointing one. Despite having similar levels of per capita GDP than the British colonies in the Western Hemisphere at the beginning of the nineteenth century and attaining independence at roughly the same time, the nations of Latin America and the Caribbean fell rapidly behind the U.S. and Canada in terms of economic performance. Latin America experienced no growth in per capita GDP during the nineteenth century – a time during which the GDP per capita of the US grew between four and sixfold (Haber, 1997, Atack and Pasell, 1994). Although Latin America was able to experience solid economic growth from the start of the Great Depression on, the nineteen eighties saw the whole region live through a protracted macroeconomic crisis and a collapse in its growth rates. Although many countries seemed to resume economic growth during the early eighties, at the time of writing most Latin American economies were again experiencing negative economic growth.

It is the contention of this paper that it is not possible to understand Latin America's poor growth performance without understanding its politics. From the years of independence, Latin America's high levels of social, political and economic conflict have generated strong impediments to its economic development. This paper will concentrate on the political reasons for Latin America's inability to attain the high levels of investment in human and physical capital necessary for sustained economic growth. We will also argue that a grasp of Latin American politics is fundamental for understanding the region's poor institutions and its perverse reaction to natural resource abundance.

It should be evident that not all the reasons for a region's poor economic performance can be said to be political. A region's isolation with respect to the rest of the world, for example, can affect its ability to take part in the gains from specialization with other regions. Lack of natural resources can impair a country's ability to develop domestic industries as well as to have a significant source of export revenues. Cultural values and religious beliefs may be more or less conducive to the development of efficient economic institutions. Instability may be a consequence of external factors, such as particularly volatile terms of trade or external conflict.

In many – though not all – of these fronts Latin America actually had a more favorable environment than the rest of the world. Latin America's geographic situation put it much closer to world trading centers than Asia or Oceania; Latin America was one of the main exporters of natural resources during the past two centuries, and it has arguably been less subject to external conflict and invasions during the nineteenth and twentieth century than any other region of the world. These reasons only seem to magnify the puzzle of the region's poor growth performance. It thus appears that a

Careful look at Latin America's political institutions may be particularly important for understanding its growth performance.

The rest of the paper is divided into four sections. In Section 2 we study the historical evolution of decision making in Latin America. We ask how today's institutions came into being and how they can be associated with institutions which emerged during colonial times or later. Section 3 explains our approach to the study of the political economy of growth and discusses the alternative views of politics and of growth that we will use in our analysis. Section 4 is devoted to one of the most important determinants of growth, the investment rate. We separate the discussion of the investment rate not only because of its strong robust link with growth but also because its endogeneity is likely to make it related to many factors that are also directly related to growth. In particular, Section 4 emphasizes the role of political uncertainty and credibility in shaping investment decisions in the region. Section 5 discusses other determinants of growth – investment in human capital, resource abundance, institutions, democracy, and trade policy, exploring at every point their political economy determinants.

2. The Historical Evolution of Decision Making

If there is one factor that permeated Latin America's decision making process during colonial times, it was the ongoing conflict between provincial authorities and local interest groups - which represented the interests of local landowning elites - and the centralized bureaucracy put in place to represent the interest of the Spanish and Portuguese crowns. Whereas the Spanish kings were represented in the colonies by the Viceroy and, more importantly, by the colonial courts (*audiencias*) – set up precisely to ensure a strong judicial and executive presence in the provinces – these often met with strong and intense opposition from planters and miners. One example of these were the fierce political conflicts generated by the *encomienda* – a system whereby colonists were entrusted the teaching of Christianity and “civilized” conduct to a number of Indians while at the same time being given the power to determine how their labor would be allocated.¹ In 1542, the Spanish Crown promulgated the *New Laws and Ordinances for the Government of the Indies* forbidding the issue of new *encomiendas* by royal administrators in America, and ordering the inheritance of existing *encomiendas* to be reversed. However, a rebellion of colonists that toppled the Peruvian Viceroy in 1546 forced the crown to back down on the most important restrictions of the New Laws. Colonists' respect for the authority emanating from the metropolis was so limited that they commonly invoked the curious principle of *se acata pero no se cumple* (we adopt the law but do not abide by it) in response to the provisions of the Crown that they did not like.

Provincial governments were therefore strong and weak at the same time. They had tremendous strength to enforce laws and dispositions which were in the interests of

¹ For a description of the *encomiendas* system see Bakewell (1997) and Skidmore and Smith (1992).

landowning colonists – but they were extremely weak in enforcing the dictates of the Spanish Crown. On the other hand, they were extremely efficient as a mechanism for extracting mineral wealth from the Americas: between discovery and 1610 extraction of silver from the Spanish colonies alone totaled 11.3 million kilograms². This efficiency was obtained only at the cost of a substantial share in that surplus that was given by the Crown to miners and provincial officials in order to maintain their incentives: the Crown's royalty was only 21% of mining output.³

One particular consequence of the economic structure adopted by Latin America – a production structure based on plantation agriculture, characterized by economies of scale and a high labor intensity – was the inflow of high numbers of slaves and the intensive use of the native population as workers. This can be contrasted with the pattern observed in the Northern parts of the British colonies, where colonists strove to expel natives from their lands rather than use their labor. The result was a very unequal income distribution which was to have long run consequences (Engerman and Sokoloff, 1997). This distribution of economic power mirrored the distribution of economic power – although independence in Spanish America came at roughly the same time as the independence of the British colonies, the extension of suffrage to Latin America came much later.⁴

The hypothesis that Latin America's disappointing growth performance during the nineteenth century can in great part be traced to its higher income inequality has been proposed by a number of authors. As pointed out in the introduction, although Spanish America at the beginning of the 19th century had similar levels of GNP per capita than the British colonies, during the nineteenth century it experienced zero economic growth while the US's GDP per capita grew between four and six-fold. Numerous case studies have documented how the power of landed elites in nineteenth century Latin America put severe limits on the ability of the political system to enact fiscal and economic reforms that would have created a sufficiently high tax base and well-defined property rights. Without these reforms, Latin America was unable to fund the investments in infrastructure, public goods and human capital accumulation which were key for economic growth during the nineteenth century⁵. This is an attractive explanation for Latin America's poor economic performance during the nineteenth century, as alternative explanations do poorly at accounting for it. Cultural explanations that rely on the differences in economic institutions inherited from their respective metropolis fail to

² Garner (1988).

³ Bakewell, 1997, p. 174.

⁴ Some countries held elections in Latin America during the nineteenth century, but these had severely restricted franchises and/or a public, oral voting process, with registration rolls controlled by government officials. See Ochoa (1987) for a description of the extension of the franchise in Latin America and Graham (1990) for a description of the Brazilian voting process during the nineteenth century.

⁵ Studies of the political power wielded by economic elites in nineteenth century Latin America include Prado Junior (1957) and Graham (1990). Summerhill (1997) describes the retarded evolution of railroads in nineteenth century Latin America, while Marichal (1997) deals with obstacles to the development of financial markets. Haber (1998) shows that when securities markets were finally reformed in Brazil in 1890, the productivity increases were significant. On the importance of these factors for nineteenth century US economic growth see Fogel (1964) for railroads, Timberlake (1993) for the financial system, and Goldin and Katz (1998) for education.

account for the disappointing growth performance of the former British colonies of the Caribbean and South America, while explanations based on political instability have the challenge of accounting for the Brazilian experience, during which despite a 19th century without wars or internal disputes there was an average annualized growth rate of less than one-tenth of a percent from 1820 to 1900.

A marked concentration of power was at the basis of the evolution of Latin American economic institutions during the nineteenth century. Bakewell, for example, points out that during the thirties "the whole [of Chile] was controlled by families who inhabited four square blocks in central Santiago." (1997, p. 424). These sectors were concentrated in export activities, which benefited from economic openness and little government intervention in international trade. Logically, most Latin American regimes pursued policies of openness to international trade during the nineteenth century. The solid growth of exports between 1850 and 1912 (which for all of Latin America grew at an annualized rate of 3.77 percent during this period⁶) strengthened exporters both economically and politically. Their political strength helped put in place regimes that interfered little with international trade. In most countries a "triple alliance" developed between the state, landed elites and foreign investors – perhaps best exemplified by the governments of Porfirio Díaz in Mexico and Juan Vicente Gómez in Venezuela. Only in Argentina did an urban-based party achieve power before World War I, and, even there, it failed to challenge the landowners on the issue of free trade (see Moran, 1970 and Solberg, 1987). As Ronald Rogowski (1989, 16 p. 47) points out: "The notoriously weak capitalists of South and Central America, the region's inarticulate and, often, racially oppressed workers, and – perhaps not least – the powerful influence of Great Britain as principal trading partner, all contributed to the political monopoly of the landowning class in this period."

This pattern of distribution in political power started to change with World War I and the depression of the 30s. The fall in the world demand for Latin American products during this period pushed Latin American economies into the production of industrial goods – to satisfy the demand for goods which had previously been imported⁷. As industrial production grew the economic and political power of urban workers and capitalists rose. The groups representing the landed interests gave way to political parties and military leaders backed by urban labor unions and import-substituting industrialists. The PRI in Mexico, Acción Democrática in Venezuela, the APRA in Peru and the Peronista movement in Argentina, as well as the short-lived Chilean experiment with socialism, are all examples of Latin American "Populism", the term given by political scientists to this alliance between the owners of labor and capital against the owners of land.⁸ Populist movements, as well as the early success of import-substituting

⁶ This growth in exports was a response in great part to the increase in demand arising from the industrialization of Europe. See Bulmer-Thomas, pp. 63, 433.

⁷ See Thorp, 1984.

⁸ Latin American populism is commonly defined by political scientists as "a set of *economic policies* designed to achieve specific *political goals*. The political goals are (1) mobilizing support within organized labor and lower-middle-class group; (2) obtaining complementary backing from domestically oriented business; and (3) politically isolating the rural oligarchy, foreign enterprises, and large-scale domestic industrial elites." (Kaufman and Stallings, 1991, p. 16).

industrialization, ensured the continuation of the import-substitution strategy for the next forty years. Import substitution consisted of high levels of trade restrictions coupled with active state involvement in the productive process and overvalued exchange rates that benefited urban dwellers⁹. The political capacity of populism to group labor and capital interests and to therefore keep wage demands sufficiently in check – much in the way of European corporatist states – thus ensuring an adequate growth of profits was the principal political pillar behind the import substitution strategy.

The initial unintended phase of import substitution fundamentally altered Latin America's political game. Industrial and labor groups became the dominant forces in Latin American politics. The persistence of their political strength even after the world trading system regained its footing during the postwar period is due not only to the fact that these groups were now richer, but – perhaps more importantly - that the incentives for political organization and mobilization had been altered by growing urbanization. The expansion of manufacturing had brought about the rise of the Latin American city. By the end of the 1960s nearly 60 percent of the region's population lived in cities – compared to less than 40% in 1940 (Bulmer-Thomas, 1994, p. 247).¹⁰ As Robert Bates (1981) has argued, the rise of urban concentration systematically alters the conditions of the political game. Cities make communication, negotiation and coordination of strategies easier and therefore give their dwellers a relative advantage in forming interest groups vis-à-vis scattered agricultural producers. As Latin American cities became more consolidated, the political power of manufacturing groups became much more solid. The latter half of the twentieth century saw a succession of alignments and realignments among three fundamental groups – the previously all-powerful rural oligarchy, whose small numbers had always enabled it to be politically mobilized, and the recently consolidated urban capital and labor owners.

To these groups we must add two additional fundamental actors that cannot be traced back to original economic interests but that developed their economic autonomy as a result of the fluidity of twentieth century Latin American politics: political parties and the military. Political parties commonly arose to organize the demands of one or more sectors, but, once formed, would tend to take on a life of their own. Their survival and success was to a great extent due to the interlocking system of loyalties, clientelism and political patronage that developed in Latin America and in which the apportionment of government bureaucratic posts played a fundamental role. For many purposes, it will be important to think of political parties and the government bureaucracy as classes in themselves, jockeying with other groups in society for the control of resources. As to the military, their importance arose from the high incentives that political actors had in many instances not to abide by the rules of the political game but rather to call the military to their aid. This was impossible to do before modern armies, with compulsory military service and recruitment and training of officers in specialized academies, were consolidated. But by the late 1920s these institutions were fully in place in most Latin American countries and almost immediately became a fundamental actor in the region's

⁹ See Edwards, 1995, pp. 40-48.

¹⁰ Krugman and Livas (1996) provide a formal model to explain why greater restrictions on international trade are likely to raise urban concentration.

politics. Modern bureaucratized armies constituted a formidable political ally for groups that were willing to commit to favoring it when in power, and the onset of the Great Depression offered a fantastic opportunity to topple exiting governments: between 1930 and 1932, nine constitutional Latin American regimes fell to military insurgencies. There is no defining pattern to Latin American dictatorships, however, as these ranged from the authoritarian rightist dictatorship of Pinochet to the populist Velasco Alvarado regime.¹¹

Latin American economies experienced solid economic growth during the import substitution period. From 1925 to 1980, the average GDP per capita of Argentina, Mexico, Chile, Colombia, Mexico, Peru and Venezuela grew at an annual rate of 2.17%; even the slowest growing of these economies over this period, Argentina, saw its per capita GDP more than double.¹² This stands in stark contrast to the low growth of the 1820-1900 period, over which Mexico grew by only 0.5% and Brazil by 0.06%.¹³ This solid rate of economic growth ensured the political survival of the populist coalition until the nineteen-eighties. But there were important fissures in this coalition. In particular, tensions between left-wing labor movements and capital were often present and marked the basis for much of the continent's political instability. Social democratic leaders with political platforms based on redistribution and land reforms such as Venezuela's Gallegos or Chile's Frei were unable to hold together the delicate coalitions necessary to keep them in power for long; giving way either to right-wing dictatorships or to radical leftist experiments. In other cases - in particular Cuba and the guerrilla movements it inspired in Latin America - the interests of agricultural laborers and landowners were revealed to be very much at odds. These tensions and fluidity in ruling coalitions reflected the multiple dimensions of distributive conflict in Latin America. On the one hand, urban workers and industrialists were in agreement on issues like commercial policy - where protection tended to benefit both groups. On the other hand, their interests were opposed when it came to redistribution of wealth. Politically successful populist movements - such as Peronism - were able to exploit the former coincidence of interests, whereas other attempts at building coalitions - such as the Frei and Gallegos experiments - fell prey to the salience of the latent conflicts. Latin America's unstable and continuous oscillation between democracy and dictatorship during the postwar period can to a great extent be explained on the basis of shifting political alliances in a context of these multiple dimensions of conflict.

