CHAPTER 8

Policies on Markets and Institutions

This chapter discusses the relationship between markets and inequality. In terms of the conceptual framework presented in Chapters 1 and 6 (see Figure 1.2), such an exploration involves moving from policies that affect asset distributions (the subject of Chapter 7) to policies that influence market returns to these assets. In turn, the role of one set of institutions, those that are directly linked to market outcomes, must be considered. The subject of this chapter is only part of the broader question of how and to what extent institutions influence inequality (the central role of political and social institutions was discussed in Chapter 5). Links among all factors will be considered and referred to at various points throughout this chapter.

The question of the impact of market-oriented reforms on inequality is one of the more controversial areas of debate in Latin America. The issue is often framed in black and white terms: have market-oriented (and macroeconomic) policy reforms been a curse or a cure for Latin America’s ills of slow growth and high inequality? This report takes a more nuanced view. As the structure of the third, current part of the report indicates, institutions affecting markets are only one domain of economic policy that is relevant to distribution (and growth, of course.) It is also important to look separately at different market-related institutions, and to recognize that the consequences of markets will depend on the structure of asset ownership and social and political structures.

This chapter first looks at overall evidence on the relationship between structural market-based reforms and inequality. It then briefly surveys issues in the labor market, recognizing that this area in particular warrants a much fuller treatment than there is room for here. Particular focus is placed on the relationship among macroeconomic crises, policy responses, and inequality, which is a major concern in Latin America. Both the review of evidence and new work undertaken for this report support the view that financial crises will typically be regressive, a fact that underscores the importance of strengthening policies to avert crises and developing both policies and institutions that ensure more equitable resolutions to crises when they do occur.
8.1. Markets and inequality

Over the past two decades or so, most countries in Latin America have undertaken major policy reforms that have opened their economies to greater market influence. Structural changes have included the substantial liberalization of trade and domestic financial policy, opening up of capital accounts, privatization of state-owned companies, and tax reforms that entail more uniform tax treatments and greater reliance on value-added taxes. The following section reviews these overall issues (see Chapter 7 for a more detailed treatment of the privatization of infrastructure).

The initial driver for policy reforms in Latin America was economic crisis and the imperative to restore growth. There are numerous accounts of both the reform process and its effects on growth. (For a recent example, see Loayza, Fazlynbler, and Calderón 2003 and Burki and Perry 1998.) Two important conclusions can be drawn from these analyses. First, there is consensus that many reforms were indeed undertaken. To illustrate, Figure 8.1 presents reform indices constructed by Sam Morley, then of the Economic Commission for Latin America and the Caribbean (ECLAC), that are based on earlier work by Eduardo Lora of the Inter-American Development Bank (IDB). Although such indices pose difficulties, they nonetheless provide support for the view that there has been a significant move in the direction of more liberal, market-oriented policies throughout the region.

Significant variation has occurred both across countries and reform categories. Among a few countries selected as illustrations, Chile and Uruguay were early and strong reformers on many dimensions, but Argentina and Costa Rica had caught up with them by the mid-1990s. Brazil has undertaken fewer reforms on average, while Venezuela has been a laggard. In terms of the type of reform that has taken place, a steady and large wave of reform in trade liberalization has occurred since 1987, followed by a burst of reform in the financial sector around 1990, and significant capital account opening in the 1990s. Tax reform has been slower. Privatization started at a relatively high level—since many countries did not have large public sectors—and then underwent less change, although important and high profile privatization processes did take place in some countries.

Second, there is a somewhat weaker consensus that reforms had a positive impact on growth, but that this effect was more muted than originally hoped for. Reforms helped, but didn’t lift Latin America up onto East Asian-style growth paths. A recent analysis that includes reform indices as well as other structural factors such as education and governance (2003) finds that the reform response of countries in Latin America has been in line with results based on global experience. However, achieving rapid growth requires far more than a specific set of market-oriented reforms. As Rodrik (2003, p.2) has argued in a review of growth strategies, “First-order economic principles—protection of property rights, market-based competition, appropriate incentives, sound money and so on—do not map into unique policy packages. Reformers have substantial room for creatively packaging these principles into institutional designs that are sensitive to local opportunities and constraints.” (For a general discussion on this topic, see Lindauer and Pritchett 2002.)
FIGURE 8.1.
The extent of policy reforms in Latin America, with country and policy variations

Note: The average reform index is the simple average of the index of reform in the five policy areas for each country; the regional index for a policy area is the simple average of all countries.
The achievement of growth has complex institutional underpinnings. There is aggregate evidence that the quality of institutions is a powerful determinant of sustained long-term growth, although debates continue over the relative importance and independence of “institutions” and market-oriented policies that foster greater economic integration. Some authors argue at one extreme that “institutions rule over policies,” while others believe that the role of institutions is overstated in some of the recent literature on economic growth. A fair statement might be that both perspectives matter and that there are causal interrelations in both directions.

The issue of concern here is the potential impact of market-oriented reforms on inequality, a subject about which there are diverse views. Box 8.1 outlines two opposing views, each of which is intellectually coherent. Those reform advocates who have focused on questions of inequality anticipated strong, positive effects. Others predicted disequalizing consequences. The approach of this report—which has emphasized the strong interactions between markets, institutions, and sociopolitical factors—would suggest that theory is ambiguous, and will often be context-specific. What does empirical work suggest?

**BOX 8.1.**

**Alternative views on the potential impact of market-oriented reforms and inequality**

Theoretical expectations of the relationship between reform and inequality are diverse. At the risk of putting forth a slightly caricatured perspective, two of the currents of thought prevalent in debates in Latin America (as well as elsewhere) are outlined here.

*In the blue corner.* Market-liberalizing reforms are equalizing for three central reasons:

1. **Rent reduction.** A panoply of state controls has only served to create “rents,” that is, opportunities for gains based on protected privileges that were systematically appropriated by the rich and powerful. These rents also entailed efficiency costs. Market liberalization reduces rents and opportunities for corruption, allowing people to receive income that is in line with their economic worth, not their influence.
2. **Reduction of distortions.** Trade protection, domestic regulation, and financial repression maintain a systematic bias against labor, including unskilled labor, which encourages industry over agriculture, import substitutes, and capital-intensive production choices rather than labor-intensive exports.
3. **Access to markets.** Deepening markets would have significant equalizing effects, since most often the poor are precisely the ones with the weakest market access.

*In the red corner.* Neoliberal policies are disequalizing because they dismantle systems of support and protection that nurture employment growth, provide institutional support for agriculture, and facilitate widespread social provisioning. The chill winds of international competition hurt the weak and benefit the strong. This is especially true for those companies and individuals with an initial basis for economic strength in terms of economic capital, skills, access to financial systems, and international and domestic connections, and which are therefore best positioned to benefit from market opportunities. Liberalization also reduces the power of labor, both by making capital more accessible and by withdrawing state-mandated protections for workers.
The big picture suggests that there is no simple story

Chapter 2 presented patterns of change in income inequality over the past decade and reviewed the literature on evidence from previous decades. Some patterns emerged from that analysis, with a number of countries showing mild distributional improvements in the 1970s, many experiencing a worsening in the 1980s, and a subset of South American countries showing slight worsening in the past decade. However, the dominant pattern is of resilient high inequality under a wide array of policy regimes.

Moreover, every pattern has its exception. In the past decade, Brazil and Mexico both implemented major reforms and have, respectively, experienced a small reduction in inequality and no clear trend. In the 1970s and 1980s, Chile experienced growing income inequality. Eagerness for an overarching explanation might attribute this trend to the vigorous shift toward market-oriented policies under the Pinochet regime, starting in the 1970s. However, there was a lot more going on in Chile than market liberalization. The military junta explicitly sought to reverse the redistributive measures of the previous government and destroy the power of organized labor. The variety of country experiences suggests a multiplicity of distributional stories across relatively homogenous countries.

The lack of any dramatic or obvious pattern is further illustrated by looking at the simple bivariate relationships between reform effort and changes in income inequality. In Figure 8.2, the change in the average reform index between 1980 and 1995 is compared by country, with the change in income inequality measured by the Gini coefficient at the beginning and end of the 1990s. (This is a rough form of calculation that allows for possible lags between reforms and effects. A similar lack of a bivariate relationship was found between the level of reform and the change in inequality). As indicated, no clear pattern emerges.

FIGURE 8.2.
Correlation between changes in reform and changes in income inequality

Source: Authors’ calculations based on Morley 2001 and inequality measures reported in Statistical Appendix Table A.5.
Attempts to disentangle effects suggest modest and mixed effects

With the words of caution given above, attempts to disentangle the effects of market-oriented policy reforms on the income dimension of inequality can be examined. The lack of an obvious bivariate pattern, as illustrated in Figure 8.2, may hide more complex causal effects. (As frequently emphasized, this is only one dimension of inequality that is of interest. Chapters 2, 7, and 9 discuss some important gains in the distribution of spending and access to associated services, which in many cases have helped reduce inequalities in well-being and opportunities.) Several studies on market-oriented policy reforms have been conducted, especially those associated with ECLAC (see in particular Morley 2001). Also notable are a cross-country review in Berry 1998 and a cross-country analysis on effects on wage inequality by Berhman, Gaviria, and Székely (2001). An additional important study is by Gauzua, Taylor, and Morley (1998), although it focused on the effects of reforms on poverty rather than on inequality.

These studies generally compare changes in measures of income inequality in relation to changes in policy, using reform indices such as those put forth by Lora (2001) (as illustrated in Figure 8.1) or other similar work. Cross-country analysis in particular exploits variations in the timing of different reforms to look for statistical associations with changes in inequality. Table 8.1 summarizes results from this approach, along with recent work undertaken at the World Bank (as background for this report) on a global database (see López 2003). The latter was conducted within the same overall framework as the growth study referred to above (Loayza and others 2003).

Most studies find modest negative effects on household or individual income inequality in at least some areas of policy change. However, the effects are not always statistically robust and different studies find different effects for different categories of policy reform. For example, Morley (2001) finds slightly negative effects of trade liberalization on income distribution, while Berhman, Birdsall, and Székely (2001) find positive influences of trade liberalization but negative effects of financial liberalization on wage inequality.

It appears that market-based policy reforms have been neither a curse nor a cure for income inequality, as the opposing views presented in Box 8.1 would have suggested. On balance, the evidence suggests mild disequalizing effects. Modest and complex effects could well have been lost in a sea of other variables that bring about changes in inequality, both in terms of economic assets and the broader set of sociocultural and political variables that can be forces for sustaining or changing income differences. Although general cross-country studies do not lead to firm conclusions, one category of work is more persuasive. There is an emerging consensus that economic integration is a force behind the transmission of skill-biased technical change in the labor markets of many countries. This is based on a careful analysis of labor market trends conducted through a prism of interactions between the relative supply and relative demand of different skill categories. A number of country studies and the new work conducted for last year’s World Bank report (de Ferranti and others 2003) have applied such a supply- and-demand framework. Since this approach was detailed in that report, only a brief summary of the results is provided here.


<table>
<thead>
<tr>
<th>Study</th>
<th>Trade liberalization</th>
<th>Financial liberalization</th>
<th>Capital account liberalization</th>
<th>Tax reform</th>
<th>Privatization</th>
<th>All</th>
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<tr>
<td>Morley/ECLAC</td>
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<td>0</td>
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<td>Berhman, Birdsall, and Székely</td>
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<td>López</td>
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**Note and Sources:** Morley (2001) and Berhman, Birdsall, and Székely (2001) address Latin America; López (2003) uses a global database.