Political instability generates short-run incentives for political actors. Short run economic growth becomes the main policy goal of agents worried about their long term survival. Populist politics gave rise to populist macroeconomics. The consequences of populist macroeconomics were often disastrous, resulting in repeated cycles of growing budget deficits, high or hyperinflation, balance of payments crisis and temporary but highly contractionary stabilizations. As Andrés Velasco describes it¹⁴:

¹¹ In contrast, precisely for the reasons emphasized by Bates, peasants were never a key force in this equation, forming at best a marginal sector of governing coalitions. On the Latin American military, see Rouquié and Suffern (1998). Rural mobilizations are discussed by de la Peña (1998)

¹² Own calculations based on Maddison, 1995.

¹³ Data from Maddison (1995).

¹⁴ See also the book by Dornbusch and Edwards (1991).

“These cycles were of the type well-known to students of Latin American macroeconomics: aggregate demand expansion under fixed exchange rate overvaluation and a deteriorating trade performance, eventually the near exhaustion of reserves leads to a devaluation of the currency and the corresponding sharp acceleration of inflation; once inflation becomes excessively high, alarmed authorities enact emergency stabilization measures, which often tend to be merely temporary, thus serving as the preface to the next phase of unsustainable expansion.” (Velasco, 1991)

Furthermore, short run incentives generated a lack of institutional capacity for reacting to the negative external shocks that were to hit the region during the early eighties.¹⁵ By the late 1980s, most Latin American economies were in disarray, heavily weighed down by accumulated external debt, delayed adjustment to negative external shocks and a desperate need for reserves. Severely weakened left-wing movements in the aftermath of the Soviet collapse as well as the perception that developing countries which had adopted more market-friendly strategies had enjoyed much better economic performance were among the factors leading to the shift towards market liberalization.¹⁶ A large accumulation of privately held external assets in the hands of wealthy Latin Americans and greater international capital mobility is also likely to have altered the preferences of capital owners over economic policies.¹⁷

The eighties and nineties were characterized by a wave of economic liberalization and democratization. For the first time in its history, all the governments of Latin America have been elected in sufficiently free and fair elections for them to be labeled democratic. Democratization has also coincided with a wave of economic liberalization and reform. However, severe economic problems remain – Latin America’s economic growth after economic reforms has been unimpressive, its unemployment rates are at their highest level in recorded history, and budget deficits are still dangerously high¹⁸. A provocative hypothesis that is suggested by these facts is that the same factors that led to Latin America’s disastrous experience with populism are still there. In what follows, we will seek to understand how those factors are influenced by the internal and external politics of Latin American countries.

3. Political Economy: The Determinants of the Determinants of Growth

This paper seeks to understand the politico-economic interactions that have led Latin America to undertake policies that have had a significant – positive or negative – effect on its economic growth. It is thus a study of the political economy of growth. A study of the political economy of growth requires a theory of politics and a theory of

¹⁵ On the relationship between latent political conflict, institutions of conflict management and growth collapses, see Rodrik (1998).

¹⁶ These factors are emphasized by Edwards (1995)

¹⁷ Rodríguez (1999c) estimates the annual income earned by Venezuelans on their holdings of foreign assets in 1997 at 4.16 billion US\$, or 5% of the country’s GDP and 17% of its exports.

¹⁸ Easterly, Loayza and Montiel (1997) argue that Latin America’s post-reform growth has not been disappointing. Between 1990 and 1993, they point out, Latin America returned to its historic rate of growth of 2%. However, Latin America’s growth appears to have significantly slowed down in the most recent years, suggesting that a reappraisal of this hypothesis with more recent data is necessary.

growth. Regrettably, it is far from clear what these should be. Alternative theories of growth and of politics abound, and although it would not be fair to say that consensus is totally absent, there is still substantial disagreement as to what the basic determinants of political and economic outcomes are.

On the side of politics, the basic disagreements center on whether politics can be best viewed as a relatively efficient mechanism to aggregate the preferences of the majority of individuals or whether it should be conceptualized as an arena in which well-organized powerful groups successfully exert political pressure on policymakers in order to appropriate rents. In other words, there is disagreement as to whether societies should be modeled as well functioning democracies, or whether we should model the political decision making process as responding to the influence of particular vested interests.

This debate goes back to the tension existing in the early rational choice literature between works like Anthony Downs' *An Economic Theory of Democracy* (1957) and Mancur Olson's *Logic of Collective Action* (1965). The first book asked what the equilibrium outcome would be of democratic voting among rational individuals whose preferences could be represented in one relevant dimension, finding that they would reproduce the preferences of the median voter; the second one asked what incentives individuals have to organize and mobilize politically in order to attempt to have an effect on policies. These are two radically different questions which capture different basic visions of what the political process is. The modern literature on political economy has largely reproduced this initial split, divided among researchers that use extensions of the median voter theorem to understand politics¹⁹ and those that rely on models of interest groups and political influence.²⁰

What is the appropriate theory for understanding Latin American politics and how it influences economic growth? The argument for using some type of political influence or interest groups approach is strong: a median voter model seems an unreasonable approximation to the determination of policies in countries in which the structure of the policymaking process is often completely undemocratic. Furthermore, even in democracies the outcome of the political game tends to favor those who have better capacity to mobilize human and economic resources into the political arena, so that models that assume that the distribution of power is relatively egalitarian – as median voter models do – will be systematically biasing their predictions. Take the example of the media's influence in Latin American politics. In Mexico, the practice of journalists receiving bribes in exchange for favorable coverage of politicians (called the *embute*) is widespread. And the most influential privately owned television conglomerate, Televisa, is partly owned by the son of a former president of Mexico. Indeed, its president openly declared during the 1988 elections that "Televisa is with the PRI." During that same campaign Televisa's news program *24 Horas* was documented to devote more than 80% of campaign news to the PRI candidate (Semetko, 1996, p. 267). In such a context, it appears that not taking into account the systematic influence of money on politics (and of

¹⁹ See Meltzer and Richard (1981), Alesina and Rodrik (1994), Persson and Tabellini (1994), and Alesina and Perotti (1996).

²⁰ See Becker (198x), Grossman and Helpman (1994), Grossman, Helpman and Dixit (1997), Dixit (1997), Magee (1997).

politics on money) would systematically distort our understanding of the political economy of growth.

These criticisms have often been leveled at proponents of the median voter model. However, there is much to say in favor of not losing sight of the predictions of this model. Perhaps one of the best articulated defenses of the use of the median voter model to understand the experience of developing countries comes from the work of Alberto Alesina and Dani Rodrik:

“our use of the median voter model should not be taken as a literal description of the political process we have in mind. We appeal to this theorem simply to capture the basic idea that any government is likely to be responsive to the wishes of the majority when key distributional issues are at stake. Even a dictator cannot completely ignore social demands, for fear of being overthrown.” (Alesina and Rodrik, 1994, p. 466)

In this essay we will take an eclectic view regarding what the appropriate theory of politics is for studying the economies of Latin America and the Caribbean. We believe that both models seem to capture something important about politics: the median voter model concentrates on studying how the policies desired by the majority of the population differ across countries and change over time, whereas interest groups/political influence models analyze how the policies that politicians are willing to undertake change due to the pressure that vested interests exert on them. They both illustrate important dimensions of the policymaking process.

In the field of economic growth, the schism among alternative models is by no means as pronounced. The basic divide has traditionally been between believers that in the long run, the growth rate cannot be affected by policies, and those that hold to a view of long-run technological change as endogenous. However, even those who believe that long-run growth cannot be affected by policies would concede that policies have an effect on the level of income and therefore on the transitional growth of the economy as it adjusts to that new level of income.

Both groups agree on the relevance of empirical work to ascertain what the main determinants of economic growth are. The empirical growth debates over the last fifteen years have focused on what variables should be included in the right-hand side of the growth regression. The literature has uncovered a number of fundamental determinants of growth. Among them are the investment rate, the level of human capital, institutional quality, macroeconomic distortions and natural resource endowments. Considerable controversy exists as to whether other variables, such as the degree of openness of an economy, inequality of income distribution, financial development or democracy are significant.

In what follows we will discuss the determinants of each of these variables. First we review the empirical evidence – at the cross-country level – for each of the links between alternative explanatory variables and growth. At each step we will discuss what

the Latin American data on these determinants is and what the evidence is in Latin America regarding the alternative theories of their political economy.

We first turn to one of the basic determinants of growth - the investment rate - in the next section. In Section 5 we turn to other direct determinants of growth, including human capital accumulation, natural resources, institutional quality, democracy, trade and macroeconomic policies.

4. Investment

The positive relationship between the investment rate and economic growth seems clear cut. On the theoretical side, a relation between changes the savings rate and the growth rate is easy to derive theoretically in both neo-classical and endogenous growth models. On the empirical front, virtually every study of economic growth finds a positive relationship between investment and growth. However, the causality implied by this relationship is open to question. Blomstrom, Lipsey and Zejan (1994) have shown using Granger causality tests that growth Granger-causes investment – and not the other way around. A plausible interpretation of their evidence is that exogenous shocks in productivity and other determinants of the steady state level of income lead to inflows of investment; on this interpretation investment-inducing policies may not be necessary for causing growth – investment will simply be a response to institutional and policy changes that raise the marginal product of capital. However, even in this interpretation policies for raising investment – at least insofar as they act through raising the marginal product of capital – make sense. In this section, we will concentrate on the determinants of this marginal product.

As shown in Table 1, Latin America's investment rate is low by world standards. At 21.1%, Latin America's investment rate for 1960-97 was two percentage points below the world average and a full seven percentage points below that of East Asian countries. In the nineties, the gap between East Asia and Latin America has widened, with East Asia's investment rate now exceeding Latin America's by more than 15 points. Conventional estimates from growth regressions (e.g. Barro and Sala-I-Martin, 1995, p. 425) imply that if Latin America were to have had an investment rate equal to East Asia's over the 1960-97 period it could have raised its average growth rate by more than half a percentage point.

Latin America's investment problem does not seem to be mainly one of not attracting enough foreign direct investment – FDI for Latin America has been higher than the world average and can in any case account for only a small fraction of the difference in aggregate investment rates with other regions. Rather, the problem seems to be in the low rates of domestic savings of Latin American nations. How can political economy theories help us understand these low savings rates?

Political Economy Theories of Savings

The first modern political economy models of investment are due to Alesina and Rodrik (1994) and Persson and Tabellini (1994). Their starting point is the classical

political economy model of voting over redistribution of Allan Meltzer and Scott Richard (1981), in which voters trade off the benefits from redistribution (more transfers) with its costs (higher taxes). For voters with less than average income, the former effect outweighs the latter, leading them to prefer a positive amount of redistribution. As income distributions tend to be positive skewed, the median voter will have less than average income, and will vote for a positive level of redistribution. Her incentives to vote for redistribution, however, will depend on *how* poor she is. The lower the income of the median voter (higher inequality) the more incentives she has to support higher redistributive transfers. If these redistributive transfers are financed with taxes on capital they can lead to lower levels of investment and growth.

This theoretical explanation of why inequality leads to low levels of investment does have several problems. For one, it implies that inequality should be positively associated with redistribution, but most studies have found a zero or negative correlation between inequality and redistribution.²¹ They have also found a positive – if any – relationship between taxes and growth²². Furthermore, these models' basic assumption is that voting over redistribution takes place within the context of a well-functioning democracy. For our purposes the assumption that those poorer than the median voter and those richer than the median voter have equal political power seems hard to justify given our previous discussion on the structure of the Latin American policymaking process.

These problems are easily illustrated when we look at the Latin American case. One implication of median voter style theories of redistribution is that an extension of the franchise to lower income individuals should raise the amount of redistribution that emerges from the political equilibrium. This hypothesis has found relative support when tested using data for polities in which the authoritarian threat has been absent and the military has not played a significant role: Husted and Kenny (1997), for example, have found evidence that significant increases in redistributive expenditures were preceded by the extension of the franchise to poor and minority voters in U.S. states. In Latin America, however, the relationship becomes much more complex. The first Latin American countries to extend the franchise were in the region's Southern Cone: Argentina first introduced a secret ballot and removed literacy and property requirements in 1912. It was soon followed by Uruguay in 1918. Chile introduced the secret ballot soon thereafter, in 1925, although literacy requirements were relaxed much later.²³ The openness of the democratic regimes in the Southern Cone combined with relatively favorable economic conditions to create the necessary conditions for the emergence of broad based labor movements. By the 1960s, leftist movements with redistributive platforms were poised to take power in Uruguay, Chile and Argentina, something they briefly achieved in the early seventies in the latter two countries. But a succession of military coups (In 1973 in Uruguay and Chile, in 1976 in Argentina) quickly reverted this political situation and reasserted the political dominance of business groups. Protracted periods of political repression against organized labor followed in the three countries, characterized by persecution of extreme left groups and the rewriting of labor legislation

²¹ See Perotti (1994), Rodríguez (1999a), Lindert (1996) Lybeck (1986), and Henrekson (1988).

²² Easterly and Rebelo (1993), Perotti (1994).

²³ Chile's high literacy rates (80 percent by 1950) however, made literacy requirements much less binding.

in order to significantly weaken the bargaining power of unions.²⁴ What survived from these processes was a group of more moderate and politically weakened powerful labor movements unable to realistically attempt to capture power on their own.²⁵

It is therefore evident that a simple median voter theory cannot capture the complexities of the Latin American political process as relates to the effect of politics on redistribution. If some groups do indeed have the capacity to subvert the outcome of a purely democratic process then the key assumptions of the democratic process break down and we must appeal to non-median voter theories of investment. For example, Rodríguez (1999b) has presented a non-median voter political economy model of redistribution in which inequality has an effect on the politico-economic equilibrium because it raises the resources that the rich have to influence politics. In his model higher inequality leads to greater rent-seeking by agents who give money contributions or bribes to politicians in exchange for political favors. Inequality can raise the amount of resources that are deviated towards those activities, resources which under other conditions would have gone to productive investment and growth.²⁶ Latin America appears to be the prime example of this model: the region in the world with the highest levels of inequality is also characterized by low levels and quality of government spending.²⁷

Investment, however, is affected not only by the mean expected return but also by the variance around that return. One of the characteristics of Latin American politics is its high level of political instability and its frequent number of changes in political leadership. Perotti (1994), Alesina and Perotti (1992) and Alesina et al. (1992) have argued that social and economic polarization may lead poor groups to pursue their political and economic objectives outside normal channels. Therefore it may lead to higher participation of these groups in violent political movements that cause high levels of uncertainty to investors and therefore restrict capital accumulation. In a certain sense this hypothesis is a reformulation of the median voter model, but without the median voter politics: as inequality increases, the majority of voters, facing a system which is politically more controlled by economic elites, turn against the system through protests, riots, and participation in attempts to overthrow the system.

²⁴ For a description of this process see Drake (1996).

²⁵ The Southern Cone countries were probably the only ones in the region in which labor ever had such a possibility. For most of the region, labor movements were co-opted into being participants of the corporatist Import Substitution coalition.

²⁶ Benabou (1996) has also provided a political economy model in which the decisive voter is richer than the individual with median income. In his model, inequality can lead to lower taxes if the decisive voter is sufficiently rich. However, given a narrow definition of physical capital, the Benabou model cannot account for a positive relation between inequality and growth. Benabou does show that other channels exist – in particular investment in human capital and the relaxation of liquidity constraints – that can lead for inequality to be negatively associated with growth.

²⁷ La Porta et al. (1998) show that the level of government spending is positively correlated with the efficiency of government spending. In fact, they argue that countries which inherited the French legal tradition and the Catholic religion are associated with low levels of government quality, a conclusion which is largely driven by the prevalence of both of these characteristics in Latin America.

There is some intrinsic appeal of all of these theories for the study of Latin American politics. On the one hand, the populist and socialist experiments of Latin America were marked by attempts to enact considerable amounts of redistribution, often leading to a paralysis of investment, as suggested by the Alesina-Rodrik and Persson-Tabellini models. On average, however, taxation in Latin American economies is characterized by higher regressivity and a narrower fiscal base, suggesting greater power of elites to avoid taxation, as the Rodríguez model suggests. Furthermore, Latin America has a long history of violent popular uprisings and high political instability which appear to have negatively affected its economic performance.

Can these explanations account for differences in investment among Latin American economies? In Table 2 we present some basic data that shows these variables for Latin American economies. Indeed, a quick glance at Table 2 shows that there may be something to both of these stories. Latin America has the highest political instability and income inequalities of the world, and performs worse than the average country both in terms of percent of time involved in a war – a variable which may reflect political tensions – and its corruption. Within Latin America, most of the countries with low investment rates seem to have either Gini coefficients above 50 (as in the case of Mexico, Brazil and Nicaragua) or high amounts of political instability (as in El Salvador, Bolivia and Guatemala). The simple regression analysis of Table 3 confirms our story. Inequality, Political Instability, and War seems to be the most important determinants of investment rates, accounting for more than 40% of their variation within Latin America. Although it is always risky to make any type of inferences with a number of observations as small as we have (19 countries), it does seem that the explanatory power of these variables is striking. This fact is brought home by a glance at Figures 1 and 2, which show the partial correlation plots of these variables with growth.

How about the rent-seeking channel? Data on rent-seeking is extremely hard to come by. In Table 2 we show average 1988-1996 corruption rankings produced by the University of Gottingen based on a series of investor surveys. They are only available for eight Latin American countries, and the ranking that they give does not seem to be associated with investment in any particular way – although on average Latin America does seem to do worse than the Middle East and East Asia although better than Africa and South Asia. Some anomalies can be explained: high corruption and high investment in Venezuela would seem to be associated with higher oil wealth; whereas the low investment and corruption averages in Chile mask a striking difference between the 1960-1987 period, during which the average Chilean investment rate was 17.1%, and the 1987-97 period, over which it was 26.7%. But the data is far too sketchy to suggest that there is a strong relationship between corruption and investment.

In sum, there seems to be something to the story of high levels of inequality and political instability leading to low levels of investment, in terms of its capacity to account both for Latin America's poor growth experience as well as the within-Latin America variation, although the data is much more limited than would be desirable for a satisfactory evaluation of these theories.

Credibility and Predictability of Policies

A favorable and predictable investment climate is fundamental for ensuring a high rate of investment. As we have shown above, political instability and policy uncertainty appear to be at least partly behind Latin America's low investment rates. In fact, there is strong microeconomic evidence that the confidence of Latin American investors in their governments is low. Table 4 shows the summary statistics from responses by private investors to the World Development Report 1997's Survey of the Private Sector. Column 1 summarizes the responses to a set of questions that dealt with the credibility and predictability of governments' laws and policies. These questions include questions about how often investors were subject to major policy changes, whether they were informed or not about these changes and whether their opinion was taken into account in the process of policy formation. Column 2 refers to questions about how often constitutional and non-constitutional changes of government were associated with changes in major policies, as well as about how secure investors considered their property rights to be. The answers were scaled from 1 to 6, so that a higher number in the table means a more favorable environment. In general, Latin America's scores are mediocre on both the credibility and the instability front. Latin America's poor credibility score is particularly surprising, as its credibility rating is barely above that of Africa. This is heavily influenced by the fact that Latin American investors tend to believe less in policy commitments that policymakers make than their African counterparts. In both indicators, Latin America does better than the economies that have recently emerged from communist rule in Eastern Europe and Central Asia as well as Africa, but considerably worse than economies in the Middle East, North Africa and South and South-East Asia.

Other research has also shown credibility to be a key problem for macroeconomic policymaking. As Calvo and Vegh (1999) have noted, recent exchange rate based stabilizations in Latin America have been characterized by expansionary booms in which there is a long and sustained real appreciation and a deteriorating current account. As the current account deficit becomes unmanageable, the economy almost invariably heads towards collapse of the stabilization attempt. In their study of twelve exchange-rate based stabilizations (11 of which occurred in Latin American countries), they show that "Eight of the twelve plans ended in full blown crises with large losses in international reserves...In fact, of all the major programs listed in Table 1, the Argentine 1991 convertibility plan is so far the only successful plan which has maintained the exchange rate at the level chosen at the inception of the program"

What leads to these patterns of exchange rate appreciation that end in a collapse of the stabilization is a matter of debate. But among the existing stories, one of the most appealing is that of lack of credibility. Calvo and Vegh (1999) and Calvo and Drazen (1999) have shown that when a stabilization is introduced but private agents believe there is a probability that it be reversed the pattern of boom and bust will follow naturally. A plan to reduce the level of the exchange rate and to stabilize inflation which agents believe will be reversed at some finite time in the future will *temporarily* lower both the exchange rate and the nominal interest rate. As consumers perceive that the exchange rate will only be low for a finite amount of time, they decide to consume higher levels of tradeables, leading to a deterioration in the current account. The lower nominal rate also stimulates intertemporal substitution to the present, leading to a boom in demand and thus to an appreciation of the exchange rate. Thus the model is characterized by a boom in

consumption of tradeables and a real appreciation, eventually followed by a contraction in the consumption of tradeables and a depreciation. If price stickiness is introduced into the model, several other stylized facts of exchange rate based booms can be reproduced, such as the joint occurrence of an output boom and a real exchange rate appreciation towards the beginning of the program, a recession in the non-tradeables sector which can start before the program is discontinued, and a rate of inflation which remains above the rate of devaluation until the program is discontinued. All of these are stylized facts characterizing the booms associated with exchange rate based stabilizations that have been undertaken in many Latin American countries.

The Calvo-Vegh-Drazen models show that macroeconomic performance can be severely impaired by the lack of credibility. Less credibility leads to a deteriorating balance of payments situation which in itself makes more difficult to stick to the stabilization program. The collapse of exchange rate based stabilizations can emerge as a self-fulfilling prophecy – the program cannot be maintained precisely because it is not credible. Environments where private agents do not believe in policymakers to begin with – be it because of previous experiences or because of high political instability – will be also the environments in which policymakers will find it more difficult to stick to optimal plans.

5. Other Determinants of Economic Growth

5.1 Human Capital

Another of the main results of the recent empirical growth literature has been the finding of a robust association between the stock of human capital and economic growth. Societies with healthier, more educated populations appear to have higher growth rates.²⁸ Note that it is hard to tell an intuitive story here for the reverse causation hypothesis – which would imply an influence of the growth rate of GDP (not the level) on the *stock* of human capital. A number of models justify theoretically the existence of such a link – either within the context of neoclassical growth models²⁹ or endogenous growth models.³⁰ Microeconomic studies also consistently find that higher levels of personal human capital accumulation are associated with higher levels of productivity.

²⁸ Two caveats about the results: the first one is that a number of regressions have found a negative association between economic growth and female secondary schooling while at the same time finding a positive association between male secondary schooling and economic growth. However, the coefficient on female secondary schooling has recently proved not robust to the addition of newer data and only appears after fertility rates are controlled for, suggesting that the total effect of women's education on growth occurs through decreased fertility. Furthermore, this finding appears inconsistent with the microeconomic evidence and thus likely to be due to sampling error. The second one is that, although secondary and higher level education has a significant effect on growth, primary schooling seems to have no independent effect on growth. However, primary schooling is a prerequisite for secondary and higher schooling and in that sense it is related to growth. See Barro, 1997, for a discussion of these results. For a dissenting view, see however Pritchett, 1996.

²⁹ Mankiw, Romer and Weil, 1992, Mankiw, 1995.

³⁰ Lucas (1988), Uzawa (1965).

On this dimension, Latin America's performance is actually quite good. Latin America's schooling levels (see Table 5) are actually quite close to East Asia's and considerably higher than those in the rest of the developing world. However, in terms of spending over GDP, Latin America spends much more of its GDP on public health and education spending than East Asia and most other regions of the developing world (Table 6). Given its higher levels of GDP per capita, we would expect Latin America's high investment rates in human capital accumulation to have produced greater stocks of human capital. That this is not the case suggests severe inefficiencies in the process of investment in human capital.

One of the sources of such inefficiencies was captured in Barry Ames's (1987) seminal work on the spending patterns of Latin American governments. Despite differences in preferences over spending in human capital accumulation, Ames argued, Latin American spending patterns were often conditioned by the need of the administrations in power to ensure their political survival. The threats of coups and countercoups as well as electoral sustainability forced governments in times of crisis to adopt one of several strategies for survival. These strategies could include pacifying the military, expanding the reach of the public sector by recruiting bureaucrats, targeting local interests, increasing transfers or rewarding politically pivotal social strata. The desirability of alternative strategies would vary according to the political situation as well as structural and institutional factors. For example, a strategy of increased transfers would be optimal when intermediate organizations are weak, as they allow leaders to directly appeal to the masses. When political parties are strong, governments seeking political survival will tend more towards expansions in the size of the bureaucracy.

The prevalence of political crises in Latin America, by leading to high levels of variability in patterns of spending, is likely to hamper the effectiveness of investment in human capital. Indeed, Ames found that health, welfare and education expenditures went down when governments transferred resources to pacify the military, or when they shifted to public works spending in order to target local interests, but rose when the strategy of raising transfers was adopted. When governments moved to post-crisis strategies, they often found themselves trapped in a dilemma: whether to continue catering to the military to avoid the consolidation of pro-coup forces or to cater to voters and ensure themselves electoral success. The prevalence of this dilemma constituted a major impediment to the attainment of the institutional stability necessary to stabilize patterns of spending and investment in human capital.

Aside from Ames's study of the political economy of the variability of government expenditures, there is regrettably little work on the determinants of *levels* of spending in human capital accumulation. Wacziarg (1999) suggests that democracies have faster rates of human capital accumulation than dictatorships because dictators are likely to be more sympathetic to the demands of better off groups – who benefit less from human capital accumulation. Rodríguez and Pineda (1999) present a common agency model of interest groups and investment in human capital in which there are two types of interest groups who try to influence the government's decisions: the owners of human capital and the owners of physical capital. To the extent that the resources in the hands of the owners of physical capital are greater, they will be able to buy politicians into

spending less on human capital accumulation (which is financed by taxes on physical capital), thus lowering the rate of investment in human capital. The authors use capital's share in GDP to proxy for the amount of resources available to capital and show that capital shares are indeed negatively related to human capital accumulation. Although Latin America's capital share is not substantially different from the world average, it has gone up steeply since the early seventies, indicating that owners of physical capital have become politically much stronger.

Pineda and Rodríguez also show that capital's share is also associated with the distribution of spending on education – countries with a higher capital share tend to spend less on primary education and more on higher education. It appears that this maldistribution of education spending may be one of the principal reasons behind Latin America's inefficiencies in capital accumulation. Indeed, Latin America's education spending is severely skewed towards higher income groups. As shown in Table 7, although Latin America's spending per student (as a fraction of its per capita GDP) is 57% as high as that of OECD countries, its spending on students enrolled in higher education is 87% as high. Latin America's spending on education thus seems to be skewed towards better off groups.³¹ As Fernandez and Rogerson (1995) argue, this fact is puzzling when viewed from the perspective of standard models of education provision which show that the optimal composition of spending in education involves implicit transfers from rich to poor individuals³².

Fernandez and Rogerson's explanation for this phenomenon relies on the interaction between political economy factors and the fact that education is commonly only partially publicly provided. If credit constraints affect education decisions, then a decision on the magnitude of the subsidy to education is also a decision on who benefits from the subsidy. By choosing to support a lower education subsidy, high income individuals can exclude poor individuals from the benefits of education and also implicitly extract resources from them as taxpayers. Of course they need to be able to convince other groups to ally with them in order to enact this implicit tax on the poor. Their natural ally is the middle class. Fernandez and Rogerson show that under certain conditions the middle class will ally itself with the rich in exchange for a sufficiently large education subsidy.