It is unambiguous that many countries have experienced rising demands for workers who are educated through the tertiary level that typically outweighs increases in the relative supply of these workers. The extent of increase in this premium varies across countries, but has been particularly strong during various periods in Argentina, Chile, Colombia, and Mexico, and present but weaker in Brazil. By contrast, there has not been a significant rise in the premium placed on workers with a secondary education (primarily because the substantial expansion in the relative supply of workers with secondary schooling largely offset increases in demand).

There has been debate in the economic literature as to whether these observed changes are due to the classical effects of increased trade, in which those countries with relatively abundant unskilled labor would (in simple models) have experienced rising demand for such labor and subsequent increases in the wages of the unskilled. According to this account, the fall in relative demand for unskilled labor in Latin America would have been caused by the entry into world markets of such labor-intensive giants as Bangladesh, China, India, and Indonesia.

In fact, economic analysis identifies a different pattern of generalized biases against the unskilled and in favor of the skilled across both more and less labor-intensive industries. This provides support for the view that the dominant source of the observed changes is what economists refer to as skill-biased technical change (SBTC). It should be noted that such skill-biased changes can come from many sources, including technological advances in the layman’s sense (for example, owing to information technology), as well as changes in the occupational and sectoral composition of work organization that favor tertiary or secondary school graduates.

Although significant changes in labor market policies have not occurred, there is some evidence that some shifts have sharpened trends toward rising wage differentials, owing in particular to
declines in unionization and a more binding minimum wage (particularly in the case of Colombia). More generally, it is possible that the combination of easier access to capital and periodic crises have weakened the bargaining power of labor (see section 8.3 for more on this point).

Finally, although the classical effects of trade on wage inequality have not occurred, economic integration and liberalization—including the expansion of trade, financial liberalization, and Foreign Direct Investment (FDI) inflows—appear to have a mediating influence that has spurred technological, sectoral, and work organization changes, which have in turn led to rapid growth in the relative demand for skills.

This is probably the strongest evidence to support the view that policies that spur economic integration often lead to increases in wage inequality. This process reflects a tradeoff between growth and distribution, at least during economic transition. A growing demand for skills has been associated with processes of innovation and economic change that are central to Latin America getting on a faster growth path. Moreover, there is some evidence that such change is once-off. For example, both Chile and Mexico—the two countries that have gone furthest in terms of international economic integration—appear to have experienced a leveling off in the past few years (see discussion in de Ferranti and others 2002 and 2003). It should also be noted that increases in wage inequality have not been systematically associated with rising income inequality in terms of household-level per capita incomes, as discussed in Chapters 2 and 6.

**What can be done so that market-based reforms have more equalizing effects?**

The effects of both opening up markets and economic integration are complex, and may be once-off or temporary. However, the existence of likely disequalizing economic pressures in already highly unequal societies is an important issue. What can be done to offset such disequalizing effects? Potential policies can be organized into four categories, as follows.

(1) **Complementary measures to provide more equal assets across households and groups.** The assets that individuals, households, and groups possess have a powerful influence over their capacity to respond to new market opportunities. This is illustrated by differing returns on educational levels, but also applies to other economic assets such as land and infrastructure. Policies should facilitate a rapid expansion of educational attainment in response to increased demand for and premiums placed on skills, and support broader access to land and infrastructure (as discussed in Chapter 7).

(2) **Sequencing of policy changes.** Economic development involves a process of creating and destroying jobs, firms, and economic activities. Part of the dynamic that empirical trends indicate is a more rapid destruction than creation of activities for the unskilled. Some countries have managed to create new productive activities while simultaneously shielding old, less productive ones. This is perhaps most dramatically illustrated in the case of China, where dynamic nonstate activities (for example, town and village enterprises) and private firms expanded significantly in the 1980s and 1990s, whilst large numbers of unproductive jobs in state firms were preserved.

This was also the case in Japan during its high-growth era. Internationally competitive export industries grew while inefficient domestic sectors (for example, agriculture and construction)
were preserved through explicit public policies (which were in turn facilitated by political pressures and underpinned by substantial electoral malapportionment). However, the Japan example also illustrates the risk of such an approach: it is difficult to stop protecting inefficient sectors. In the 1980s, when the Japanese economy looked strong, observers declared victory for the Japanese model of capitalism (that is, a system with strong state intervention via industrial policy with strategic foresight). However, once the Japanese economy began to perform poorly in the 1990s, the weight of opinion shifted to favor the U.S. model, in which the market presumably operates to clear inefficiency out of the system in at least some areas. The U.S. agricultural sector is an important counterexample that again illustrates the political difficulties of ending protection of a politically influential sector.

Policy change is an important area that is influenced by both economic design and political economy. However, this report has neither conducted original work on this issue, nor found a clear synthesis from existing work. Nonetheless, it can be suggested that these factors may be quite significant in some cases. For example, opening up an economy at a high and fixed exchange rate (with significant declines in the price of capital in Argentina being one result) may have contributed to large job losses among relatively unskilled workers. Sorting out these issues will clearly require much more careful work in the future.

(3) Measures to provide safety nets or “ropes.” The process of job destruction can lead to temporary or permanent income losses, with adverse effects on various aspects of both social and psychological well-being. A central part of a well-functioning market economy is the provision of safety nets to catch those who are hurt, or of safety “ropes” to help limit their fall. To the extent that these exist in Latin America, they have tended to be unequal in scope; options for reform are discussed in Chapter 9.

(4) Deeper markets and a more equal investment environment. Markets are by no means uniform with regard to both their reach and effects. An important part of the objective of achieving more equal effects through market-oriented policy reform involves the deepening of markets to provide more equal opportunities for all potential market participants. Doing so will require increased attention to the economic, political, and sociocultural factors that contribute to the unequal effects of markets.

It should be remembered that the investment environment is central to the dynamics of economic change and job growth (Stern, forthcoming). The determinants of an investment environment are complex, including market opportunities, access to inputs, infrastructural quality, the extent to which transactions are associated with corruption, and the role of government agents in facilitating or obstructing the wide variety of measures needed for investment and production by firms.

Important for the present focus is the fact that, although the investment “environment” connotes a public good, in most cases conditions stray significantly from that quality. A public good implies that its benefits would be the same for everyone and the actions of some agents would not affect the position of others. In most Latin America societies, it is more realistic to talk of a series of investment environments for different groups of firms, which are influenced by market structure, property rights, a firm’s characteristics, political influence, and social connectivity (as
discussed in Chapter 5). In other words, investment environments are embedded in unequal sociocultural and political structures.\(^5\)

It will be necessary to pay more attention to factors that influence both inequalities in the investment environment and market access and inequalities among individuals and households. Doing so will require careful empirical analysis that combines economic and social science approaches. A recent analysis by Hellman and Kaufmann (2003) on the relationship between “inequalities of influence” in the business sector and the quality of the institutional environment is suggestive of the importance of these issues. This issue is also closely related to one of the general themes of this report: that there is a circular relationship between weak institutions and inequalities of power, wealth, and position.

Hellman and Kaufmann (2003) construct an index of “crony bias,” which is “perceived by the firm as the difference between the firm’s characterization of the influence of individuals or firms with close, personal ties to political leaders and the influence of its own business or trade association on recently enacted laws, rules, and regulations affecting their business” (Hellman and Kaufmann 2003, p.9). In extreme cases, state capture, or the use of illegal means by private groups to obtain favorable government policies, result. This phenomenon has been well documented in the case of Russia and other successor states of the former Soviet Union, but there is also evidence from global analyses and recent business surveys that attests to at least the perception of its importance in many other places. (See Kaufmann, Kraay, and Mastruzzi 2003 for a summary of the results of surveys.)

A global survey finds an inverted U-shaped relationship between the crony bias index and an index of voice and democratic accountability, as indicated in Figure 8.3 and using data from the World Bank governance database. The highest level of crony bias occurs in societies with intermediate levels of democratization, which is typical of most of Latin America. Apart from providing advantageous influence to the large and powerful, crony bias is also associated with weakness in public institutions, as discussed in Chapter 5. In societies with high levels of crony bias, firms trust and use the courts less, pay fewer taxes, and have less secure property rights; bribery is also more prevalent. Figure 8.4 illustrates this problem in terms of the question of tax payments. Hellman and Kaufmann (2003) suggest that these patterns can lead to a self-reinforcing dynamic, with lower support for public institutions perpetuating the weakness of institutions and, in turn, a greater likelihood of capture by more influential groups.

As always, one should be cautious about overinterpreting cross-country results, and new in-depth work will be needed to explore these mechanisms further. However, it is worth noting that the themes considered here are consistent with a current focus in the political economy literature: the new distributional coalitions that emerged post-liberalization and could take advantage of new means of securing better deals. (See Schamis 2002 for a discussion on this point in the context of privatization).

**FIGURE 8.3.**
Crony bias versus democratic voice and accountability
A complementary issue concerns the role of business associations, especially those that represent small and medium firms. As noted above, the crony bias index is itself largely a product of the perceptions of these groups. Related cross-country work finds a positive relationship between the importance and activity of such associations and measures of institutional performance. This is...
consistent with case study evidence of the potential role of such associations in transitions away from clientelist and patronage-based relationships between government and business. There is literature on this issue from developed countries, and Angell, Lowdon, and Thorp (2001) document related patterns in their comparative analysis of experiences in different medium-sized Colombian cities.

The policy agenda related to crony bias involves building the institutional basis for increased transparency, less corruption, better corporate governance, and more effective regulation. This is likely to involve alliances between new forms of governance (as discussed in Chapter 5) and business associations, especially those that represent small and medium firms.

Although reducing unequal influence at the “top” and strengthening the effectiveness of institutions will provide general support for more equal treatment across firms, there are also special issues related to the informal sector to consider. Participants are highly heterogeneous, including the self-employed, micro and small firms, and medium and large firms with informal practices (especially with regard to employment). Extensive literature on conditions and policy exists, and two key points can be made in this context. First, there is an agenda of proactive measures to improve the business and investment environment for small and medium firms that is rooted in some of the fundamental questions of market failure and weak influence that were discussed in Chapter 1. This agenda is likely to involve a range of areas of action, including reducing excess regulation, strengthening property rights, providing infrastructure, streamlining bureaucracy, and deepening financial markets (see de Soto 1989 and 2000 and Tendler 2002, among others). Second, this agenda is not institution-free, but is very much about the forms of political and social interaction that exist in the broader societal context. As one example, the spectacular success of the “Third Italy” small-scale sector was not a product of government favors, but of vibrant associational activity that provided specific services to firms in order to facilitate the processes of formalization and recognition of workers rights (see Box 8.2).

**BOX 8.2.**

The evolution of small-scale firms in the “Third Italy”

The expansion of the small firm sector in central and northeastern Italy is one of the great economic successes in the second half of the 20th century. This change contributed to the absolute and relative economic and social transformation of the region. Modena, for example, went from being a high unemployment region in the early 1950s, ranking 40th amongst Italy’s 95 provinces in terms of per capita income, to the top of the list in 1980 and one of the wealthiest areas in Europe.

Part of this story provides lessons on the dynamics of small firms in developing countries today. As Criscuolo (2002) discusses in a case study of firms in Bologna and Modena, dynamic growth emerged neither in the form of special government favors nor generalized burden-relieving or deregulation. In the developing country context, Tendler (2002) has argued that such approaches risk confining the small firm sector to social policy, and rendering it vulnerable to the exchange of favors or relief for political support.