Fernandez and Rogerson's model is an attractive explanation for Latin America's skewed distribution of expenditures in education. For it to make sense, however, it must be the case that the rich and the middle class have the political power necessary to impose a policy that they desire, regardless of the preferences of the poor. Since Fernandez and Rogerson model the interaction between these groups as the result of a voting process, they need to assume that no group has an outright majority. In Latin America, however, those who receive higher education are only 7% of the population (and those who finish a

³¹ Latin America's spending on higher education as a percent of its education budget is lower than that of the OECD, but a distinction appears to exist between countries of Iberian heritage and others. Latin American countries of Iberian Heritage spend 24% of their education budget on higher education, as compared to 21% for advanced industrial countries and 11% for Latin American countries of non-Iberian heritage.

³² On this see Psacharopoulos (1986).

secondary education are only 18%)³³, making the possibility that they alone can form a winning voting on the basis of their votes highly unlikely. For Fernandez and Rogerson's model to make sense as an explanation of the skewness in Latin American education spending, one must assume that higher income's groups greater wealth allows them to have a disproportionately high access to political power. In other words, one must assume that the underlying model of the political system is much less a democratic model and much more a model of political influence and interest groups.

5.2 Natural Resources

Another potential culprit of Latin America's low growth is, paradoxically, its resource abundance. Sachs and Warner (1995b) have shown that natural resource abundance, as measured by the share of primary exports in GDP, have a robust negative association with economic growth. Latin America's share of primary exports at an average of 15%, is higher than that of East Asia (2.4%) or of OECD countries (7.5%) although lower than that of sub-Saharan Africa (18.07%).

But why should natural resource endowments have a negative effect on economic growth? This is indeed a puzzling phenomenon, and the causes for it are not yet well understood. The impressive development failure of Latin America's oil-richest nation, Venezuela, is a striking example of this puzzle. Arguably, Venezuela is the greatest missed opportunity for development of the post-war period. From 1963 to 1996, Venezuela sold 329 billion US\$³⁴ of fuel exports to the world - 20,420 \$ per Venezuelan - However, in 1997 Venezuela's GDP per capita was 8% lower than in 1963. In 1963 Venezuela boasted a democratic political system with stable transitions and civil and political rights which were the envy of any other Latin American country. But during the nineties the system barely survived two military coup attempts and 48% of Venezuelans expressed no confidence in it according to opinion polls.

The Venezuelan case parallels a number of other similar cases of development failures among oil-rich nations in particular and resource-rich nations in general.³⁵ Perú's failure to take advantage of the nineteenth century guano boom and the sustained decline during the nineteenth centuries of the once-rich plantation economies of the Caribbean are both examples that suggest that this is not a new phenomenon.³⁶ A number of explanations have been proposed for this phenomenon. The *Dutch Disease* explanation argues that the specialization of some countries away from tradables as a natural response to resource discoveries make them lose out on the positive externalities generated by exporting. A problem with this explanation is that evidence of learning-by-exporting (a necessary prerequisite of major externalities in the export sector) has been remarkably

³³ Own calculations based on the data of Barro and Lee (1993).

³⁴ Evaluated at constant 1995 dollars.

³⁵ See the case studies in Gelb (1988) and Karl (1997).

³⁶ Indeed, André Gunder Frank's (1967) famous critique of export-led development was based on the observation that a great number of developing countries – most of Frank's examples were taken from Latin America – had experienced economic collapses that followed primary export-led booms.

hard to find in microeconomic studies of developing and developed economies³⁷. An alternative explanation has a political economy bent: Tornell and Lane (1994) have proposed that resource booms can lead to an expansion of rent-seeking activities to the detriment of productive capital accumulation. Therefore countries that have abundance in natural resources whose property is either public or not well-defined will tend to have greater levels of rent-seeking and corruption.

A problem of the rent-seeking and Dutch disease explanations is that they imply that countries with higher dependence on natural resources will ultimately end up with a lower level of economic growth and per capita GDP. But Rodriguez and Sachs (1999) have pointed out that economies with natural resource abundance tend to have *higher*, not lower levels of GDP per capita than those that lack natural resources. Rodríguez and Sachs have proposed an alternative explanation for the growth-resource abundance correlation: they point out that introducing a factor of production which cannot expand one-to-one with labor and capital into a Ramsey economy generates an *overshooting result*: the economy tends to surpass its steady state level of income in finite time, thus converging to its steady state from above, and displaying negative rates of growth (albeit higher levels of GDP) on the transition. The authors calibrate a dynamic computable general equilibrium model to the Venezuelan economy and show that Venezuela's negative economic performance during the 1972-1993 period can be well accounted for as a result of its convergence of the economy from above to its steady state.

The overshooting model has stark political economy implications. Imagine that a country like Venezuela were to undergo the structural reforms – whatever they are – necessary to raise its rate of productivity growth to a level similar to that experienced by South Korea during the 1960-90 period. Whereas in the case of South Korea the productivity growth generated by those reforms would translate into increasing levels of well-being for the population, therefore creating political support for the enactment of these reforms, Rodríguez and Sachs's calculations show that in a country like Venezuela such reforms would only be able to maintain the level of GDP per capita constant. Building a political base for reforms in the presence of voters who are imperfectly informed about the structure of the economy will thus be more difficult in a country which, like Venezuela, is converging to its steady state from above.

5.3 Institutions

Following the seminal work of Douglas North (1990), considerable attention has been paid to understanding the influence of institutions on economic performance. North defined institutions as the humanly devised constraints - both formal and informal - that shape human interaction. The institutional - as opposed to the material - component of these constraints can either be captured in written rules that are sanctioned by the explicit agreement of society, or, alternatively, in informal rules of behavior. North hypothesizes that institutions that help minimize transactions costs have a considerable effect on economic performance and growth.

³⁷ See the evidence by Clerides, Lach and Tybout (1999) and Bernard and Jensen (1995, 1998).

Why some countries may have poor institutions is a much more difficult question to answer. The literature on institutional change has followed several stages in developing answers to this variety of questions. The early works of Douglas North and Robert Thomas (1973) viewed institutional change as an efficient response to changes in implicit prices. North later abandoned that hypothesis, pointing to a number of reasons why institutional change is not efficient. One reason for which institutional change may fail to be efficient is that institutions are built by groups with bargaining power in society and efficient institutions will not necessarily favor these groups. A second reason is due to the logic of lock-in under increasing returns, originally pointed to by Brian Arthur in the study of why some technological innovations are not adopted despite their higher efficiency (1994). North extends this reasoning to institutions, arguing that societies can get locked into institutions precisely because institutions are characterized by large setup costs, massive increasing returns, and coordination effects. Individuals will not take advantage of the gains from trade that exist in the generation of new, more efficient institutions because of the inherent inefficiencies of political markets and because of the difficulties of coordinating change in formal and informal constraints.

Difficulties with the measurement of these institutions have been the principal impediment to their use in empirical work to explain cross-country differences in output per capita. However, a robust result in the empirical growth literature appears to be that several measures of institutional quality have positive effects on economic growth. In particular, attempts to measure the extent to which institutions give rise to bribery and rent-seeking, their enforcement of the rule of law, and prevailing economic freedoms and protection of property rights, all seem to produce a positive correlation with economic growth. The relationship between economic growth and democracy, however, appears to be more complex.

Another result that arises from the empirical growth literature is that, to the extent that it can be accurately measured, the degree of trust and civic cooperation also has a positive effect on economic growth. Following upon the work of political scientist Robert Putnam, who studied civic cooperation in Italian communities and found it to be strongly associated with economic performance (1993), Steve Knack and Phil Keefer (1998) have attempted to study the effect of trust and civic cooperation on economic growth. They measure "trust" by responses to the question "Generally speaking, would you say that most people can be trusted, or that you can't be too careful in dealing with people?" and the strength of civic cooperation by responses to questions about whether conducts such as cheating on taxes, keeping money that you have found on the street, failing to report damage done accidentally to a parked vehicle, claiming government benefits to which you're not entitled or avoiding a fare on public transport can be justified. The authors find that both civic cooperation and trust have a positive effect on growth.

On all of these institutional measures, Latin America measures up poorly. As shown in Table 8, Latin America is consistently below the world average for seven alternative measures of institutional quality ranging from perception of corruption to quality of the bureaucracy. As Panizza (1999) points out, institutional quality in Latin America appears to be even poorer once one controls for its level of GDP. Institutional

Quality certainly does not appear to have helped Latin America achieve high economic growth.

This assessment of Latin American institutions based on highly imperfect aggregate data is reaffirmed by more detailed case studies that have attempted to understand the workings of the Latin American state. In his analysis of the Brazilian state, Peter Evans (1995) discusses the negative impact of political patronage on the effectiveness of the bureaucracy. Compared with other developing countries, the extensive powers of political appointment and the difficulties experienced in implementing meritocratic recruitment and promotion procedures in Brazil were high. The career pattern of Brazilian bureaucrats is highly punctuated by changing political balances. A survey of Brazilian bureaucrats, for example, found that they changed agencies every four or five years. Although some leaders tried – with varying levels of success – to create “pockets of efficiency” such as the National Development Bank, even when these pockets survived they did so within a highly segmented and fragmented state, undermining the possibility of coherent state action. This “embedded autonomy” of some institutions in Brazil was limited by its partial nature and the pervasiveness of clientelistic and patronage links as the predominant form of political exchange.

Why does Latin America have such poor institutions? In one of the first systematic empirical studies of the determinants of institutional quality, La Porta, Lopez de Silanes, Shleifer and Vishny (1998) point to a number of alternative determinants of institutional quality. In particular, they concentrate on the impact that economic, political and cultural determinants have on institutional quality. They find that although richer countries appear to have better institutions, that is far from being the whole story. In particular, they find that political and cultural variables are also extremely important. High levels of ethnic and linguistic fragmentation, which are a measure of underlying political conflict, are negatively associated with institutional quality³⁸. But so is the nature of the legal and religious institutions adopted by countries. In particular, La Porta et al. argue that the tradition of civil law, which developed as an instrument to allow the sovereign greater control over economic life should be inferior in terms of its capacity to generate higher economic performance than common law, which emerged as part of the attempt to limit the powers of rulers. They also seize upon an argument dating back to Max Weber about the stimulus that protestant values give to economic development. They find convincing statistical evidence that institutional quality is significantly better in countries with both a tradition of common law and a high proportion of protestants in the population. Extending upon the work of LaPorta et al., Panizza (1999) argues that the quality of institutions is also affected by the incentives that politicians have to cater to local interests as opposed to broad based interests – what he defines as *political particularism*. Panizza’s argument is that extreme values of this index (originally proposed by Carey and Shugart (1995) and Gaviria et al.(1999)) have a negative incidence on institutional quality. The underlying reasoning is that when particularism is too low policymakers will have little incentive to respond to the wishes of voters, but where it is high the incentive to free ride among different constituencies is accentuated.

³⁸ See also the work of Alesina, Bazir and Easterly (1997) who find evidence that ethnic fragmentation adversely affects the provision of public goods.

Panizza finds that this index of political particularism is negatively related to institutional quality for a cross-section of countries. He also finds that the existence of checks and balances is positively associated with institutional quality.

For analysts of Latin American politics, these results are certainly cause for worry. The results of La Porta et al. suggest that an important source of negative economic performance is precisely in the religious and legal institutions that were adopted from the Spanish and Portuguese crowns. Indeed, Latin America has one of the worst possible mixes of institutional determinants: a catholic heritage coupled with a tradition of Civil Law. It is only favored by its relative ethnolinguistic homogeneity. But both the nature of country's culture and their legal tradition are extremely hard if not impossible to change.

However, much further research is needed in this field to identify the real source of these effects. In particular, as LaPorta et al. recognize, their results are particularly sensitive to controlling for prior colonial status and continental dummies. Therefore their indicators of culture and legal tradition may be proxying for other omitted institutional determinants that are also associated with geography or colonial heritage. Much more work is needed for disentangling the effects of rough proxies of culture and legal tradition from the number of alternative factors that they could be correlated with. Furthermore, the incompatibility of cultural and legal traditions with institutional quality surely must be conditional on the modality of institutions that nations attempt to build. Alternative institutional forms from those in existence may be compatible with the legal and cultural traditions of Latin America without being in clear dissonance with its cultural and legal traditions.

5.4 Democracy, Authoritarianism and Economic Performance

Perhaps one of the most salient characteristics of Latin American political history has been its constant alternation between authoritarianism and democracy. Latin American economies were characteristically unable to maintain a minimally stable constitutional order during the nineteenth and twentieth century. Although by the beginning of the twentieth century most countries had been able to consolidate some type of "oligarchical democracy" with a restricted franchise and limited political competition³⁹ these systems succumbed to the economic and social turmoil caused by the breakdown of export markets during the great Depression. As in Europe, democratic forces fell to authoritarian governments during the pre-World War II period; but in contrast to the European experience the return to democracy after World War II was sporadic and short lived.

To a great extent the authoritarianism-democracy conflict has emerged from a conflict between the central state apparatus and provincial governments, a conflict broadly reminiscent of the pre-independence conflict between the Spain-backed colonial government and autonomous provincial forces. The conflict between provinces and the executive has combined itself with the great degree of social polarization to generate

³⁹ Both Argentina and Uruguay went further, instituting universal male suffrage in the 1910s.

strong incentives for those who capture power to attempt to concentrate it in their hands. It is this combination of geographic and social polarization that hides behind many of the political alterations experienced by Latin American states. Therefore great part of the political alterations in Brazil can be viewed from the perspective of changing relative fortunes of Sao Paulo and Rio (geographic polarization). Similarly, many breakdowns of democratic rule have been provoked by electoral victories of left-wing parties and the real or perceived attempts by them to concentrate power (economic polarization).⁴⁰

Has the inability to –until recently – consolidate solid democracies hurt Latin American economic performance? The efficiency effects of democracy are difficult to identify empirically. On the one hand, Barro (1997) and Tavares and Wacziarg (1998) have found no clear (positive or negative) association between democracy and economic performance. In particular, Barro (1997) suggests that the relationship may be non-linear, with increases in democracy at low levels of democracy leading to economic growth but further increases leading to a decline in economic performance. Barro hypothesizes that at low levels of democracy an increase in political rights may reflect precisely the relaxation of restrictions on civil liberties and rights of association that may be particularly important for ensuring protection of property rights and capital accumulation. Further relaxation, however, could lead to the emergence of redistributive pressures and high tax rates that would reduce the stimulus for investment. Another reason to believe that democracy may not have positive efficiency effects is that, to the extent that dictators can act as residual claimants on the product of society, they will be able to internalize the efficiency effects of decisions with a public goods/externality dimension. We should expect dictatorships to be more capable of solving particular problems – such as the existence of fiscal deficits – that arise from the existence of strong incentives for free riding on the part of political actors in a democratic society.⁴¹ On the other hand, dictators are likely to have more extreme preferences and ideas than the great bulk of voters, which is likely to lead to greater variance in economic performance.

Barro uses the Gastil index of political rights to measure democracy (Freedom House, various years), in which countries are rated according to the existence of rights for all adults to vote and compete for public offices, and the right of elected representatives to have a decisive vote on public policies. In that index (which ranks countries from 1 to 7, where 1 indicates most democratic) he finds that the turning point at which democracy starts being bad for growth is at a value of approximately 4. Table 9 shows the values for the Gastil index of Political Rights as well as a similar indicator of civil liberties for different geographic regions. It shows that Latin America appears to be on the region where democracy appears to be no longer important for growth.

Are democracies in a better position to withstand economic crises and to enact meaningful reforms? Przeworski and Limongi (1993) study ten South American countries and find that authoritarian systems were more likely to succumb when an economic crisis

⁴⁰ Chile (1973), Peru (1963), and Venezuela (1948) are examples.

⁴¹ For evidence that societies with political systems that tend to internalize public goods effects have better fiscal performance, see Alesina and Perotti (1994).

hit; but democracies were not. Therefore democracies would appear to be less vulnerable to economic crises. They also show that the number of other democracies in the region was very important in making democracy more likely in a particular country, although previous democratic breakdowns in that country made it less likely. These results are very different from what they obtain for the rest of the world, where both democracies and autocracies are vulnerable to economic conditions.

In a number of clear cases it is clear that the breakdown of democracy was the result of widespread perception of its failure in economic terms. This is the case of Peru in 1991 and Venezuela's two militarily failed but politically successful coup attempts of 1992. However, in many cases economically successful democratic governments have been overthrown by military regimes. An example of this is the case of the Frei regime in Chile in which a Socialist candidate successfully ran against the government candidate in an economy with moderate growth and stability where genuine attention had been paid to issues of equity and structural reform (Larraín and Meller, 1981). In these cases the failure of democracy was more a reflection of the lack of incentives to political agents to abide by the rules of the game when they failed in the electoral contest. This refusal to play by the rules was partly caused by the high degree of political polarization which made powerful extreme groups feel severely threatened by the rise to power of groups with diametrically opposed platforms.

5.5 Stabilizations, Inflation and the Politics of Delay

Most analyses of the link between macroeconomic policies and growth show that weak macroeconomic policies, whether they are proxied by government budget deficits, exchange rate disequilibria and volatility or the rate of inflation, are harmful for growth.⁴² In particular, the rate of inflation appears to have a negative yet possibly non-linear effect on growth, with increases in the rate of inflation from a starting point above 15% having a negative significant effect on growth but increases in inflation rates between 0 and 15% not being significantly associated with growth. Furthermore, the relationship is maintained when some plausible instruments for inflation are used, such as prior colonial status and lagged inflation.

If one is to believe the results arising from cross-country growth empirics, Latin America's disappointing growth experience vis-à-vis the rest of the world can mostly be explained by its poor macroeconomic performance. Barro (1997) points out that the Latin America dummy becomes insignificant in growth regressions when the inflation rate is introduced. Indeed, Latin America's average inflation rates have been considerably above those of the rest of the world (see Table 10), with an average inflation rate over the 1971-97 period of over 100 percent. Indeed, there are only seven countries

⁴² For the black market premium, see Barro and Sala-i-Martin, 1995; for volatility see Gavin and Hausmann (1996); for inflation see Barro 1997.

in which the average rate of inflation exceeded 100% from 1971 to 1997; five of them are in Latin America⁴³

Given that the costs of inflation are so well understood, how can one account for such striking differences in inflation performance? Why is it that some countries choose to have highly inflationary policies despite the evidence of the considerable efficiency costs and disruptions it generates?

At one level the answer to this question is that many governments that pursued inflationary policies were initially unaware of the negative efficiency consequences of inflation when they undertook those policies. Many were also skeptical that high rates of money creation would actually generate high inflation. For example, a 1963 conference held in Sao Paulo by the Yale Center for Economic Growth brought together a number of economists from within and outside the region to discuss the effects of monetary policy on inflation and growth. Whereas a number of the participants, such as Arnold Harberger and Roberto Campos held to the orthodox position that monetary expansions would generate no long run growth but rather would significantly accelerate inflation, structuralists like Celso Furtado, Oswaldo Sunkel and Nicholas Kaldor argued that monetary expansions were unlikely to generate more than a mild acceleration in inflation and that this was a reasonable cost to pay for economic growth. Indeed, many popular development models of the time featured a horizontal labor supply curve⁴⁴ which implied that expansions in aggregate demand had no effect on wages or on price levels. These early development theories permeated the thinking of many policymakers. For example, the architects of Perú's 1985 heterodox program – which ended in hyperinflation – argued that “in heterogeneous economies, the way prices are formed varies tremendously according to particular markets. All this conduces to a different vision of how to control inflation” (1987a, p. 24); “it is necessary to spend, even at the cost of a fiscal deficit, because, if the deficit is the result of transferring public resources to consumption of the poor so they can demand more products and firms are able to reduce unitary costs, this deficit will not create inflationary pressures, but all the contrary.” (1987b, p. 24)

Although mistaken beliefs may be the explanation for why episodes of high inflation get started, it cannot be a satisfactory explanation for why it is so hard to end them. For example, in Argentina the inflation rate exceeded 90 percent for sixteen continuous years, (from 1975 to 1991) but repeated stabilization plans ended up in failure. Well before the end of this period the efficiency costs of continuing inflationary policies had become evident, and a promise to end inflation was one of the fundamental points in the economic programme of Raúl Alfonsín, who assumed power in 1985. Why, then, is inflation so hard to end?

One possible explanation emphasizes the existence of multiple equilibria in the supply of seigniorage. Very high levels of inflation are associated with low levels of money demand; therefore they may be consistent with low levels of seigniorage and low

⁴³ The countries are Congo (1276), Nicaragua (1148), Brazil (683), Bolivia (521), Peru (486), Croatia (385) and Argentina (351).

⁴⁴ See the famous paper by Lewis (1954).

underlying fiscal deficits. In this case the transition from a high inflation to a low inflation equilibria is a coordination problem – there is little that conservative fiscal policies can do and they may even worsen the problem, as the equilibrium inflation rate corresponding to a lower deficit in the neighborhood of the bad equilibrium has an even greater inflation rate associated with it. Sachs and Zini (1995) have suggested that in the late eighties the Brazilian hyperinflation could be characterized in this way – Indeed between 1990 and 1992 the Brazilian budget deficit averaged 3.3% of GDP yet hyperinflation continued unabated. This explanation is consistent with the fact that when stabilization finally came to Brazil, it was relatively painless and provoked no major social conflict

Not all Latin American stabilizations have been as painless. For example, by 1990 Nicaragua's budget deficit had reached a surreal 35% of GDP. For these cases, it appears that the explanation for why stabilizations are delayed has something to do with how the costs of the stabilization are borne out. Alesina and Drazen (1991) have proposed a model in which conflict over how the costs of stabilization are to be distributed among competing groups leads each group to follow a strategy of wait and see. Specifically, Alesina and Drazen model stabilization as a war of attrition in which groups have the choice at any moment of time between conceding – and accepting to pay the costs of the stabilization – or waiting to see if the other group will concede. Unless a group has a very high cost of waiting, it is rational for it to wait and see if the other group concedes first for a finite amount of time. As time drags on, a group that has not seen its opponent concede will realize that its opponent is likely to have much more power to resist the costs of not stabilizing and/or a greater capacity of political organization – and will reassess the rationale for conceding. As time goes on the probability that one of the groups concedes rises, so that the stabilization happens in finite time. But the probability that it happen immediately is zero, so that there is a rational delay in the adoption of the stabilization plan.

The war of attrition model appears to be consistent with the main salient facts about Latin American stabilizations. In particular, the prelude to nearly all –failed or succesful – Latin American stabilizations seems to be characterized by bitter discussions about the distributions of the gains. When stabilization attempts collapse they do so amid refusals by powerful groups to accept reductions in their share of rents or increases in their tax burdens. For example, the 1985 Austral plan began with an attempt at simultaneously freezing wages and prices. After an initial success at lowering inflation the government approved an increase in wages in 1987 which fell far below the accumulated inflation rise. Labor union leaders protested and called several labor strikes. Tensions escalated until in mid 1988 a general strike by public sector utilities workers ended in an eruption of riots and vandalism in Buenos Aires' Plaza de Mayo. In July 1988 the government created a Price Commission to follow up prices and costs jointly with trade union representatives. Unions agreed to restrict wage demands in return for stricter enforcement of price controls. To keep prices low, trade barriers were lowered and financing was given for imports of goods which were perceived to be contributing to inflation. Firms, anticipating price controls, used their oligopolistic power to set prices higher than they otherwise would have in order to protect themselves from the

government's efforts to fix low prices. (see Fernandez and Montel, 1988). Prices spiraled out of control and in July 9, 1989, a disgraced Alfonsín reconized his inability to put the crisis under control and handed over power early to his successor, Carlos Menem. Menem was able to use the Peronist party's control of unions to force the labor sector into acquiescing to the reform program. The success of his program was to a great extent due to the unwillingness of the Peronist controlled unions to defect to the opposition (see Murillo, 2000). In other words, the pronouncement of important Peronist leaders for an orthodox program of stabilization convinced unions that they had both less capacity of political maneuver and less capacity to withstand a prolonged struggle than the industrial sector.⁴⁵

An alternative model that is commonly used for explaining why stabilization may not be carried out despite it being optimal is that of Fernandez and Rodrik (1993). In that model the authors show that when there is individual-specific uncertainty about the distribution of the gains from a reform this reform may be rejected by a majority of the population even though ex-post it will benefit a majority. The reason is that many of those who ex-post will benefit from the reform are uncertain ex ante about whether they will benefit. In particular, if a sufficiently large number of those who will lose know this with certainty but many of those who will gain do not, then one will see a tendency towards status-quo bias emerge: the reform will not be instituted despite it being optimal.

Note that the Fernandez and Rodrik model requires agents who are going to gain from the reform to be uncertain about whether they will gain from the reform or not. For it to be a satisfactory model of stabilizations, it would require a sufficient number of agents to be either certain about whether they will benefit from lower inflation or whether they will bear the larger share of the costs of adjustment. However, the existence of uncertainty about the distribution of the gains from reducing inflation seems improbable – typically high inflation episodes are sufficiently short lived for agents to have information on how well off they are under low levels of inflation. Even when they are long-lived, as in the Argentine case, there is sufficient variation from one year to another in the level of inflation for individuals to infer whether they benefit from it or not. It appears that this model may be best suited to the analysis of trade and other structural reforms for which the uncertainty about the distribution of reforms may be large. It is important however to understand that stabilization is commonly introduced as a policy package together with a set of reforms, and that politically important groups may not necessarily have the option of accepting the stabilization component while rejecting the trade policy/structural reforms components. It is the uncertainty about the benefits/costs of this whole package of reforms that is often necessary for understanding the political gridlock which they have tended to generate in Latin America.

There is one key similarity between the Alesina-Drazen and the Fernandez-Rodrik story which is particularly important for the study of Latin America. In both of these models the inequality of the distribution of the gains and costs from the reform is fundamental in generating the stabilization's delay. In the Alesina and Drazen model,

⁴⁵ For an explanation of why left-wing or populist parties may be in a better position to undertake stabilizations see Cukierman and Tomassi, 1998.

when the stabilization's costs are borne equally, the expected delay of the stabilization collapses to zero, whereas in the Fernandez and Rodrik model, the status quo bias emerges precisely from the fact that losers from the reform are not being compensated – the gains are distributed asymmetrically. To the extent that inequality of incomes indicates inequalities in the political power to capture gains from the reforms Latin America's inequality may be one of the main explanators for its repeated problems achieving stabilization. Indeed the whole history of Latin American stabilizations is filled with repeated disputes about who was to bear the brunt of the reforms.

Underlying social conflict, however, is not the only explanation behind differences in macroeconomic instability. How this conflict is managed through existing institutions will also have an effect. Rodrik (1998), for example, has provided empirical evidence that what is particularly destructive to an economy's capacity to react to external shocks is a combination of high latent social conflict and poor institutions of conflict management (such as social safety nets, democratic institutions, rule of law, and efficient government institutions). He finds that an interaction of these is a strong predictor of growth collapse during the 1980s. Rodrik's results suggest that Latin America's combination of high inequality and poor institutions is one of the main reasons behind its problems in achieving low inflation.

Haggard and Kaufman (1992) have also concentrated on the institutional determinants of the inflation rate. In their work, they find that macroeconomic stability is profoundly affected by the security of tenure of political elites and their independence from the pull of distributive pressures. Political systems characterized by frequent regime changes, party fragmentation and the exclusion of significant political contenders from electoral contests will tend to give rise to higher levels of inflation. In contrast, when strong authoritarian governments have managed to proscribe electoral politics and repress the demands arising from politically important groups they have achieved success in controlling the inflation rate. But low inflation can also be maintained in democratic regimes where institutionalized parties are able to mute conflict among competing social forces, at least when inflation has historically been low or moderate. It is only when there is a history of high and persistent inflation that labor-repressive authoritarian regimes have been more capable of carrying out successful stabilizations.