Two elements of Criscuolo’s (2002) diagnosis are worth highlighting here. First, central to the dynamics of the sector and its interactions with the state was vigorous associational activity. The Confederazione Nazionale dell’Artigianato (National Confederation of Artisans, or CNA) emerged from anti-fascist resistance in the 1930s and 1940s, and had close connections with the communist movement. It became the key actor for the small scale sector in terms of interactions with governments on policy and supporting small firms in effecting change in organization and practices.
Second, the type of policies and practices adopted strongly favored what would now be termed formalization. Ideologically committed to worker rights, and pragmatically committed to productivity growth, the CNA was an important advocate for good working conditions and efficient organization. The major type of instrument it used was what Criscuolo terms “development burden-relieving,” or the provision of a range of both administrative services (around accounting, payroll management, and fiscal counseling) and production-targeted support (around producers’ consortia, industrial sites, and innovation centers). These activities helped small firms both comply with the formal regulations that the CNA advocated and sustain high levels of productivity growth.

A remarkably dynamic small scale sector emerged as a product of mobilization and the central role of deliberate, proactive, and persistent support of association. This helped artisan firms pursue the “high road” to small business development. While institutional context is intrinsically specific to geography and history, there are potentially valuable lessons to be learned for deepening markets in Latin America.

Source: Criscuolo 2002.

8.2. Labor market policies and inequality

Can well-designed labor policy and institutions lead to greater equality without the occurrence of major losses in efficiency? As with overall structural policies, there are sharply divided opinions on this question. One school of thought argues that inflexibilities in the labor market and high levels of protection and privilege for formal workers are sources of higher inequality between “insiders” and “outsiders” with respect to formal labor policies and institutions, as well as sources of lower growth in “good” jobs. Another school of thought argues that state polices on labor are essential to ensure decent working conditions, reduce the risk of exploitation of the vulnerable, and provide reasonable levels of income security against job loss, sickness, and old age. Sorting through these issues is a major (and important) undertaking (see World Bank 1995 for an overall discussion). The design of labor policy is complex, and the literature on the issue is expansive. Specifics need to be carefully worked out in particular contexts. As with many issues covered in this report, the current discussion is restricted to a few general policy themes.

Current labor policy and institutions are an unholy compromise in much of Latin America. To the extent that they make a difference to labor market outcomes, this assessment holds true in the context of partial coverage. In some cases, such coverage is associated with differential privileges, which impose implicit costs on outsiders; social security provisions in many countries are an important example. There are also areas in which labor institutions lead to inflexible and inequitable outcomes.

Teachers unions are an example of a labor institution that has often (though not, of course, always) been an impediment to reforms that would lead to higher quality and more equitable schooling, which is an area of fundamental importance to the expansion of more equal capabilities. (Such cases reflect “opportunity hoarding,” in the language of sociologists.) More generally, while unions often have helped improve the working conditions of their members, this rarely leads to greater equality. Estimated effects are usually negligible. In the case of Brazil, unions seem to lead to greater inequality of wages. This is because, in contrast to Organization of Economic Cooperation and Development (OECD) countries, unionized workers tend to be in the more skilled and better-paid part of the overall wage distribution.
The other side of this situation is that large segments of the workforce are not covered by union action, protected in terms of health standards, discrimination, or abuse, or provided with even basic forms of income security. Many Latin American countries are reasonably flexible in overall labor market adjustments (though there are important differences between, for example, relatively flexible Mexico and Argentina), but flexibility is the flip side of having large informal sectors that are weakly covered by formal working conditions. Minimum wages generally have modest and mildly equalizing effect on the structure of wages, but this is offset by reductions in employment, especially for young, low-skilled, and female workers (World Bank 2004). Where significantly binding, as in Colombia, minimum wages probably contribute to lower levels of formal employment.

Large informal sectors are symptomatic of both weak formal employment growth and a high ratio of the costs to the benefits of formalization, whether for employers or workers. However, this does not imply that workers in the informal sector are necessarily worse off, or that they are queuing up for better work in the formal sector. The key word is heterogeneity. Many informal sector participants are self-employed entrepreneurs who are in that sector out of choice because of higher returns or preferred working conditions. (See Maloney 2003 for a survey of issues related to informal sector employment.) In some cases, households may adopt diversified employment strategies, with one worker maintaining a formal job in order to secure social security and health benefits and others pursuing informal activities.

However, informal work can also be more susceptible to socially based inequalities. As Heller and Mahoney (2003) argue, because the informal sector is largely outside the reach of the state and transactions within it are largely extra-legal, success is often dependent on networks and on noninstitutionalized mechanisms of reducing transaction costs. In other words, “Access to capital, control of space and markets, enforcement of transactions, and maintaining buyer and seller networks thus all involve controlling access to a resource or a network by erecting strong boundaries of ethnicity, gender, community, and race. Criminal networks, with their deeply reified blood ties, rituals of membership, and high existence costs are only the extreme case” (Heller and Mahoney 2003, p.41).

A number of directions that could be taken to achieve a more equitable labor policy are put forth here, in the spirit of seeking to both extend worker rights to all and increase the flexibility in those sectors of the labor market that are relatively protected. These policies can generally be framed in terms of increasing incentives for formalization by both reducing costs and increasing benefits.

First, policies that support the informal sector are needed (as noted in the preceding section). In particular, Latin American countries should seek innovative ways to increase the productivity of firms in this sector and facilitate their participation in formal institutions. The informal sector should not be viewed exclusively as a pool of workers left out of formal employment due to excessive regulations, but rather as a group of entrepreneurs, and their employees, that need support and amenable policies in order to grow and succeed. Such policies include the reduction of transaction costs, the availability of credit and formal mechanisms through which to operate, and, most importantly, labor laws that permit firms to adapt to changing economic conditions.
Second, labor market laws and minimum wage-setting procedures should be assessed carefully in each country. Dual objectives should be to remove excessive rigidity and to reduce the impact of minimum wages on unemployment. More specifically, removing excessive rigidity means giving employers and employees alike efficient mechanisms with which to adapt to the business cycle, which would then be reflected in higher formal employment rates in the long run. Regarding minimum wages, it is important to ensure that the mechanism used to set them be based not only on purchasing power, but also on considerations related to productivity and employment.

If managed effectively, these policies can be consistent with greater support for workers. This can be done through both reduced informality and the spinoff effects of a generally more supportive approach to labor in terms of institutional functioning. Figure 8.5 illustrates the tradeoff between more rigid protection and informality. However, note that Costa Rica has both more rigidity (as proxied by an index of the costs of firing workers) and lower levels of informality than does the Dominican Republic. In an in-depth comparison of the labor markets in these two countries, Itzigsohn (2000) argues that this pattern is the product of an overall strategy in Costa Rica that was more supportive of worker rights and working conditions than efforts in the Dominican Republic. The effects of this approach were therefore as much a result of the impact on the functioning of institutions as of the details of policies.

**FIGURE 8.5.**

**Labor market rigidity and informality**

![Graph showing labor market rigidity and informality](image)


Third, reforms in the area of social security should continue to be made with the intention of achieving a more equitable form of risk management for all workers and households (see Chapter 9).

Fourth, unions have a central role to play in both the workplace and society, but the context in which they function influences the distributional effects of their activities. Where unions have
become means for protecting privileges that impose costs on others—especially those who are less fortunate—then more flexibility will be of greater value. There is a contrast between those union movements that were effectively incorporated into vertical state structures (Mexico, for example) and those with stronger horizontal affiliations (as in Brazil). The latter will be more likely to act in the interests of broader groups of poor workers and households. (This is not, however, to say that they will not still seek to vigorously defend the interests of their members.)

Finally, there is no inherent inconsistency between unions, state regulation, and integration into the global economy via a high productivity route. This is illustrated by a case study of union involvement in export-oriented, high-value crops in northeastern Brazil (Box 8.3). Unions have been an important element of a shift toward a path to integration that has benefited both workers and firms, primarily at a local level in a specific industry. Cases in which productivity has increased cooperation at a national level are probably harder to find in Latin America, in contrast, for example, to the role of the Swedish union movement in that country’s development (de Ferranti and others 2002).

### BOX 8.3.
**Unions, firms, and the expansion of high-value export crops in Petrolina-Juazeiro in northeastern Brazil**

A study on the evolution of worker-firm relationships in the high-value export crop sector in Petrolina-Juazeiro underscores the potential positive role of unions in increasing both productivity and the well-being of workers. In a seemingly unpromising environment of landless agricultural laborers, union activity was an important ingredient in the shift to work practices that both offer better working conditions and achieve high productivity—as well as, importantly, high quality—in a successful area of export agriculture. This outcome was facilitated by a combination of market conditions and the strategy and history of institutional actors. The critical importance of timing for quality in the agricultural process (for example in harvesting grapes) gave the workers potential leverage. The rural union had to significantly change its strategy from focusing on its traditional base among small farmers in order to represent the interest of landless workers. In addition, the farm owners were primarily large-scale firms from southeastern Brazil with experience in collective bargaining, in contrast to the more traditional large-scale sugar farmers of the Northeast,— who were accustomed to more repressive and conflictive labor relations. *Source:* Damiani 2003.

### 8.3. Inequality and macroeconomic crises

Macroeconomic instability has been the bane of long-term economic performance in Latin America. Periodic crises have been sources of pervasive and deep social scars. In recent decades, the 1980s debt crisis brought to a halt an extended period of growth in much of the region, albeit growth that occurred on highly unequal terms. By the beginning of the 1990s, most countries appeared to have gained a sounder macroeconomic policy footing, and market-based debt reductions had helped reduce the debt overhang. Yet crises continued to hit the region in the subsequent decade. The 1994–1995 Mexican and the 2001–2003 Argentine crises will be remembered as much as the steady gains in health and education that occurred throughout the region during this time.
The causes of crises—as well as of optimal macroeconomic, financial, and debt management policies to prevent and manage crises—is an immense area of study. The literature and debates are not summarized here, but instead crises are examined through the prism of the concerns and approaches contained in this report. Are there any causal links between weak and unequal institutions and crises? What are the distributional consequences of crises? Does the perspective of this report cast light on feasible policy options that are better for reducing inequality and managing crises? Each of these questions is considered in turn.

What causes macroeconomic crises? Proximate and deep factors

Earlier parts of this report explored how weak and unequal institutions can be self-sustaining with regard to long-term development processes and underlying policy choices. Some institutional weaknesses may actually be functional for the powerful. Can weak and unequal institutions also be a source of macroeconomic instability and the unequal resolution of crises?

The usual suspects for crisis causation have traditionally been faulty macro-level policies, especially those associated with excessive public spending, overvalued exchange rates, and loose monetary management. There are well-documented links between such factors and volatility, high inflation, and currency and banking crises. These have correctly received significant attention—not least of all by international financial institutions—with the objective of achieving better macroeconomic policies to prevent crises. In the wake of the 1980s debt crisis, realistic exchange rates and prudent fiscal and sound monetary policies were central to the policy platforms being advocated for, and eventually adopted by, countries in Latin America. There were important gains that have, in particular, been associated with large reductions in inflation. Most studies find that lower inflation tends to have positive effects on income distribution.