In Latin America, the authoritarian route to stabilization is probably best exemplified by the Chilean experience.⁴⁶ Before the 1973 coup, the Chilean polity was deeply split into parties with contrasting ideological differences, leading to high levels of fragmentation and instability. This fragmentation and the tenure insecurity that it generated for political actors appears to have been associated with its macroeconomic instability: four of the nation's pre-1973 surges of inflation occurred at the end of presidential terms in office, as leaders struggled to keep up with the inflationary demands of labor and business interests before elections. The fragmentation also allowed for Marxist-leaning Salvador Allende, clearly unpalatable to right-wing groups, to achieve power with 36.2 percent of the vote. Allende's accession to power significantly raised the costs to the right of continuing to abide by the rules of the game. With the support of

⁴⁶ Our description of the Chilean experience is based primarily on Stallings (1989) and Valenzuela (1999)

the U.S. government, the Chilean military engineered a coup in September 1973 and general Augusto Pinochet quickly moved to assert his power over dissenting sectors, both within the military and in society at large. The coup was followed by the complete repression of the opposition with the aims of destroying the parties of the left and engineering a fundamental restructuring of political institutions in which debate would be significantly circumscribed. Military units moved in to “clean up” neighborhoods that were strongholds of the left and close to 3000 people died as a result of officially sanctioned repression. Labor unions were sharply circumscribed and parties were either banned or declared “in recess”. After ascertaining his power within the ruling military, Pinochet moved to gain approval for a new Constitution that severely restricted certain political groups and ideologies and established a permanent role in politics for the armed forces. The Constitution was approved in a questionable plebiscite in 1980, paving the way for the military government to carry out a restructuring of the public finances without having to deal with any substantial opposition. It was in this context that Chile was able to carry out its deficit reducing reform of the pensions system and privatizations program. The fiscal accounts quickly moved into surplus (from a deficit of 7% of GDP in 1973) and the government was easily able to resist pressures for wage increases from a labor movement whose leaders were either in jail or had disappeared. Not only was the government capable of adjusting its finances, it also regained the ability to adjust to negative shocks through relative wage decreases, as it did when the 1982 banking crisis hit. Despite a massive government bailout of the banking sector, prices were kept under control through repression of demands for wage increases after the June 1982 devaluation. Indeed, real wages fell by more than 14% between 1981 and 1985. A bout of protests led by the copper workers’ union was quickly repressed with massive deployments of military force and the declaration of a state of siege in 1984. By the late eighties, it was clear that labor had lost the political game and had to settle for a new equilibrium in which business interests would predominate when adjustment to a negative shock was necessary.

Although the Chilean experience appears to suggest that authoritarianism can be helpful in carrying out economic adjustments (with severe and perhaps undesirable distributional costs), democratic governments have also been capable of carrying out politically costly stabilizations. Indeed, the late eighties and early nineties saw a number of examples of countries where traditionally populist parties with strong ties to the labor movement were able to carry out adjustments that implied high costs to labor. As Blanca Heredia’s (1994) analysis the Mexican case shows, when the political system has a strong clientelar base, relations of power tend to become organized through vertical instead of horizontal channels of influence. This is because agents have an incentive to develop links with those willing to provide protection within the system, not to ally themselves with those with whom they may share common characteristics. In other words, when a system of patronage is deeply imbedded in society, the majority of agents end up competing for divisible benefits controlled by the state and the PRI government party. When the de la Madrid administration was faced with the debt crisis and decided to carry out a program of stabilization and structural adjustment, the vertical nature of the aggregation of interests made class-based organization and response to it particularly difficult. Indeed, the government was able to garner support for its program through the

systematic management of the benefits under the discretion of the state. The introduction of “targeted” social programs, such as the Programa Nacional de Solidaridad (PRONASOL) served the purpose of allowing the government to channel resources towards politically pivotal groups (Heredia, 1994). This management of the benefits of being near power was skillfully used by de la Madrid and his successor Salinas in order to negotiate their program of stabilization and structural adjustment and to stop the debt crisis from escalating into high levels of inflation.

Therefore we find that a variety of institutional structures appear to be consistent with the maintenance of low levels of inflation. The importance of these institutions is enhanced, however, by the high levels of inherent social conflict of Latin America, which can again be traced back to its high inequality and polarization.

Central Bank Independence

Although Rodrik and Haggard and Kaufman have emphasized the importance of political institutions, other authors have studied the relevance of monetary and fiscal policy institutions as determinants of inflation. In particular, there appears to be a strong case arising from the theoretical literature for an independent Central Bank as a mechanism for the control of inflation. Going back to Kydland and Prescott (1977) and Barro and Gordon (1983) the fact that monetary policy is characterized by a dynamic inconsistency problem is well understood. Even if the monetary authority is maximizing the welfare of private agents, it will have an incentive to generate surprise inflations in order to raise output above its present level.⁴⁷ Rational agents will understand this incentive and expect higher inflation – therefore in equilibrium there will be rationally expected high inflation and the same level of output than if the government had been able to credibly precommit itself to a low rate of inflation. Herein comes the independent Central Bank: if the head of the Central Bank is independent and more averse to inflation than policymakers, it would choose lower levels of inflation. As private agents understand that the policymaker will choose a low level of inflation, they will adjust their expectations of inflation downward and the equilibrium will be characterized by lower inflation without lower output.

Regrettably, there is little support for this hypothesis in the data. Although Alesina and Summers (1993) provided promising evidence that there is a negative association between central bank independence and inflation for sixteen developed countries, this conclusion is very sensible to the sample of developed countries used, as Barro (1997) has pointed out. And Cukierman (1992) has found difficulty extending these results to developing countries, finding little correlation between central bank independence and inflation for developing countries.

Latin America is an example of how poor that correlation is. Table 11 shows Cukierman’s index of central bank independence along with the 1960-90 inflation rate for the Latin American countries in the sample. The patterns are striking: Nicaragua has the

⁴⁷ This incentive can only exist if there is a distortion which makes output suboptimally low.

third most independent Central Bank in Latin America (a bank which is rated as independent as Israel's) but the highest rate of inflation in the region and second highest in the world); Colombia's central bank is least independent in Latin America but yet Colombia has the lowest inflation rate among the countries of South America (22%).

Cukierman suggests that this lack of association between inflation and central bank independence at the level of developing countries may be a reflection of the fact that whether a central bank is legally independent may not reflect its "real" independence, and suggest looking at actual rates of turnover instead of legal provisions in order to ascertain a Central bank's independence. When this measure of central bank independence is used, the negative relationship between central bank independence and inflation reemerges for developing countries. However, how much this result says about the link between central bank independence and inflation is questionable. In particular, it is evident that policymakers are more likely to remove central bankers who are not doing their job well from office, suggesting that high turnover rates may be no more than a consequence of low inflation.

Fiscal Policy

Another set of possible solutions to the inflationary problems of Latin America may lie in the nature of its fiscal institutions. Deficit financing associated with unsustainable levels of government spending are an usual suspect in inflationary experiences and are certainly behind a number of Latin American experiences with inflation. However, the typical image of Latin America as a region of big spending, irresponsible governments does not fit in well with the facts. Indeed, Latin America's average budget deficit over the 1970-95 period was only 1.4 % of GDP, considerably lower than the average for OECD countries (see Table 12). As a matter of fact, Latin America's primary surplus has been on average positive!

There are however some important characteristics to Latin America's fiscal policy that set it apart from other countries. One is that its tax base is much smaller, causing these deficits to be considerably higher when measured as a proportion of total revenues. This may be important from the point of view of evaluating the state's capacity to raise additional resources in order to finance deficits. Another key difference with OECD countries is that Latin American fiscal policy is highly unstable. Despite its smaller size, Latin America's budget surplus had a standard deviation of 3.3 percentage points of GDP, twice as large as that of the OECD. Total expenditures and revenue growth rates have been four times as volatile as in OECD economies. As shown by Gavin and Perotti (1997) Latin American fiscal policy is highly procyclical, suggesting that governments are substantially deviating from tax-smoothing policies. In particular, Gavin and Perotti show that this procyclicality comes from a highly procyclical government expenditure and not from countercyclical revenues.

Since this behavior is at odds with conventional neo-classical (i.e.: tax-smoothing) explanations, a number of alternative hypotheses have been suggested. A political economy explanation for the procyclicality has been suggested by Tornell and Lane

(1999) and Perotti (1996b). They have provided positive models of policymaking in which a positive shock in revenues leads to a more than proportionate response in spending. The explanation is what Tornell and Lane term the “voracity effect”: when the productivity of a publicly held asset increases, the demands of the groups that can share in the revenues from those assets rise more than proportionately. The reason is that in an equilibrium a group must be indifferent between what it gets and the next best alternative – but what it gets is equal to what is left over after all other groups’ demands have been subtracted. Therefore an increase in revenues leads to an increase in demands just large enough so that the sum of the increments of $n-1$ groups sum the total increase in revenues – and the sum of all the n increases in demands must exceed the increase in revenues.

There are other possible explanations for the procyclicality of fiscal policy in Latin America. One is that it is simply due to the fact that Latin American governments face tight liquidity constraints: during a crisis creditors may not be willing to give loans to Latin American governments. Another possibility is suggested by the Stein, Talvi and Grisanti (1998), who find that procyclicality in the response to the business cycle is more likely when there is a higher degree of proportionality in the electoral system⁴⁸. Proportionality is measured as the average number of representatives per district and is a measure of how tight links are between the electorate and representatives. Stein, Talvi and Grisanti argue that governments with higher degree of proportionality are more likely to have parliamentary systems characterized by a number of important minority parties, exacerbating the free-riding problem in the budgetary process.

The procyclicality of Latin American fiscal policies may go some way towards explaining Latin America’s poor experience with inflation (although it is unlikely to be the primary cause). Latin American governments appear to be spending more precisely at times where aggregate demand is high, exacerbating aggregate imbalances and fueling inflation increases. Indeed, Gavin and Perotti also find evidence that in Latin America high fiscal deficits are strongly associated with subsequent increases in the inflation rate.

5.6 Trade Policy

The effect of trade policy on economic growth is one of the most contentious areas of the modern growth literature. On the one hand, a number of authors (see for example Dollar, 1992, Sachs and Warner, 1995, Edwards, 1998, and Ben-David, 1995) claim that policy-induced trade barriers are positively related to economic growth. However, Rodríguez and Rodrik (1999) have disputed the findings of these papers, pointing to a series of methodological shortcomings in them which severely bias their results. For example, Rodríguez and Rodrik point out that the correlation between indicators of tariffs or non-tariff barriers and growth is near zero, and that it is only when these indicators are put together with other variables - whose link to trade policy is questionable - to form composite openness indices that they become negatively associated with growth.

⁴⁸ Stein, Talvi and Grisanti measure proportionality according to the average number of representatives per district. See also Lijphart (1990)

Theoretically, there are good reasons to think that there may not be an unequivocal link between trade policy and growth. Although trade barriers generate static efficiency losses that lower the steady state level of per capita GDP they can also raise production in industries that have positive externalities. Thus if the forces of comparative advantage lead the economy to specialize away from technologically dynamic sectors that produce knowledge spillovers then trade restrictions may, by raising output of these industries, stimulate economic growth.⁴⁹

In Latin America, these considerations have always been salient in the debates about trade policy. Raul Prebisch (1962, 1984), Celso Furtado (1964) and a number of other Latin American structuralist economists argued that there were a number of basic market failures inherent in Latin American economies that led them to underproduce manufacturing goods. It was for this reason that import substitution could help these countries start the take-off into sustained economic growth.

Latin American structuralists and *dependistas* pointed to the initial spurt in economic growth associated with the growth in internal industry that occurred during the breakdown in the world trading system after World War I as proof that import substitution would lead to high growth. After World War II, Latin American governments started to take this possibility seriously, and embarked on a programme of inward-looking development based on high tariffs and active state involvement in the economy.⁵⁰ The swift economic results produced by ISI constructed the political floor for its continuance. ISI was supported by a coalition of unionized workers and import-competing industrialists who had to gain from higher prices for industrial goods and lower agricultural prices. These workers and industrialists saw their interests coincide with that of an emerging state, struggling to consolidate itself in relation to the provinces, and a military which equated modernization with industrial growth. The extent of labor and business participation in government was considerable – in comparison say to East Asia – and this fact in great part explains why Latin America took much longer to shift from ISI to export-orientation than East Asia.

The Mexican example illustrates how necessary it was to keep all members of the ISI coalition happy. Under the presidency of Lazaro Cárdenas Mexico pursued an aggressive program of import substitution with land redistribution and expanded rights for labor. In essence, the support for Cárdenas came from organized labor and peasants, but industrialists were wary of his redistributive policies. They therefore backed an opponent to Cárdenas's hand-picked successor during the election of 1940⁵¹ and facilitated the victory of Manuel Avila Camacho (1940-96). Under Avila Camacho the Mexican state engineered a purge of leftists from the union movement, replacing them

⁴⁹ See the models in Grossman and Helpman (1991), Matsuyama (1992) and Rodríguez and Rodrik (1999).

⁵⁰ Indeed the practice of activist import substitution often preceded the theory. As Prebisch (1984) recalls: "In reality, my policy proposal sought to provide theoretical justification for the industrialization policy which was already being followed (especially by the large countries of Latin America), to encourage the others to follow it, too, and to provide . . . an orderly strategy for carrying this out" (Prebisch 1984).

⁵¹ See Michaels (1971)

with labor leaders who were willing to enter into an alliance with industrialists in the interest of national development.

It is also easy to overplay the power that domestic business interests had in these coalitions. During ISI, many governments actively sought out Foreign Direct Investment through preferential treatment for foreign firms, a move which met with strong opposition from local business interests.⁵² Many in business and labor opposed the growing influence of patronage-based political parties and the state apparatus.

Why did import substitution last so long? One apparent reason was that the high rates of economic growth experienced by Latin America under it made deviations from it seem unnecessary. But the Fernandez and Rodrik model discussed in the previous subsection suggests another apparent reason: that trade policy may be pervasively characterized by status quo bias. This is because the winners from a trade policy are often very hard to identify, whereas it is clear cut who the losers will be. Indeed, the Fernandez and Rodrik model is a much more appealing model for trade and other structural reforms than for stabilization, because trade and structural reforms are often associated with a high degree of uncertainty as to who will benefit from them. For example, the sectors that most gain from trade liberalization may be export industries that do not exist previous to the liberalization – such as in the famous case of Korean wig exports – so that there may be considerable uncertainty as to who may reap those gains. But the losers will almost certainly be import-competing firms that are well-established and can easily be identified. Furthermore, the constitution of a pro-trade coalition is made even more difficult by the fact that some of the main winners from trade are consumers, whose gains are however so diffuse that they face a great incentive to free-ride in political organization. For the same reasoning, it takes a strong external shock (such as the Great Depression) to make some groups sufficiently strong so as to be able to enact trade policies that they benefit from.

By the 1970s, ISI appeared to be running out of steam. Powerful labor groups appeared to have imposed on Latin American economies a very high amount of wage rigidity which made adjustment to external shocks difficult and high levels of inflation likely. The structuralist stance on inflation as necessary for economic growth⁵³ had led to lax fiscal policy and continued increase in prices. Backed strongly by business interests, conservative military leaders grabbed power in a number of countries – particularly in the Southern Cone – freezing wages, cutting government expenditures and restricting credit. This was the typical reaction in the Southern cone countries (Argentina, Chile and Uruguay) as well as in Brazil as early as 1964. In all of these countries the labor movement was stronger and more independent of government and the party system was extremely fragmented, making necessary a forceful intervention in order to bring down

⁵² For example, in 1955 the Kubitschek administration in Brazil approved - against the protest of domestic firms - the controversial Instruction 113, which gave it the power to grant preferential exchange rates for profit remittances and amortization of direct investment.

⁵³ See our discussion above of the debate between structuralists and monetarists regarding the effects of monetary policy on the economy.

real wages. Countries where labor had been co-opted into existing parties (such as Mexico) could avoid adjustment by commanding labor to moderate its demands

Between 1980 and 1999, virtually every Latin American country adopted a variant of the IMF-World Bank supported structural adjustment-cum-liberalization policy package which included a significant degree of trade liberalization. Why they did so is still somewhat of a puzzle. Some authors⁵⁴ have emphasized domestic economic collapse and the failure of import substitution as the main motivating force behind the shift to free trade. However, whether it was the failure of ISI or failed macroeconomic adjustment policies that led to the low economic growth rates of the eighties is not evident. Indeed, as Rodrik (1996) has pointed out, the common reasoning that ISI led to balance of payments difficulties relies on poorly articulated and conceptually murky links between micro-economic policies and macro-economic outcomes.

Furthermore, as the example of countless development failures has shown, it takes more than a failed policy to compel policymakers to change course. The balance of payments difficulties experienced by Latin American countries during the eighties were not unprecedented. Neither was liberalization the *only* possible response – indeed the common response to these difficulties in the past had been a mixture of devaluations and exchange controls. And the fact that some countries (most notably Mexico and Chile) initiated economic reforms before a significant pressure from voters of international donors to do so had emerged suggests that domestic factors may be at play in determining when reforms are carried out. It seems that a satisfactory explanation would explain trade liberalization as a function of changes in the internal and external balances of power.

In Latin America, trade liberalization and structural adjustment were generally carried out by the same groups that had held power under – and benefited from – the period of ISI. This is typical of economic reforms and revolutions – they tend to be carried out by domestic powerholders. In Latin America, it is strikingly clear that the parties that initiated the reforms – Acción Democrática in Venezuela, the PRI in Mexico, Peronismo in Argentina – were the same parties that had led the ISI coalition. It is also clear that these parties are today less powerful than they were when they initiated the reforms. So are the labor unions and import-competing industrialists that formed their power base. But why would those that have the most to lose from reforms be the ones who initiate them?

Aaron Tornell (1998) has provided an attractive theoretical model to account for this phenomenon. He shows how political infighting among dominant groups can result as a by product of endogenous economic decline. Before infighting erupts, a dominant coalition of groups (unions, industrialists, political parties and the military) enjoy rent-seeking privileges. A reform occurs when a group unilaterally gives up these privileges. Such a sacrifice entails an immediate economic loss for the reformist group. No group

⁵⁴ For example, Edwards (1995) discounts explanations giving multilateral institutions an important role and argues that “an interpretation closer to history would give a fundamental role to the soul-searching that began in Latin America in the early 1980s.” (pp. 55-6).

will want to do this as long as they have a high amount of benefits to enjoy from their rent-seeking privileges. But as the simultaneous exercise of rent-seeking brings about an endogenous economic decline, the incentives of individual groups change. In particular, a given group may have an incentive to unilaterally give up its rights if such an action weakens other groups in the coalition. The reason is that if they do not give up their rights then other groups in the coalition may be able to enact a reform which will leave them worse off. Therefore industrialists will be willing to liberalize trade not because they prefer trade liberalization to the status-quo, but because they prefer trade liberalization to expropriation by labor groups. Trade liberalization would be supported by industrialists because, by weakening labor, it helps them avert a situation in which they would be even worse off.

Tornell's explanation is consistent with the stylized facts behind many of the reforms. In almost all cases, reforms have counted with the support of the business and industrial sectors. In many cases – Chile in the seventies is perhaps the best example – there was a real threat of expropriation by labor and left-wing groups. And in all cases reform followed a prolonged period of economic decline.

Recent Developments in Trade Policy

More recently, a number of bilateral trade agreements and free trade areas have started to gain importance in Latin America. These have included new trade agreements (such as Mercosur) or revived agreements which had been signed during the ISI period but had never taken off (this is the case of CARICOM). Although these agreements are often viewed as a natural extension of the transition to free trade, both theory and the empirical evidence are ambiguous about the efficiency effects of discriminating trade agreements. On the theoretical side, it is well known that a trade agreement to lower tariffs between small countries will result in an aggregate welfare loss if both countries continue to trade with the rest of the world after forming the free trade areas as in this case trade diversion will exceed trade creation (Bhagwati and Panagariya 1996). And on the empirical side, Vamvakidis (1999) has failed to find a positive effect of free trade agreements that include developing countries on growth, and Panagariya (1996) has argued that the North American Free Trade agreement has hurt rather than helped Mexico.

There may, however, be good political economy reasons for forming a free trade agreement. For example, free trade may be a first best policy which is also time inconsistent. Governments may have an incentive to carry out surprise redistributions either through tariff rates or through levies on FDI (Staiger and Tabellini, 1990). Under unilateral liberalization, there are few ways to bind countries into not carrying out such surprises. However, free trade areas, in which a violation will be punished by the partner countries, offer a manageable alternative. Some authors have suggested that free trade agreements serve as a commitment device. Tornell and Esquivel (1995) note that Mexico's entry into NAFTA had elements of time inconsistency: the ruling party's political machine, which to a great extent is based on control of the votes in agricultural regions, will likely be weakened as these sectors decline. However, the design of

NAFTA committed the Mexican government to eliminate protection in agriculture and services over the next fifteen years. Furthermore, free trade agreements may further reinforce the power of exporters, thus setting up the political coalition that will ensure its survival.

In an interesting empirical analysis, Olarreaga and Soloaga (1998) attempted to account for deviations from internal free trade in Mercosur as well as the structure of its common external tariff. They argue that these can be well accounted for by a model of interest groups like the one proposed by Grossman and Helpman (1995). As that model predicts, internal barriers to free trade seem to be higher in potentially trade creating sectors, because in these sectors importers will lobby for protection, whereas exporters will lobby for free trade in their sectors. This suggests that the degree of effective trade creation may be very small in agreements like Mercosur, and that the associated welfare losses may be large. Whether this is an appropriate model for understanding Mercosur and other regional trading blocs to a great extent hinges on whether the interest groups/political influence view is appropriate for the study of Latin American politics.

5.8 The Politics of Transformation and the Transformation of Politics

Up to this point, we have been concerned with how politics has affected Latin American economic performance. In other words, we have treated politics as an independent variable. To the extent that many political institutions change only slowly over time it is correct to think about them in this way. But the period under study has also seen profound transformations in Latin America's politics, transformations that have not occurred independently of economic developments. Perhaps nowhere has the transformation of politics been more salient than in the near collapse of the delicate equilibrium between presidentialism and strong political parties that had started to emerge during the latter half of the twentieth century. With the exception of the countries of the Caribbean Basin, the region has boasted presidentialist systems with bicameral legislatures since independence. These systems were originally premised on the desirability of separation of powers and the existence of checks and balances. Rather than concentrating power in the hands of the executive, these systems often produced a widely divided political system where the legislative and the executive were constantly at odds. Hartlyn and Valenzuela (1998) note in a review of seventy-one presidents elected in democratic contests in Latin America that only twenty-seven counted with the votes of a majority of the citizenry. Most presidents therefore had to enter into substantial negotiations with divided parliaments in order to ensure a modicum of governability. The deadlocks that were often generated by this situation were an important factor in causing the region's persistent democratic breakdowns.

Political systems in Latin America were able to gain some stability in the countries where the party system was more stable and the number of parties was small. In particular, institutionalized parties that effectively incorporated a broad spectrum of relevant groups in society (especially dominant economic groups) were more successful in forming the backbone of a strong party system. This was the case in countries like Colombia, Costa Rica, Uruguay and Venezuela. In contrast, democratic breakdowns

were much more likely in the countries where a large number of ideological parties played a role (Hartlyn and Valenzuela, 1998).

The experience of the eighties and nineties, however, has led to a considerable weakening of the party system over almost all of Latin America. Many traditional institutionalized parties, such as Venezuela's COPEI or Peru's APRA have gone from being majority parties to almost irrelevant political actors. They have commonly been replaced by fragmented and short-lived parties often associated with transitory political personalities. During this same period, alternative forms of political organization have arisen. These "new social movements" (Escobar and Alvarez, 1992) range from spontaneously formed civil movements of black and indigenous people to ecological and human rights NGOs. In a number of cases, these associations emerged as alternative ways of channeling the need for political participation under military regimes that severely repressed opposition political parties. However, in other cases they emerged simply as a response to the perceived lack of capacity of existing political parties to respond to the demands of specific groups. For example, in the wake of the 1985 Mexico City earthquake, participants from 20 neighborhoods severely affected by the floods formed the *Coordinadora Unica de Damnificados* (CUD). Despite an initial negative of the de la Madrid government to recognize them, the CUD assembled a list of more than 55,000 families seeking housing that had not been recognized by the government's postearthquake housing program. The CUD later transformed itself into a more permanent political association (the *Asamblea de Barrios*). What is important is that this type of association can have far-reaching political effects without being organized towards the capture of political power as it is traditionally understood. The form of political participation that they promote is also different from that of the party system.

Structural adjustment reinvigorated many of these social movements.⁵⁵ Partly this comes from the fact that a number of movements arose from within the region's disenfranchised, many of which bore the brunt of stabilization-induced economic contractions. Another reason is that Washington consensus programs in the majority of programs were carried out by long-standing traditional parties such as Mexico's PRI, Venezuela's AD or Argentina's Peronista party. Existing established parties, labor unions and other traditional forms of political association appear to be losing an increasing number of spheres of influence to these new social movements.

How will Latin America's politics look if the trend towards severely weakened parties and a more decentered and pluralistic participation through new social movements continues? It is of course extremely hard to predict. In one view, these new social movements form the backbone of a strong democracy and should be viewed as a positive development. Indeed, Alexis de Tocqueville emphasized the role played by this type of "associations" in consolidating American democracy. In a more pessimistic view, severely weakened parties leave a political vacuum in which a counterweight to the executive's power is absent. New social movements are commonly too weak to attain or hold on to executive power on their own. However, their demands often leave the space

⁵⁵ See the studies in Smith and Korzeniewicz (1997)

open for other actors to step in. A case in point is the recent Ecuadorean experience, where a well organized indigenous peoples movement unwittingly opened the space for a military seizure of power in early 2000. The short lived seizure was used by conservative groups in the military to purge their ranks of the elements that had supported the indigenous peoples movement. In the pessimistic view, the Ecuadorean experience of five heads of state in a period of four years may presage what is in store for the rest of Latin America. Such a change could make the region's economies completely unmanageable.

Concluding Remarks

This paper has suggested a number of ways in which political factors can help account for Latin America's disappointing performance. Several themes appear recurrently in our discussion:

1. *Political Instability*: Latin America's policy instability seems to have significantly contributed to its poor growth performance. Instability has been shown to be a main factor affecting the investment rate and investor confidence (Section 4); as well as distortionary features of macroeconomic policies such as Latin American fiscal policy's marked procyclicality (Section 5.5), which has contributed to it having the world's highest average inflation rates. It has also been behind governments' inability to stabilize the composition of their budgets (Section 5.1). The region's political instability is best exemplified in the continuous swings that the countries of the region experience between democracy and authoritarianism (Section 5.4) as well as between populist and orthodox macroeconomic policies (Section 5.5).
2. *Inequality in the Distribution of Political and Economic Power*: Latin America is the most unequal region in the world. Inequality has been shown to have an effect on the region's investment rates (Section 4) as well as on aggregate economic growth. Inequality fuels policy instability and also biases policies in favor of economically powerful groups; this has been a contributing factor to the region's inefficiencies in human capital accumulation (Section 5.1). Inequality in the distribution of the benefits from economic adjustment and reforms appears to be a reason for the region's difficulties in achieving macroeconomic stability (Section 5.5).
3. *Rent-Seeking*: A third factor in which Latin America performs negatively with respect to the rest of the world is in the perceived corruption and rent-seeking which plagues these countries' governments. Rent-seeking may be a response to the country's asymmetries in distribution of political and economic power (Section 4), the poor institutional structure inherited from colonial times (Section 2, 5.3), or the region's abundance of natural resources with inherently poorly defined property rights (Section 5.2).
4. *Voters or Vested Interests*: Much of the debate in the recent political science literature revolves around whether or not a positive theory of politics can best account for existing policies by assuming that they arise from popular preferences or from the preferences of powerful vested interests. The Latin

America experience illustrates that both theories can complement each other in explaining the political economy of growth. On the one hand, the pressure on political parties to follow populist economic policies is very high in Latin America, reflecting a greater popular demand for redistribution than in more egalitarian societies; on the other hand the power of elites to thwart this demand has been manifested in the way in which even populist policies appear to end up being distorted so as to benefit powerful vested interests. A view of politics that emphasizes the role of vested interests appears necessary to explain the prevalence of rent seeking (section 4), the maldistribution of education spending (Section 5.1) and the structure of commercial policy (Section 5.5)

An often neglected area of policy reform is endogenous politics. Traditional reform proposals center on the immediate determinants of economic growth and stability. To the extent that these determinants are endogenously determined themselves by the policymaking process, reforms that do not take this into account will be more likely to end up in failure. The above discussion suggests that policy reform proposals must address the reasons for the region's high instability, its unequal distribution of political and economic powers, its prevalence of rent-seeking and its poor institutional structure. Reform proposals that do not take these factors into account are in effect assuming that the region's policies are determined in a political vacuum, an assumption that may significantly cripple the possibilities for successful reforms.