Substantial gains in these policy areas seem to have ushered in a period of stability. However, this changed with the 1994–1995 Mexican crisis, the ripple effects of the East Asian and Russian crises in 1997 and 1998, and macroeconomic difficulties in countries such as Argentina, Bolivia, and Venezuela starting in 2000. All problems had clearly not been solved. In the economics field, these and other crises (including those that occurred in Europe during the 1990s) helped spawn a range of new thinking. Recent perspectives have emphasized asymmetric information problems in financial markets, the possibility of multiple equilibria with high and low external capital flows, currency balance sheet mismatches in government and the corporate and financial sectors, and weak financial sector regulation and performance.7

Even when fiscal and monetary policies are reasonably sound (as they were in much of East Asia before crisis ensued), surges in capital inflows reinforced by premature or poorly designed capital account liberalization, as well as weak prudential regulation and supervision, have led to the excessive accumulation of short-term external debt and credit booms. This pattern rapidly reversed when the booms ended, and led to sharp domestic asset price declines and large currency devaluations. These problems in turn resulted in widespread corporate bankruptcy and deep recessions.

One theme of relevance to this report can be emphasized here. As in many areas discussed in other chapters, economic processes interact with institutional conditions. Weak institutions (which are related to inequality in ways discussed in Chapters 4 and 5) may have a causal
influence on the occurrence of crises. There is a suggestive association between weak institutions and macroeconomic volatility, as illustrated by the bivariate relationship between a measure of the extent to which the executive is constrained by national institutions and the standard deviation of growth in Gross Domestic Product (GDP) (Figure 8.6). This association, however, says nothing about causation, but some studies do provide an empirical basis for the influence of some causal processes on the relationship.

**FIGURE 8.6.**
The association between macroeconomic volatility and measures of institutional conditions (index of constraints on the executive index and the standard deviation of GDP growth)

![Graph showing the association between macroeconomic volatility and institutional conditions.](image)

*Correlation coefficient: −0.3638*

*Source:* Authors’ calculations, using World Bank statistics and the Polity IV database for constraints on the executive index.

An example of empirical work on crises is a recent study by Acemoglu, Johnson, and Robinson (2002) that explores the relationships among macroeconomic policies, institutions, and macroeconomic volatility. It argues that the strength of institutions is a principal long-term causal force behind volatility, which can be manifested through macroeconomic policies or other factors (Box 8.4).

This analysis is useful, but does not explore the specific mechanisms of crises. Two are likely to be of importance and to lie at the intersection of concerns over inequality: management of distributional conflict and the relationship between unequal influence and the functioning of the financial system.
Recent work by Acemoglu, Johnson, and Robinson (2002) explores the relationships among institutions, macroeconomic policy choices, and economic volatility. Countries that have had faulty macroeconomic policies (such as excessively expansionary fiscal policy, loose monetary policy, and overvalued exchange rates) have also experienced higher macroeconomic volatility, as well as lower growth, in the past few decades. The question is whether the end of the story is that governments make the “mistake” of choosing bad policies that then cause volatility.

An alternative view is that both the choice of policy and economic volatility reflect underlying institutional weaknesses. By institutions, the authors are concerned with a “cluster of social arrangements that include constitutional and social limits on politicians’ and elites’ power, the rule of law, provisions for mediating social cleavages, strong property rights enforcement, a minimum of equal opportunity, and broad-based access to education, etc.” (Also see the discussion in Chapter 5.) The key argument in this regard is that institutional weaknesses will tend to lower investment and increase volatility and policies, for example through the inability to manage distributional struggles.

Cross-country evidence in support of this argument is provided by exploring the empirical relationship between macroeconomic policies—an indicator of institutional strength using an index of constraints on the executive from the Polity IV database—and measures of economic volatility, including the standard deviation of growth and largest declines in output. The empirical challenge is that both macroeconomic policies and institutions are likely to be endogenous, or to reflect the influence of omitted variables. To deal with this, the authors use an identification strategy based on the substantive view that extractive institutions formed in colonial periods can have a persistent negative influence on contemporary institutional conditions (see Chapter 4.) Such extractive institutions are more likely to evolve in situations where there is relatively modest settlement, which allows for the use of an index of settler mortality during the colonial period. This measure of the hospitability of the environment is correlated with recent institutional measures, but there is no reason why it should have any direct influence on current macroeconomic policies.

When the analysis of influences on volatility is undertaken using settler mortality as an instrument to identify the exogenous, historically determined component of recent institutional conditions, the relationship between macroeconomic policies and volatility largely disappears, while measures of institutional strength remain robustly significant. This trend applies both when macroeconomic policies are treated as exogenous (which would generally bias the results to favor the influence of such policies, if these variables are actually endogenous), or if lagged values of macroeconomic policies are used as instruments. There is weak support for the role of exchange rate overvaluation, but not for the role of inflation or measures of public spending and deficits. The authors suggest that where underlying institutional weaknesses exist, they can spill over into crises in various ways, sometimes through macroeconomic policy mechanisms and sometimes via microeconomic routes. This is further illustrated by case study analyses of Argentina and Ghana.

Source: Acemoglu, Johnson, and Robinson 2002.


With respect to the management of distributional conflict, there is a tradition of work that focuses on how fights between groups can have potent influences on the conduct of macroeconomic policy. (See Bates 1981 for a seminal piece on this subject.) The interaction
between distributional struggle and institutional weakness is illustrated in cross-country work by Rodrik (1999). That analysis seeks to explain the varying impacts of the shocks of the 1970s on growth in terms of the interaction between latent social conflict or distributional struggles on the one hand, and institutions for conflict management on the other. The study looks in particular at differences in growth during 1960–1975 and 1975–1989, periods when most of Latin America suffered a significant decline in economic growth while East Asia actually experienced accelerated growth; this difference occurred despite the fact that both regions experienced shocks.

Countries that experienced the largest declines in growth were not necessarily those that suffered the greatest shocks, but rather those with a combination of more divided societies (as measured by indices of inequality or social difference between groups) and weak institutions for conflict management (as proxied by indicators of the quality of governmental institutions, the rule of law, democratic rights, and social safety nets). In Rodrik’s (1999) analysis, more conventional influences on economic vulnerability—including economic openness, the share of government consumption, and levels of indebtedness—become insignificant predictors of growth collapse once the measures of latent conflict and institutions for conflict management are introduced. The discussions in this report (especially in Chapters 4 and 5) support the view that Latin America is generally a region of high social cleavage and weak institutions, including weak constraints on the power of elites, when compared with East Asian and OECD countries.  

Completing this type of story would require careful case study research. A vivid contemporary example is Venezuela, where social-political conflict and the associated stoppage by the oil industry directly led to approximately a 26 percent drop in GDP from March 2002 to March 2003. Less dramatic episodes also occurred earlier, with the government’s ability to engineer “social pacts” increasingly exhausted from the mid-1980s on, a trend that in turn limited society’s ability to resolve distributional conflict through semicorporatist settlements. This is an interesting example precisely because Venezuelan democracy was founded on the basis of an explicit pact between the government and the elites, as well as on the deliberate use of distributional—but not redistributional—public policies stemming from the abundant public resources generated by oil revenues. This scheme worked for a while: Venezuela succeeded in maintaining remarkable macroeconomic stability and quite respectable levels of growth during the 1960s and 1970s.

The second area in which institutional weaknesses may be associated with crises is the links between unequal influence of the corporate sector and the functioning of the financial system. As noted in section 8.1, “crony bias” is associated with a range of weaknesses in institutions. To the extent that this phenomenon weakens the lending practices and prudential behavior of the financial sector, it can have a pernicious influence both on crisis causation (via excessive credit expansion) and crisis dynamics (through poor portfolios). This is of particular importance to interpretations of some of the more recent crises that were not based on fiscal laxity.

The studies referred to here are by no means the last word in empirical investigation of interactions among macro-level policies, institutions, and volatility with regard to both cross-country analysis and, perhaps more importantly, in-depth case studies. As noted earlier, an extensive economics literature on the sources of crisis already exists. Questions related to institutional weakness and links to inequality intersect with only some of the mechanisms
discussed in that literature. Macro-level policy choices of course have an effect at least in the short- to medium-term, and the functioning of the financial system will be central to whether crises occur and how severe they are. The mechanisms whereby institutional weaknesses interact with distributional struggles to form a source of volatility require considerably more exploration. Nonetheless, there is a need to bring these issues back to the center of an analysis of crises.

The distributional consequences of macroeconomic crises

Macroeconomic crises affect society in multiple ways. Four economic channels of influence are emphasized in most research: the impact of reduced demand on jobs, wages, and enterprise income; changes in prices; public spending cutbacks; and changes in the value of assets.\(^9\) As households and communities respond to these effects, secondary effects can be felt in terms of household decisions on schooling or health, the increased work of women and other secondary workers, depletion of financial assets, and reliance on social networks for support.

Many observers also emphasize the costs of macroeconomic crises to the social fabric, as individuals are forced into illegal activities or as young men and women adapt to adverse opportunities by shifting into cultures of drugs, violence, or prostitution rather than skills acquisition and productive work. Adverse effects can be persistent (a phenomenon known as “hysteresis” in the jargon of economists), for example through losses in organizational, human, or social capital that can take considerable time to rebuild. As one example, it is striking that personal violence in Latin America increased in the 1980s and then did not go down even when economies recovered in the 1990s. (For more on this subject, see Fajnzylber, Lederman, and Loayza 2000).

This section looks at three categories of evidence related to the effects of macroeconomic crises. First, the results of studies on income distribution, as measured by household surveys and via spending, are summarized. Second, information on the distribution between labor and capital is discussed. Third, distributional aspects of the resolution of crises through financial sector channels are considered. While these two latter sources are relatively new and represent early research efforts, they have a particular bearing on the issues discussed throughout this report.

Effects on income distribution

Are the costs of crises unequally distributed? It is often asserted that the poor suffer most when a crisis hits. Past work actually reveals a mixed picture in this regard. With respect to influences on incomes, evidence from household surveys typically finds losses across all strata that are partially disequalizing in some cases but not in others. For example, Lustig (2000), in reviewing 20 Latin American crises, found small increases in the Gini coefficient in 15 cases that compared post- with pre-crisis periods, but small declines in others. De Janvry and Sadoulet (2000) reviewed 48 instances in 12 countries in Latin America between 1970 and 1994 and found asymmetric effects between recessions that tended to increase income inequality and periods of positive growth, which in effect led to a ratcheting up of inequality over this period.

Morley (2001) found that during the 1980s, recessions typically led to increases in inequality, while recoveries were associated with lower inequality. However, Morley also found no clear pattern of response to macroeconomic crises during the 1990s. On the basis of worldwide
evidence, Ravallion and Chen (1997) found no overall pattern of change in the income distribution during episodes of macroeconomic decline in most regions, with increases and declines occurring in roughly equal proportion. The major exception in the 1990s was the successor states of the former Soviet Union, which experienced significant increases in inequality during episodes of large-scale income decline. (These were clearly associated with the large-scale institutional changes taking place during the transition from socialism (World Bank 2000d).

Although there is some evidence that recession increases inequality, some of the time, most of these results suggest that there is no general pattern of the influence of adverse shocks on income distribution (or at least not on that part of the distribution captured by surveys; see below). This is further borne out by case study evidence, for example with regard to the contrast between Mexico and Argentina in recent years. With respect to the Mexican Tequila crisis, López-Acevedo and Salinas (2000) found relatively high losses in the top decile of the income distribution, for which the share of total income declined from 42.3 percent in 1994 to 40.7 percent in 1996. This was the main force behind the fall in the Gini coefficient from 0.534 to 0.519 during this period. Table 8.2 shows the pattern of income decline that occurred between 1994 and 1996.

Why did richer groups in Mexico lose out in the crisis? It might have been expected that the rich would be particularly hard hit by losses in financial income in the wake of the asset price declines associated with the currency and financial crisis. In fact, the opposite appears to have occurred, at least on average. The decline in the share of the rich was instead driven by sharp declines in labor earnings in the financial and other high-paying service sectors. By contrast, the contribution of financial income to total income increased (Table 8.3), with growth in real financial income per capita at the top of the distribution rising from 6 percent for the top decile to 14 percent for the top 1 percent of the income distribution.

Evidence on financial income from household surveys is generally weak, covering only a fraction of total financial trends in a country. Although these results should be treated with caution given the usually weak coverage of capital income, the apparent capacity of the rich to increase their financial income during the crisis is striking.\(^{10}\) It is possible that this occurred because of earnings on money that was successfully shifted out of the country just before the crisis, and that consequently experienced capital gains when the exchange rate collapsed. This is only a partial picture, and large asset price movements occurred that imposed capital losses on those holding Mexican assets, especially assets that were denominated in pesos. (The role of the financial sector in redistribution is discussed further below.)

<table>
<thead>
<tr>
<th>TABLE 8.2.</th>
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<tbody>
<tr>
<td>Changes in real per capita income across the income distribution in Mexico, 1992–2000</td>
</tr>
<tr>
<td></td>
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<tr>
<td>1</td>
</tr>
</tbody>
</table>
CHAPTER 8: POLICIES ON MARKETS AND INSTITUTIONS

The finding that labor earnings became slightly more equal during Mexico’s crisis is consistent with findings by Sánchez-Páramo and Schady (2002) in a study of six major Latin American countries, which indicated that the premium placed on tertiary education tends to fall during crises. This premise is also consistent with an international analysis of influences on income distribution by López (2003) that finds banking crises to have equalizing effects on measured income after controlling for a range of other factors. Again, for most countries, measured household income is dominated by labor income, and capital income is severely underreported.

In Argentina, the recent crisis has so far led to a substantial worsening in inequality, with an increase in the Gini coefficient from 0.49 in 1999 to 0.55 in 2002. (In contrast to Mexico, reported financial income in Argentina is so small as to be implausible and is therefore not analyzed.\(^\text{11}\)) As a result, the ratio of income between the top and bottom deciles rose from 15 times in 1999 to 28 times in 2002 (compared to 11 times in 1990). The differences between the

<table>
<thead>
<tr>
<th>Deciles</th>
<th>Mean financial income per capita (in 2000 pesos)</th>
<th>Share of financial income in total income (percent)</th>
<th>Real increase in financial income per capita (percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>20.5</td>
<td>16.9</td>
<td>1.8</td>
</tr>
<tr>
<td>2</td>
<td>26.3</td>
<td>26.1</td>
<td>1.6</td>
</tr>
<tr>
<td>3</td>
<td>56.8</td>
<td>33.5</td>
<td>2.7</td>
</tr>
<tr>
<td>4</td>
<td>47.1</td>
<td>38.8</td>
<td>1.9</td>
</tr>
<tr>
<td>5</td>
<td>65.3</td>
<td>67.5</td>
<td>2.1</td>
</tr>
<tr>
<td>6</td>
<td>107.4</td>
<td>90.4</td>
<td>2.9</td>
</tr>
<tr>
<td>7</td>
<td>141.0</td>
<td>134.9</td>
<td>3.2</td>
</tr>
<tr>
<td>8</td>
<td>161.8</td>
<td>147.2</td>
<td>2.8</td>
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<tr>
<td>9</td>
<td>257.3</td>
<td>264.7</td>
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</tr>
<tr>
<td>10</td>
<td>1,444.1</td>
<td>1,535.0</td>
<td>7.1</td>
</tr>
<tr>
<td>Top 5%</td>
<td>2,524.1</td>
<td>2,833.4</td>
<td>8.8</td>
</tr>
<tr>
<td>Top 1%</td>
<td>7,416.5</td>
<td>8,448.1</td>
<td>13.1</td>
</tr>
</tbody>
</table>

Source: Authors’ calculations based on Mexican household income and expenditure surveys.

TABLE 8.3.
Increases in financial income during the 1994–1996 crisis in Mexico
two cases are undoubtedly complex, but one of the more striking contrasts lies in labor market adjustment.

Mexico has long had a pattern of adjustment at the bottom of the labor market in which firms and workers adjust through lower real wages—whether based on shifts into lower-paying work (for example, in the informal sector) or declines in real wages that are facilitated by inflation. During the Tequila crisis, unemployment spiked, but then declined rapidly to the 3 percent range a couple of years later. At the top of the labor earnings distribution, by contrast, the pre-crisis period had seen large increases. This was especially true in leading sectors such as high-paying services and finance, which were hit hard by crisis.

In contrast, Argentina shifted to a high unemployment labor market even during the relatively good times of the 1990s. This change was influenced by high layoffs due to restructuring, the relatively low relative price flexibility associated with a fixed exchange rate and low inflation, and, possibly, the influence of labor market policies. The Argentine crisis further increased unemployment, which rose to 21.5 percent in May 2002 before declining to 17.8 percent in October of that year. The spike in inflation after the exchange rate devaluation was a source of large real wage declines and a sharp rise in poverty.

A comparison of Argentina and Mexico suggests a general lesson: the way in which crises affect household distribution is conditional on the structure of the labor market, the sectoral incidence of adverse shocks, and the way that the labor market adjusts.

The above discussion refers to the evolution of income differences as measured in household surveys, which capture three channels of influence: labor market changes, relative prices, and returns to nonhuman capital assets. Although no overall pattern of distribution effects is evident, it is important to emphasize that impacts on poverty are unambiguously adverse, since declines in income push some nonpoor people into poverty and deepen the poverty of those who are already poor before a crisis. Even an equiproportionate decline in incomes across the income distribution is likely to hurt those at the bottom most; a 10 percent decline in income for those in poverty is more costly in terms of well-being than it is for those in the middle or upper parts of the distribution.

This result applies with even greater force to households living in extreme poverty, which generally have insufficient resources with which to purchase adequate food or pay for medical expenses, especially during deep or protracted recessions. (See de Ferranti and others, 2000). In addition, particular individuals and households can experience much larger drops in income, a phenomenon that is hidden in data based on averages. Large income declines for individuals and households are concerns that are distinct from chronic poverty on both welfare and political grounds. (See Pritchett 2001 for an analysis of Indonesia.) This fact has implications for the design of safety net instruments, as discussed in Chapter 9.

The other main channel that has been studied in past research concerns the distribution of public spending and the consequential distribution of services and transfers. Two general processes are important in this regard. First, in the aggregate, public spending in most Latin American countries tends to be procyclical, expanding in good times and contracting in bad (see Chapter 9). This trend is driven by political pressures to increase spending when the going is good, the
strongly procyclical nature of private market sentiments, and the proclivity for “sudden stops” in market flows when the going is bad (see de Ferranti and others 2000 and Calvo and Reinhart 2000 for more on this point). Sharp reversals in capital flows are also associated with the lack of credibility given to countercyclical fiscal policies because of asymmetric information problems: it is difficult for markets to distinguish between a prudent countercyclical fiscal policy and fiscal laxity, especially when governments have not proven able to produce surpluses in good times.

This trend in turn affects the capacity to finance deficits and increases the burden of debt service because of exchange rate depreciations for foreign and domestic dollar-denominated debt and rising risk premia. During the economic slowdown of the late 1990s, two exceptions to this rule were Chile, which had developed both the credibility and the budgetary processes to run a countercyclical policy, and Bolivia, a country dependent on concessional finance and therefore spared the vicissitudes of private market sentiments. In the case of Bolivia, the deficit rose from 3.5–3.7 percent of GDP in 1999 and 2000 to 7 percent in 2001 under International Monetary Fund (IMF) programs.

Second, when crises induce spending declines, there is a tendency to protect those categories of spending that are practically, legally, or politically more difficult to adjust. This includes debt service (except when crises are very deep and countries stop paying), permanent public employment, and social security entitlements (notably pensions for retired public sector workers). Maintaining teachers and nurses on the public payroll can help keep basic social services going, although there can be discontinuities when crises are deep and workers don’t get paid, or when declines in real wages become very costly in terms of morale and complementary inputs.

Moreover, there is evidence that cuts disproportionately hurt programs (especially discretionary ones) that are relatively progressive. Just as many programs tend to function along the income distribution as they expand, thereby crowding in poorer groups (see Chapter 9), spending cuts work in the opposite fashion (see Ravallion 2000 and 2002 and Wodon and others 2003). Of particular concern are cutbacks in targeted transfer programs, the resources of which decline or fail to expand as needs rise alongside an increase in poverty.

**The distribution between capital and labor**

Household surveys are relatively good at capturing labor income and some transfers, but are particularly weak at capturing capital income. Yet the distribution between labor and capital income is an important part of the story. This issue can be examined using information from national accounts. Doing so involves considering the functional distribution of income between workers and owners of capital rather than the personal distribution across households. There is evidence that the share of income going to labor decreases during crises and that there is some persistence in this redistribution.13

The underlying sources of information for labor and capital shares in national accounts are different from those contained in household surveys. While household surveys ask household members where they work, how much they earn, and what they spend money on, national accounts are based primarily on information from production sources (that is, surveys of firms, estimates of agricultural production, and sales statistics). Detailed information on the
composition of value added is typically only available periodically—for example from agricultural and industrial censuses and special surveys of service sectors—so that estimates of the functional distribution of income are likely to contain substantial inaccuracies. This is especially the case when the informal sector is significant.

The data on labor shares provided here cover primarily formal work. Because of all the limitations discussed in Chapter 2, household surveys are the preferred instrument for obtaining direct measures of the well-being of households and of changes over time. However, national account sources may be superior in capturing what is happening to all sources of income, including capital income. The fact that capital income and the incomes of the rich appear to be relatively poorly captured by the surveys adds another dimension to the interpretation of what happens during crisis episodes. In order for patterns of change in the distribution of income in the national accounts to reflect real changes, any biases or inaccuracies have to be the same during the entire cycle. This may not be the case during economic downturns, for example if informal labor incomes are underestimated and the relative share of this source of income rises.

With these now familiar caveats on the quality of the data in mind, the resulting patterns can be examined. Using a global database, Diwan (2001 and 2002) examines the relationship between crises (in currency, banking, or both) and labor shares. These studies find that labor shares systematically fall during crises and don’t fully recover afterward, a cross-country result that is illustrated for four countries in Latin America in Figure 8.7. The cross-country pattern is highlighted by the case of Mexico, where the labor share fell sharply in 1982, steadily recovered during the following decade, weathered the more moderate macroeconomic setback of 1989, and then fell significantly following the 1994–1995 crisis. The flip side of this pattern, of course, is that the shares of corporate and financial sector capital income rise relative to wages. There are also significant interactions with structural variables. In particular, closed trade, capital controls, and fiscal deficits are associated with higher labor shares in normal times, but also with large falls in labor shares when crises occur.

What are the mechanisms behind these trends? There are both proximate and deep explanations. In terms of proximate factors, labor market and prices channels tend during crises to lead to a disproportionate drop in the portion of value added that workers obtain through a diverse combination of wage and employment declines. Worker and household adjustments—whether occurring through shifts into lower-paying informal work or the increased labor force participation of secondary workers—do not compensate for the relatively adverse effects on initial employment conditions. (If they do, it is not captured in the data.) With regard to capital, most Latin American countries have relied significantly on external savings to finance investment (leaving them with high debt burdens and vulnerable to capital outflows) and on large movements of asset prices when confidence falls. Interest rates are typically increased to reduce capital flight, thereby also protecting domestic financial income.