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Table 1: Investment Rates in Latin America.

	Investment Rate		Net Foreign Direct Investment	
	1960-97	1990-97	1960-97	1990-97
High income	24.00	21.70	0.66	0.82
High income non-OECD	26.01	26.42		
High income OECD	23.86	21.55	0.64	0.79
East Asia & Pacific	28.30	36.08	1.38	3.35
Latin America & Caribbean	21.11	20.54	0.96	1.62
Middle East & North Africa	24.11	24.48	0.09	0.58
South Asia	20.29	22.85	0.17	0.43
Sub-Saharan Africa	20.76	17.57	0.90	1.36
World	23.86	22.41	0.68	0.98

Source: World Bank (1999)

Table 2: Investment and its Political Determinants in Latin America and the World.

Country	Investment Rate	Political Instability	Gini Coefficient	Fraction of Time in War	Corruption
Dominica	31.32	.	.	.	
Grenada	31.18	.	.	.	
St. Vincent & Grens.	30.41	.	.	.	
Suriname	28.95	0.20	.	0.00	
Jamaica	26.50	0.05	42.24	0.04	
Guyana	26.16	0.16	46.82	0.00	
Venezuela	24.66	0.17	46.22	0.00	2.73
St. Lucia	24.42	0.00	.	.	
Costa Rica	23.42	0.00	46.40	0.00	
Peru	23.42	0.08	46.34	0.04	
Trinidad	22.95	0.03	46.27	0.00	
Argentina	21.65	0.42	.	0.36	4.75
Mexico	21.22	0.00	54.94	0.00	2.47
Brazil	21.06	0.04	57.87	0.00	3.71
Honduras	20.82	0.08	55.68	0.08	
Paraguay	20.80	0.05	.	0.00	
Panama	20.66	0.09	53.30	0.00	
Dom. Rep.	20.58	0.15	46.94	0.04	
Barbados	20.28	0.00	48.86	0.00	
Ecuador	20.03	0.18	43.00	0.00	3.67
Nicaragua	19.66	0.12	50.32	0.24	
Chile	19.57	0.10	51.84	0.04	6.28
Colombia	18.89	0.01	53.02	0.32	2.90
Bahamas	17.12	0.00	45.87	.	
Uruguay	16.06	0.04	.	0.00	
El Salvador	15.87	0.41	49.13	0.36	
Bolivia	15.62	0.47	42.04	0.00	1.80
Guatemala	14.15	0.43	54.19	0.08	
Haiti	12.34	0.10	.	0.20	
Latin America	21.72	0.13	49.06	0.08	3.54
East Asia	27.33	0.06	40.47	0.04	4.56
Sub Saharan Africa	19.52	0.12	47.33	0.14	3.10
Middle East	23.84	0.12	38.40	0.10	4.02
Industrialized	23.95	0.03	33.19	0.03	7.47
South Asia	18.82	0.09	34.28	0.03	2.73
Eastern Europe	26.41	0.00	27.42	.	4.35

Sources: Investment Rate from World Bank (1999), Political Instability and Fraction of Time in War from Barro and Lee (1994), Gini coefficient from Deininger and Squire (1996), Corruption from Gottingen University (1999) .

Table 4: Responses to World Bank's Investor Survey on Credibility and Predictability of Policies.

	Predictability	Changes
Former Soviet Union	1.71575	2.3746
Eastern Europe	1.873409	2.874182
Developed Countries	2.715227	3.783636
Middle East and North Africa	2.438333	3.231333
Latin America and the Caribbean	2.204643	2.768286
Sub Saharan Africa	2.140795	2.408091
South and South East Asia	3.035833	3.243333
Average	2.187836	2.817343

Source: World Bank, (1997). Values are averages of responses. They are on a scale of 1 to 6 with 1 lower values reflecting inferior outcomes.

Table 5: Average Years of Schooling

	Primary Schooling	Secondary Schooling	Higher Schooling
OECD	5.13	1.85	0.29
Latin America	3.08	0.85	0.13
East Asia	3.36	1.03	0.15
Sub Saharan Africa	1.52	0.25	0.03
Middle East	1.82	0.77	0.15
South Asia	1.35	0.55	0.05
Eastern Europe	6.22	1.06	0.22

Source: Barro and Lee (1993).

Table 6: Spending on Human Capital Accumulation in Latin America and the World

	Public spending on education, total (% of GNP, UNESCO)	Health expenditure, public (% of GDP)
East Asia & Pacific	2.6	1.66
High income: OECD	5.5	6.15
Latin America & Caribbean	3.3	2.7
Middle East & North Africa	6.15 ..	
South Asia	3.15	0.84
Sub-Saharan Africa	..	2.55
World	5.2	5.51

Source: World Bank (1999)

Table 7: Asymmetries in the Composition of Government Spending on Education

	Primary Education	Tertiary Education
(1) OECD	15.50	40.78
(2) Latin America	8.97	36.10
(2)/(1)	57.7%	88.5%

Source: World Bank (1999)

Table 8: Measures of Institutional Quality

	Whole Sample	Latin America
Corruption (ICRG)	55.0	45.1
Corruption (Mauro)	67.8	60.4
Bribery 1997	68.1	51.3
Quality of Bureaucracy (ICRG)	55.5	41.4
Rule of Law (ICRG)	58.4	46.8
Efficiency of the Judiciary (Mauro)	70.8	63.4
Red Tape (Mauro)	60.4	51.8

Source: Panizza (1999)

Table 9: Civil Liberties and Political Rights in Latin America and the World

	Civil Liberties	Political Rights
Latin America	3.29	3.32
Western Industrialized Economies	1.55	1.40
Sub-Saharan Africa	5.39	5.67
East Asia	3.63	3.83
Middle East	5.17	5.31
South Asia	4.87	4.75
Eastern Europe	5.20	5.78

Source: Wacziarg (1999)

Table 10: Inflation Rates in Latin America and the World.

Average Inflation, 1960-97	
Western Industrialized Nations	11.46
Latin America	105.66
East Asia	8.44
South Asia	10.43
Sub Saharan Africa	52.02
Middle East	9.45
Former Socialist Republics	149.80

Source: World Bank (1999)

Table 11: Inflation and Central Bank Independence in Latin America

	Average Inflation	Central Bank Independence
Costa Rica	18.92	.52
Bahamas	5.60	.48
Nicaragua	1148.22	.47
Venezuela	26.25	.45
Barbados	8.48	.44
Argentina	351.93	.44
Honduras	11.46	.44
Peru	486.73	.44
Chile	75.40	.43
Mexico	37.17	.37
Bolivia	521.52	.29
Uruguay	60.16	.29
Brazil	683.26	.28
Panama	3.62	.23*
Colombia	22.73	.19

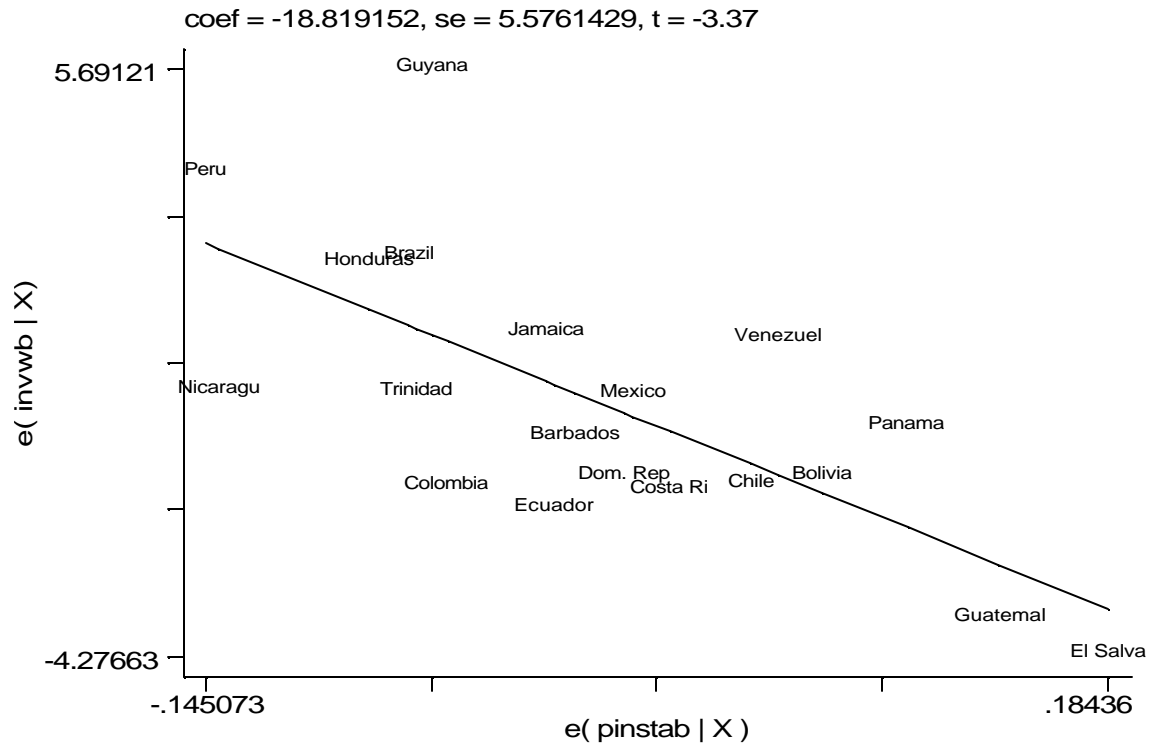
* Panama uses the U.S. Dollar as its currency and therefore does not have the capacity to inflate.
Source: Inflation from World Bank (1999); Central Bank Independence from Barro (1997).

Table 12: Fiscal Policy in Latin America and Industrial Countries

		1970-95	1970-79	1980-89	1990-95
Total Suplus/GDP	Latin America	-1.4	-1.3	-2.4	0.5
	Industrial Countries	-2.5	-0.8	-3.3	-4.1
Total Surplus/Total Revenue	Latin America	-10.6	-9.5	-17.3	1.4
	Industrial Countries	-6.5	-3.1	-8.5	-9.2
Standard Deviation of Total Surplus	Latin America	3.3	2.0	3.8	2.4
	Industrial Countries	1.6	1.5	1.5	1.3
Standard Deviation of Total Revenue	Latin America	12.2	9.8	12.9	9.1
	Industrial Countries	3.1	3.0	2.3	2.5
Standard Deviation of Total Expenditure	Latin America	12.8	9.0	14.9	9
	Industrial Countries	3.1	3	2.3	2.5

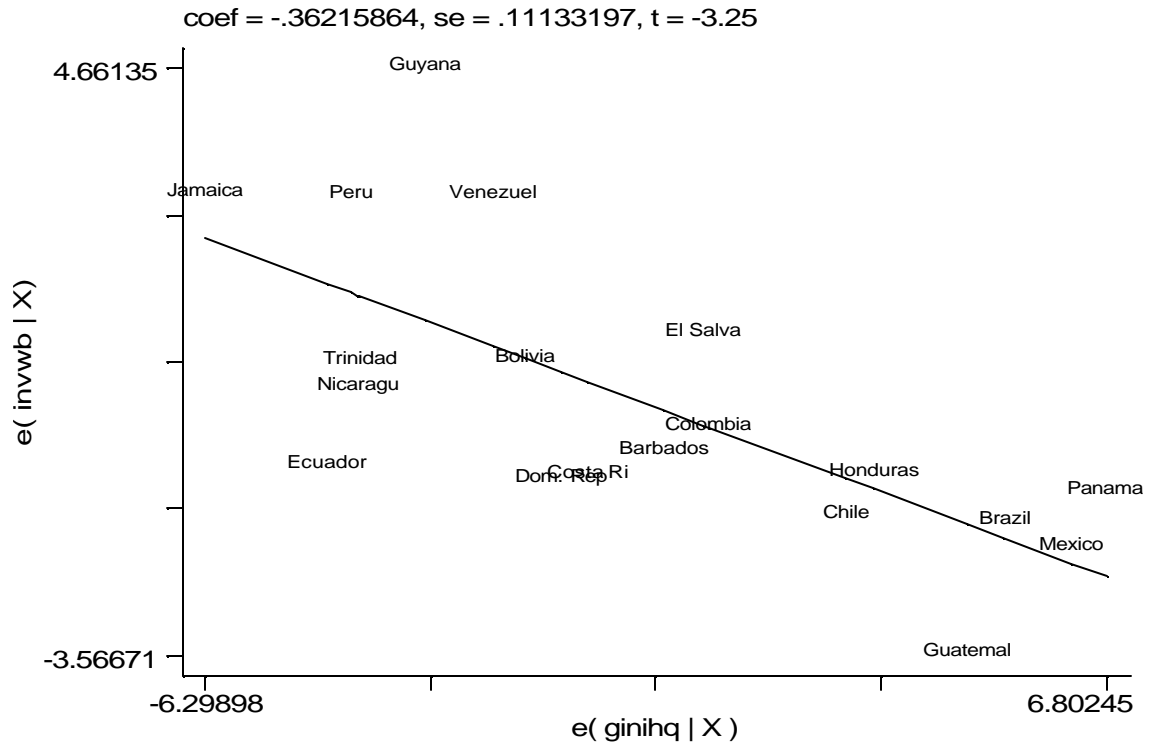
Source: Gavin and Perotti (1997)

Figure 1: Investment and Political Instability in Latin America



This figure shows the partial correlation between investment and political instability for 19 Latin American countries after controlling for log of initial GDP, male and female secondary schooling, percent of time involved in war, life expectancy and inequality.

Figure 2: Investment and Inequality in Latin America



This figure shows the partial correlation between investment and inequality for 19 Latin American countries after controlling for log of initial GDP, male and female secondary schooling, percent of time involved in war, life expectancy and political instability.