At a deeper level, the interpretation of causes depends on the underlying view of how labor market outcomes are determined. In a world in which wages are determined by marginal productivity—and are therefore subject to the multiple influences of institutional or policy-related effects on wages, from minimum levels to severance pay—the explanation should be sought in the disproportionately high decline in labor productivity, relative to returns on capital, that occurs during crises. It is not clear why this pattern ensues.
FIGURE 8.7.
The evolution of the labor share in Chile, Mexico, and Peru

Note: Crisis years are defined as years in which at least two out of three of the following occur: a 25 percent nominal devaluation, negative growth, and 50 percent inflation.
Source: Authors’ calculations, based on national accounts.
Alternatively, if bargaining or, more broadly, power relationships are an important influence on private and public wages, the explanation lies in a decline in the relative power of workers during a crisis. Under this premise, crises can be seen as mechanisms for the resolution of distributional conflicts that are not tackled during good economic times. The latter is the preferred interpretation of Diwan (2001 and 2002), who sees crises as mechanisms that societies use to “digest” social losses across groups. Labor is relatively immobile and so typically bears a higher proportion of the cost. Further exploration of this issue will require in-depth research on case studies. Fiszbein and Galiani (2003), in initial work on the Argentine case, find large changes in the labor share around the time of crises, which at least in some cases appear to be associated with the resolution of political fights between formal labor and other interests at the expense of labor. This is perhaps most clearly the case in the episode of high inflation and stabilization under the Argentine military government in the 1970s.

The impact of financial sector “adjustments” on income distribution

While the evidence surveyed here provides an important part of the picture, it still leaves out some of the larger issues at play. In particular, currency and financial crises are both driven by, and cause, large movements within the financial system, which in turn have significant fiscal consequences for the future. According to a survey of 40 banking crises, the average fiscal costs were 14.7 percent of GDP. These costs were incurred because of a variety of resolution tools, including guarantees for depositors and creditors, liquidity support, repeated capitalizations, and public debt relief. While the costs are distributed over many years, these are clearly nontrivial amounts. In addition, they have often been larger, as Table 8.4 illustrates, for Latin America and countries hit by the East Asian crisis. Mexico’s Tequila crisis cost 19.3 percent and Chile’s 1981–83 crisis cost 41 percent of GDP. The bailout of Banco Intercontinental in the Dominican Republic in 2003 (which is still too recent to be included in Table 8.4) is estimated to have cost between 14 and 17 percent of GDP (see World Bank 2003g). The bill for the current Argentina crisis is not yet in. By contrast, the Savings and Loans crisis in the United States during the 1980s cost just 3.2 percent of GDP.

<table>
<thead>
<tr>
<th>Country and episode</th>
<th>Fiscal cost (in percent of GDP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina, 1980–82</td>
<td>55.1</td>
</tr>
<tr>
<td>Brazil, 1994–96</td>
<td>13.2</td>
</tr>
<tr>
<td>Chile, 1981–83</td>
<td>41.2</td>
</tr>
<tr>
<td>Ecuador 1996–</td>
<td>13.0</td>
</tr>
<tr>
<td>México, 1994–</td>
<td>19.3</td>
</tr>
<tr>
<td>Venezuela, 1994–97</td>
<td>22.0</td>
</tr>
<tr>
<td>Korea, 1997–</td>
<td>26.5</td>
</tr>
<tr>
<td>Indonesia, 1997–</td>
<td>50.0</td>
</tr>
<tr>
<td>United States 1981–91</td>
<td>3.2</td>
</tr>
</tbody>
</table>

Note: Banking crises in Korea and Indonesia were ongoing at the time of study.
Source: Honohan and Klingebiel 2000. Costs refer to both fiscal and quasifiscal outlays.
What are the distributional dimensions of financial crises? Are richer financial sector participants bailed out at the expense of poorer groups outside the financial system? Do richer participants within the financial system gain (relatively speaking), or receive higher levels of protection for their losses, when crises occur? In background work for this report, Halac and Schmuckler (2003) found evidence of adverse distributional effects of crises through both effects. Large, foreign depositors enjoyed the greatest level of compensation, and sometimes capital gains, in crises in Argentina, Ecuador, and Uruguay, while small depositors suffered capital losses. In addition, there is evidence that large borrowers with close connections with banks particularly benefited from crises in Chile, Ecuador, and Mexico. This is illustrated here with case study evidence from Mexico and Argentina.

There is no direct, survey-based evidence of the household impacts of financial sector changes. An assessment therefore has to be formed on the basis of indirect evidence. The total size of the Mexican bailout is estimated at $112 billion (Honohan and Klingebiel 2000), with a large additional amount spent trying to prevent crises from occurring with regard to liquidity support, sovereign bond swaps, and the financing of large investors who withdraw money from projects. Halac and Schmukler (2003) use the $23 billion decline in the Central Bank’s reserves between February and December 1994 as a proxy, thereby calculating a total fiscal and quasifiscal cost of the crisis of $135 billion. This amount represents about one-quarter of Mexico’s GDP in 2000 and some four times the $33 billion received in capital receipts from privatization during the 1990s.

Winners and losers in the large financial transfers in Mexico can be roughly assessed by examining the characteristics of different social groups. Those whose losses were partially or wholly compensated by the workouts were shareholders, depositors, and borrowers. Shareholders in Mexico are primarily wealthy individuals and families. With respect to depositors, evidence of the distribution of deposits for Mexico City in 2000 found that only 14 percent of the population has a savings/debit account and a much smaller proportion a checking account or time deposit. Among those who have any type of account, 84 percent of deposits are held by individuals in the top half of the distribution, with 36 percent of individuals from the top 10 percent of the distribution.

Deposit holdings are clearly highly skewed even within Mexico City, which is a relatively well-off part of the country. The bulk of borrowers were from the formal and, in particular, the large-scale corporate sector. Owners of this sector are typically wealthy and workers come from the middle of the income distribution. Most of the beneficiaries of the financial transfers were therefore well-off by Mexican standards. It is possible that there were secondary benefits in employment stemming from financial support measures, but international evidence on bailouts does not find any association between the size of a resolution and output.

Transfers that took place were financed by higher budgetary surpluses than would have otherwise been needed in the absence of financial crisis. The distribution between higher taxes and lower spending is hard to judge in terms of its relation to the counterfactual without a financial transfer. However, the main tax instrument, the Value Added Tax (VAT), is essentially a flat tax in terms of income distribution; in other words, the poor and the rich pay in equal
proportion. As discussed in Chapter 9 and noted above, spending expansions typically crowd in poorer groups. Assuming that this would have occurred in Mexico in the late 1990s, poorer groups disproportionately lost out from the lower spending than would otherwise be the case. This indirect evidence suggests that the winners were predominantly in the top part of the distribution (including some of the very wealthy), while the losers were spread throughout the distribution, with a probable bias toward poorer groups.

The ongoing Argentine crisis provides a second case. The effects of the crisis are still being worked through, and the design and final fiscal costs of any bailout are still unknown. Nonetheless, it is possible to look at changes within the financial sector that occurred in the context of the very large reductions in well-being (and increases in inequality) associated with rising unemployment, falling wages, and spending cuts. A central element of financial management was the asymmetric “pesification” of loans and deposits. Debtors enjoyed a conversion of their pre-crisis debts at a rate of one peso to the dollar, while deposits were converted at 1.4 pesos to the dollar; the market price of the dollar at this time was 1.7 pesos. Depositors also faced restrictions on cash withdrawals on bank accounts and experienced forced reprogramming of pesified time deposits. Since the peso depreciated to almost 4 per dollar in 2002 (before stabilizing at closer to 3 in the first quarter of 2003), depositors suffered further capital losses compared to the counterfactual of an earlier conversion to dollars. In addition, banks suffered a large capital loss from the asymmetric pesification, but the government has sought to finance this with a “compensation bond” that is currently estimated at 14.6 billion pesos (roughly 12 percent of Argentina’s current GDP). The story is far from over, however, and other mechanisms are likely to emerge, the cost of which will once again be paid for in the form of either higher taxes or lower spending.

Depositors experienced large losses in Argentina; of particular interest is the question of which ones were most affected. There is striking evidence of the pattern and timing of changes in both peso and dollar deposits (Figure 8.8). Large deposit holders were moving money out of both peso and dollar deposits between December 2000 and March 2001, well before the final unraveling of the economy in December 2001 (and before the currency crash and financial sector adjustments that caused the capital losses occurred). Although withdrawals became more widespread during 2001, small depositors continued to keep money in the country in dollar deposits.

The scale of capital flight amounted to about US$12.9 billion in the year ending in December 2001 (Figure 8.9). Those who got their money out experienced large capital gains in terms of purchasing power in Argentina, a consequence of the steep real exchange rate depreciation. Private net foreign assets in the first quarter of 2002 were equivalent to 94 percent of GDP, up from between 20–30 percent in preceding years. As was speculated above, it is possible that a similar phenomenon may have been behind increases in the financial income of the top decile during Mexico’s Tequila crisis, as reflected in the (undoubtedly incomplete) data provided in household surveys.\(^15\)

An assessment of distributional dimensions of the financial effects of crises has to rely on indirect evidence of the type illustrated by these cases. A tentative conclusion is that financial sector crises can lead to large, disequalizing redistributions. Some large financial sector
participants were able to avoid losses—or even to achieve gains—by anticipating the crisis, while crisis resolution mechanisms largely protected richer groups.
CHAPTER 8: POLICIES ON MARKETS AND INSTITUTIONS

FIGURE 8.8.
Cumulative change in time deposits (by residence and size) in Argentina (in percent)

December 2000–March 2001

FIGURE 8.9.
A. Private foreign asset holdings, Argentina (in billions of U.S. dollars)

Capital flight = 12.9 billion dollars

<table>
<thead>
<tr>
<th>Month</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-00</td>
<td>94.4</td>
</tr>
<tr>
<td>Mar-01</td>
<td>95.4</td>
</tr>
<tr>
<td>Jun-01</td>
<td>97.2</td>
</tr>
<tr>
<td>Sep-01</td>
<td>102.2</td>
</tr>
<tr>
<td>Dec-01</td>
<td>107.3</td>
</tr>
<tr>
<td>Mar-02</td>
<td>110.0</td>
</tr>
</tbody>
</table>

B. Net private foreign assets (in percent of GDP)

<table>
<thead>
<tr>
<th>Month</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-00</td>
<td>20.0</td>
</tr>
<tr>
<td>Mar-01</td>
<td>22.4</td>
</tr>
<tr>
<td>Jun-01</td>
<td>21.0</td>
</tr>
<tr>
<td>Sep-01</td>
<td>24.4</td>
</tr>
<tr>
<td>Dec-01</td>
<td>28.6</td>
</tr>
<tr>
<td>Mar-02</td>
<td>93.9</td>
</tr>
</tbody>
</table>

Source: Ministry of the Economy, Argentina.
What can be done?

Countries in Latin America have relatively high levels of macroeconomic volatility and crisis-related risk, and there is evidence to support the view that fundamental reasons for this stem from weak and unequal institutions. Many countries are on a path of lower growth and higher inequality, with a greater proclivity for disruptive attempts at redistribution. Others, notably Chile, have developed strong mechanisms for economic management and encompassing coalitions that effectively manage potential distributional conflicts (see Chapter 5) and allow for relatively rapid and steady growth with continued high inequality.

What does this pattern imply for policy choice? Macroeconomic management clearly is not a policy with which to facilitate the exercise of immediate “client power” over service delivery. However, there should be a role for public debate that indirectly influences both policymakers and the relationship between policymaking and actors or organizations that manage policy directly (such as ministries of finance, central banks, and financial regulators). The discussion below organizes policy implications into four areas, with emphasis first placed on the role of fundamental social and political aspects, and suggestions then given for three areas that may help bridge the apparent social and political gulf between proximate and deep solutions.

Social and political fundamentals

The diagnosis that institutions matter with regard to crises might naturally lead to fixing institutions, in keeping with the view the world is easily amenable to such solutions. Some of the measures of the past 15 years have been taken in this vein. Examples are the granting of autonomy to central banks, policies on fiscal rules at national or local levels, greater transparency in fiscal and financial accounts, and strengthening of the institutional basis of financial systems. While these steps have often had positive effects, the analysis here suggests that such measures will not be panaceas in situations that involve complex underlying problems and weak institutions.

A striking example of such situations is Argentina, which was a poster child for the international financial community during the 1990s. This role had a strong foundation, since Argentina seemed to have broken out of its chronic instability and poor performance through a series of measures that moved the country along a more prudent path. However, problems spilled over into other directions in an example of the “seesaw” effect. In other words, when underlying conflicts and institutional weaknesses are not resolved, the domains of action are pushed into new areas (Acemoglu, Johnson, and Robinson 2002).

Manifestations of this trend in Argentina were weak fiscal control over the provinces, continued debilitating corruption, and strained relations between the executive and the judiciary. These problems interacted with policy mistakes—including pegging to the wrong currency and applying expansionary fiscal policies during the economic boom, deep structural problems (such as a de facto “dollarized” financial system), and a weaker international environment—to produce the deep economic and social crisis of the recent past. (See Perry and Serven 2002 for a review of the economic causes of the crisis.)
Where crises are products of underlying social and political structures, then the long-run solution must involve changes in these domains or, as Robinson (2002) has termed it, the move toward a new “political equilibrium.” Doing so would involve effective, inclusive, and accountable political and other types of institutions, a goal that is closely linked with tackling issues related to inequality in influence, recognition, and wealth, constraining clientelistic practices, and abuses of power (as discussed in Chapter 5).

In a good political equilibrium, everything tends to go right. Choices of policies and specific institutional arrangements are of great importance, but as instruments of the polity rather than as a means of protecting society from the vagaries of politicians, or “politician-proofing” (as phrased in Robinson 2002). This is completely consistent with recent work on economic performance that emphasizes the absence of specific, generalized policy and institutional solutions to economic challenges; instead, successes occur when societies shape solutions to fit specific contexts. (See Rodrik 2003 for a discussion on this sujet.) Such solutions are, of course, constrained by the rules of arithmetic and fundamental economic conditions; for example, budgets have to be financed and prices do make a difference to behavior.

Chile provides an illustration of this perspective. As discussed in Chapter 5, following its transition to democracy, the country has been characterized by a relatively encompassing coalition of political and social actors and extensive consensus on the strategic directions of social and economic policy. These circumstances have entailed maintaining sound macroeconomic policy and supporting property rights and open trade in the context of inclusive and equitable policies, especially in the area of public spending. Chile has been one of the few countries in Latin America that has managed to pursue countercyclical policies during good times, and recently adopted a fiscal rule that institutionalizes this approach. These processes are products of a reasonably effective political equilibrium.

**Distributionally inclusive risk-management institutions**

The importance of safety nets in mitigating the costs of crises is a longstanding focus for policy advisors, especially in the wake of the 1980s debt crisis (see World Bank 1990) and the East Asian crisis. Support for safety nets has become standard in programs supported by the World Bank and the IMF. Since creating new institutions and programs during a crisis is a bad idea, it has been argued that such safety nets should be developed independently of a crisis, and designed to kick in automatically when crises hit. (For more on this, see de Ferranti and others 2000, Ferreira, Prennushi, and Ravallion 1999, and the World Bank *World Development Report* 2001a.)

The problem is that this rarely occurs and safety nets are usually fiscally constrained (especially during crises) and inadequate relative to the problem. There are also risks that such targeted programs are captured and exploited politically. The Trabajar (work) program, established under the Menem administration in Argentina, was correctly renowned for its highly effective targeting of the poor (see Jalan and Ravallion 1999 and 2003). However, the program also became known for local political capture, and lost political support with the change in government in 1999. This led to significant delays in building a more modified and extensive program, known as Jefas y jefes de hogares (head of household) some time after the new crisis occurred.
Safety nets for the poor are often treated as policy add-ons. In this regard, the issue can be seen as part of the incompleteness of inclusion of subordinate groups in overall social and political arrangements in a society. As O’Donnell (1999a) has argued, while broad provisioning for risk was central to the process of inclusion of the working classes in Europe, this same process generally didn’t occur in Latin America. Germany’s Bismarckian welfare state was a response to the distributional threat from the Marxist Social Democrats. The Beveridge welfare state in the United Kingdom was a response to a history of mobilization by lower class groups, the unifying experience of the Second World War, and the shadow of the depression in the 1930s. By contrast, the weak and vertical forms of incorporation of subordinate groups in Latin America (as discussed in Chapter 5) led to truncated forms of social risk management that divided the formal working class from outsider groups.

Such political economy considerations imply the need for more comprehensive risk management institutions that appeal to middle class groups as well as to the poor and that provide “safety ropes” for a broad segment of the population, not just a highly targeted net for the very poor. (Gelbach and Pritchett 1997, Sumarto, Suryahadi, and Pritchett 2003). The mix of programs will depend on conditions in specific countries, but will also typically involve politically acceptable, comprehensive transfers for the extreme poor (notably those linked to human capital formation), various forms of labor-based measures (from public works to unemployment insurance), and measures for the young and old that can be expanded during times of recession. (These aspects are discussed further in Chapter 9.)

Putting broad-based risk management at the center of policymaking has an important corollary in macroeconomic policy. The design and performance of safety nets has a powerful influence on macroeconomic policy options (Bourguignon 2000). Designing broad-based risk management institutions to manage distributional losses and conflicts will effectively free up macroeconomic policy to more efficiently respond to shocks.  

**Policymaking when not in crisis: exercising “superprudence” in fiscal, financial, and debt policies**

The material surveyed here suggests a pessimistic conclusion on the capacity of societies in Latin America to effectively manage crises in an equalizing fashion. When shocks occur, the cards are stacked against discretionary choices and behaviors that favor poorer groups. Rich, powerful groups have both more information and more influence; when all groups strive to protect their wealth and incomes, this influence is likely to be exercised. This problem is seen in the initial results of patterns of adjustment and distribution of workouts within the financial sector; in the relatively limited coverage of safety nets; in poor track records related to the distributional dimensions of spending cuts; and in cross-country evidence of mechanisms to resolve distributional struggles. Although it is important to keep seeking mechanisms through which to make distributional resolutions more equitable, doing so underscores the importance of developing institutions during non-crisis periods that can automatically foster better responses during crises.

This statement has a possibly surprising implication. In public debates, adopting a less stringent macroeconomic stance is often portrayed as a distributionally progressive approach, whether in good times or bad. While there will always be specific judgments made about the distributional
impacts of a range of fiscal and monetary policy options, the analysis here suggests that taking a “superprudent” position over the course of the cycle provides greater hope of supporting a more equal development pattern. On one level, this sharply reinforces the common prescription to break procyclical policy positions. Macroeconomic restraint in good times will facilitate automatic stabilizers and a sensible easing of policies to be applied in a disciplined fashion when adverse shocks occur. Building fiscal rules and institutions that help overcome both the political economy-related pressure to deplete potential surpluses in good times and informational asymmetry problems—and hence improve credibility in countercyclical fiscal policies during downturns—therefore become a major priority (Perry 2003). This strategy would in particular provide the macroeconomic foundation for broad-based, self-expanding safety nets.

Countercyclical fiscal policy, while eminently desirable, has been elusive in Latin America, domestically for political economy reasons and externally because of the herd-like swings of private sector sentiment (de Ferranti and others 2000). In 2002 and early 2003, the region was in the downswing of a private lending cycle. This sharpened macro-level pressures, forced defensive monetary strategies, and increased domestic costs. Yet the retreat of private loan resources from Latin America has had the positive side effect of leaving the region’s external nontrade inflows dominated by foreign direct investment and remittances, both of which are much less volatile sources of financing (with remittances often displaying a countercyclical pattern) that form a healthy base for long-term development.

However, history suggests that when the next upswing occurs, private lenders will be back and borrowers (especially in the private corporate sector) will be happy to receive their loans. There is some evidence that a structural break occurred after the Russian crisis, and that flows are unlikely to return to the levels that prevailed in 1996–1997 for some time; in the long run, this is likely to be a good thing. The interactions among external debt, crisis, and distribution suggest that most countries in Latin America should be more debt-averse than in the past.

Indeed, Latin American economies have remained excessively vulnerable to the reversal of capital flows due to a combination of moderate to high public debt levels, excessive reliance on foreign and dollar-linked domestic debt, low export and tax ratios, weak prudent regulation and supervision, and procyclical fiscal policies. The implication is that the best course for macroeconomic policy in the region to take, from the point of view of reducing poverty and inequality, would be twofold: increasing public sector savings and adopting superprudent regulatory and supervisory practices in the financial system during good economic times, while at the same time increasing the level of openness of economies, developing long term domestic capital markets, improving debt management, and increasing tax ratios. Since it will take time to achieve the latter objectives, the authors recommend the generation of cyclically-adjusted public sector surpluses for a period of time for countries with high debt burdens, in order to reduce vulnerability to shocks and the likelihood of crisis.

This recommendation implies the importance of paying attention to private sector indebtedness, balance sheet currency mismatches, and patterns of capital inflows. There is also a prima facie case to be made for managing short-term capital inflows, although the verdict is out on whether policies such as Chile’s to tax such inflows have had significant, lasting effects. Technical issues on the feasibility and design of measures to manage capital flows are left for another report. Developing long-term capital markets in domestic currency is also critical, not just for
governments but for the corporate sector as well, in order to overcome the dilemma between undertaking major currency or rollover liquidity risks.

A superprudent stance implies confronting distributional conflicts in the tax and spending decisions that are made during good times. The buildup of debt in the 1970s and 1990s in many Latin American countries—despite the substantial privatization receipts of the latter period—helped avoid distributional struggles, as the cases of both Brazil and Argentina illustrate. Debt also allowed for expansions in social spending without confronting unaffordable entitlements to the nonpoor (such as public sector social security commitments in Brazil), and actually facilitated new expansions in spending (especially at the provincial and state levels in both countries). However, this trend only shifted the distributional conflicts to the future.

In cases in which fiscal policy is limited, at least in the short run, the financial sector policy becomes all the more important. This is especially true because the evidence presented above suggests that a lot of distributional action takes place between the financial sector and the rest of the economy, as well as within the financial sector itself. Taking action in good times will generally be more efficient and less costly than any rescue package offered in the aftermath of a crisis, and may be more politically feasible than restrictive fiscal policy when the going is good.

Governments can encourage market discipline and improve regulation and supervision to strengthen the financial system. This includes, among other things, a sound contractual and regulatory environment, rigorous monitoring that fosters risk awareness, risk-based capital requirements (including risks arising from currency mismatches), and countercyclical provisioning requirements. Banks on average create too few provisions in good times and are then forced to increase them during cyclical downturns, thus magnifying losses (Laeven and Majnoni 2002).

A good example of countercyclical provisioning requirements is the system established in late 1999 by the Bank of Spain (Banco de España 1999). The Spanish regulation seeks to deal with the movement of solvency risks throughout the economic cycle by requiring “statistical loan loss provisions,” in addition to both general and specific provisions for loans classified as doubtful. In other words, provisions must be set aside in order to cover transactions that have not yet been specifically identified as doubtful assets, but for which experience shows that a risk may exist. These provisions are built up in good times and then shifted into specific areas of provision in bad times (without passing through the income statement) as the loan portfolio decays. Also important is the design of deposit insurance and the desirability of having explicit, limited, and funded deposit insurance systems rather than blanket protection, whether or not the latter is explicit or implicit.

**Distributional resolutions within crisis**

It is now standard advice to protect propoor spending and increase safety net spending when crises hit. While the past record is not good (Chapter 9), moving in the direction of broad-based risk management institutions and superprudence during good times will increase the probability that it will occur. On the fiscal front, more attention could be given to increased, temporary taxation on luxuries, such as cars and other consumer durables. Even if the quantitative impact is not large, this action would serve as a political signal of a government’s efforts to share the
burden of crises more equitably, and may also facilitate negotiations in other spheres. The risk is that these measures will not be removed after the crisis passes. It would therefore be wise to focus on a very few, high profile items for a limited time, for example by adopting “sunset” clauses that require formal legislative renewal after a certain period.

The analysis of the financial sector workouts in Mexico and Argentina underscores the importance of policies that limit adverse redistributions through prorich resolution processes. This approach can be considered in terms of distributions both between the financial sector and the rest of the economy and within the financial system. With regard to the former, the major question to be considered is the costs of not bailing out. Cross-country evidence indicates that resolution policies increase fiscal costs without reducing output declines (Honohan and Klingebiel 2000). This implies financial redistributions in favor of the relatively rich, without the often-asserted gains in protecting employment.

However, discontinuity is likely to arise if a financial system were to collapse, with major consequences in terms of economic conditions. Assuming that some action is necessary to avoid financial collapse, what designs make sense? The literature on banking crises emphasizes the importance of a prompt resolution to reduce adverse effects and limit overall costs. A rapid and strict resolution reduces the likelihood that fragile institutions will gamble for resurrection and stop the flow of funds to loss-incurring borrowers. It makes sense to grant liquidity support to financial institutions that do not present solvency problems, provided that liquidity and solvency problems can be disentangled. Some guarantees for depositors are desirable, but it is advisable that these not be generalized and that associated conditions be determined ex ante. (In Argentina, the blanket bailout offered by pesification was unnecessary, even considering that the authorities would assume part of the balance sheet effect resulting from the devaluation.) Limiting a bailout reduces both resolution costs and adverse signaling effects; unrestricted aid can create problems of moral hazard for the future.

With respect to transfers within the financial sector, it is again important to take measures before a crisis to increase transparency and minimize information asymmetry problems, for example through good accounting and information disclosure standards. Once a crisis is underway, the issue becomes how to intervene. Freezing or restructuring measures could discriminate across deposits by type and size (De la Torre, Levy Yeyati, and Schmukler 2003). For example, during the recent crisis in Uruguay, the authorities decided to concentrate central bank reserves on fully backed demand deposits at troubled banks in order to preserve the functioning of the payment system. By contrast, time deposits at troubled banks were restructured by decree.

Such a policy approach could be complemented by similar measures aimed at protecting small depositors. Since large, foreign investors tend to run first, ex ante stop-loss clauses on the use of liquidity could be imposed to ensure that something is left to share among small depositors. The government could also force the reprogramming of time deposits only for deposits larger than a certain threshold amount, thereby giving some form of priority of claim over available liquidity to small deposits.

Finally, the financing of restricted assistance to the financial sector is a question that deserves attention. Since increases in standard taxes, spending cuts, and inflation cause losses to individuals outside the financial system, governments could consider alternative financing
schemes (such as a capital gains tax) that could potentially shift some of the burden to the financial system and its high-income participants.

Although policy tools with which to minimize financial transfers can be proposed, political economy factors also play an important role in regulatory and resolution-related policies. In the case of Mexico, for example, bank borrowers organized themselves and forced the government to reassign part of fiscal resources to support debt restructuring (see De Luna-Martinez 2000). In Argentina, the late 2001 deposit freeze was driven in part by the liquidity problems of state banks, which helped the authorities to recirculate liquidity from more liquid private banks. The legitimacy of the pesification—and thus the ultimate effects of the crisis—were subject to the influence over policymaking of different powers, such as Congress, the governors, the judiciary, and large debtors. Although the specific impact of political economy factors on policy measures and financial transfers is difficult to predict, those parties with greater power and capacities to organize are often likely to exert greater influence.

8.4. Conclusions

To the extent that the causes and distributional consequences of macroeconomic crises are functions of weak and unequal institutions, the shift to a better equilibrium will not occur overnight. As a final comment, there are two corollaries of the policy conclusions sketched above.

First, one strand of thinking in the past two decades has focused on the need to give greater autonomy to macro-level and financial sector management in order to shield these policy domains from the fickle, myopic, or ill-informed pressures of public opinion and politicians. This is half correct. There is a large domain of technical analysis in macro and financial management. There is also a strong case to be made for creating institutions that provide incentives for behavior independent of electoral cycles, as occurs with independent central bankers with nonoverlapping terms.

However, there is also a case to be made for both greater transparency and public debate over the consequences of actions in the macro sphere, especially in the financial sector. In light of the technical and indirect nature of the relationships involved, there is a particular role for independent, technical analyses of fiscal and financial policy to play in the domain of fiscal management (as illustrated by the work of the Institute for Democracy in South Africa or the Institute of Fiscal Studies in the United Kingdom).

Second, there are implications for the rules-versus-discretion issue in macroeconomic policy, as already noted above. Support is increasing for rules as a means of ensuring greater prudence and credibility and in order to self-discipline the unruly child of policy management of “immature” states. This is illustrated by the range of fiscal rules (at national and local levels); by the Argentine currency choice of the 1990s (as well as the somewhat surreal layers of self-disciplining rules proposed in a desperate attempt to prevent crisis in the final year of the de la Rua administration); and in proposed rules to protect categories of social spending.
Rules can have a positive impact when they are well designed and the surrounding incentives are strong, including political incentives.\textsuperscript{21} Italy’s vigorous fiscal adjustment to join the European Union’s Euro club is a case in point; this occurred in the context of strong domestic support for being at the core of the European project. Brazil’s fiscal responsibility law has probably been a useful general instrument in the attempt by the political center to bring state finances under control. Chile’s Copper Stabilization Fund and the recent structural surplus rule are good examples of how to incorporate the countercyclical elements emphasized here.

Badly designed rules, on the contrary, will have little value. Fiscal Responsibility Laws in Argentina and Peru that set rigid deficit and debt goals that were not cyclically adjusted became rapidly unviable in the recessionary environment of 2000–2001, and were therefore abandoned. Even more dramatic was the experience with the Argentine Currency Board: it worked well as long as the external environment was favorable, but once Argentina suffered major adverse external shocks after the Russian crisis and the Brazilian devaluation, it led to a significant real exchange overvaluation and a protracted recession, under which the required fiscal adjustment (that should have been made well before during good times) proved to be not only difficult but even counterproductive. In the end, the rule became unsustainable but the costs of abandoning it were huge, as well as amplified by poor crisis management. This example shows that there are no short cuts to credibility, even less so when this is attempted through rigid rules that do not fit a given country’s specific economic structure. A Currency Board pegged to the dollar can work well in a country that carries out most of its trade in dollars and is closely integrated in the U.S. economy, but it implies huge risks in a closed economy that conducts most of its trade with the European Union and neighboring Brazil (Perry and Serven 2002).

Further, rules work only in a context. Indonesia under Soeharto formally had a balanced budget rule that was often cited as a source of its relative macroeconomic prudence from the 1970s to the mid-1990s. This situation was, in fact, an illusion, since the government’s domestic borrowing and surpluses were hidden in the financial system. The budget rule was instead endogenous to the fear of hyperinflation and instability among the ruling elite in the wake of the macroeconomic and social conflagration of the mid-1960s. The political powers were willing to turn over policy to the technocrats when macro-level problems became a threat. Well-designed rules have an important role to play, but are a complement rather than a substitute for the development of sound fiscal and monetary institutions and political behaviors that facilitate both greater prudence and fairer distributional resolutions.

\section*{Notes}

\footnote{For example, in the early 1990s the Financial Reform Index did not weight regulation and supervision sufficiently and then overstated the extent of reform.}

\footnote{This cross-country analysis has used a variety of measures of institutional performance and has paid particular attention to exploring the exogenous, or independent, influences of institutions, since it would be expected that the quality of institutions would improve with general economic development. See Acemoglu, Johnson, and Robinson 2001 and 2002; Easterly and Levine 2002; Rodrik, Subramanian, and Trebbi 2002; Dollar and Kraay 2002b, among other contributions to this debate. Kaufmann, Kraay, and Mastruzzi (2003) have argued that cross-country analysis...}
indicates that although better institutions lead to better long-term economic performance, there is no evidence that growth is an independent source of institutional improvement.


4 These arguments are based on models in the Heckscher-Ohlin tradition and, in particular, the Stolper-Samuelson theorem. See Wood 1997 for arguments in this tradition.

5 It should be noted that Evans (1995) used the term “embedded” in a different but related way, also in the context of industrial development. He argued that East Asian governments managed a combination of some autonomy of action with embeddedness in societal structures, including connections with the business community. The line between embedded autonomy and state capture is possibly a fine one.

6 This section draws on the background paper by Cunningham and Santamaría 2003.


8 While the measures used in Rodrik’s analysis go some way in explaining Latin America’s worst growth collapse, there remains an additional, negative “Latin American effect.” This suggests that the indicators can only partially serve as proxies for the patterns of weak and unequal institutions that this report has argued are so central to the region’s performance.

9 See a range of authors, including Baldacci, de Melo, and Inchauste 2002, Ferreira, Prennushi, and Ravallion 1999, and Manuelyan Atinc and Walton 1998.

10 The surveys are repeated cross-sections; although representative of earnings in different parts of the distribution, they do not track changes of the same households, as is done in panel surveys.

11 This statement is based on official government statistics.

12 Inflation and devaluation are often mechanisms for effecting real wage adjustments; downward nominal wage flexibility is typically limited or sluggish.

13 This section draws in particular on Diwan 2001 and 2002.

14 See also Harrison 2002 and Ortega and Rodriguez 2002 for work on determinants of labor shares over the long term, within a somewhat similar overall framework as that presented here.

15 Household survey data in Argentina do not appear to be credible sources of financial income information because they showing large pre-crisis declines in such income in the 1990s, which is inconsistent with the evidence provided by national accounts.

16 This is consistent with the cross-section finding that greater social insurance is associated with lower propensity for crisis. For more on this topic, see Rodrik 1999.

Honohan and Klingebiel 2000 provide empirical evidence that accommodating policies such as unlimited deposit guarantees, open-ended liquidity support, repeated recapitalization, debtor bailouts, and regulatory forbearance increases overall fiscal costs by a significant amount. Providing open-ended, extensive liquidity support, for example, adds to fiscal costs 6.3 percentage points of GDP.

Debtors also impeded reforms to the bankruptcy law that would have made it easier for banks to take possession of guarantees and for the government to rapidly sell the acquired impaired assets.

As part of a long dispute, the Supreme Court sponsored a resolution that declared pesification unconstitutional and mandated the redollarization of most pesified bank liabilities, significantly changing the allocation of the costs of the crisis. The government responded with a failed attempt to impeach all of its judges.

See Perry 2003 for a review of the issues and the case for rules that have a counter-cyclical element, with the objective of reducing political economy pressures for excessive fiscal expansion in good times.