I D E A
Ideas for Development in the Americas

Inter-American Development Bank
Research Department

Volume 12
January–April, 2007

Fiscal Pacts in Latin America

Latin America has made significant institutional and political progress, which has allowed for better inflation control and a more disciplined fiscal policy. Still, in many countries the state has very limited resources to carry out its functions, tax collection is perceived by large segments of the population as inequitable and overcomplicated, and the prevailing opinion is that there is misappropriation and inefficiency in the use of resources.

As expressed eloquently and precisely by the Economic Commission for Latin America and the Caribbean (ECLAC), correction of the deficiencies of the state requires "a new fiscal pact that strengthens the reforms in progress, promotes a stable macroeconomic environment that commits the Treasury to use resources efficiently, includes transparent mechanisms of public action with equity as its key objective, and contributes to strengthening democratic institutions." Since it is difficult to disagree with these objectives, the question is how to achieve and apply these agreements so as to improve the operations of the state and, specifically, fiscal policy. This issue of IDEA attempts to answer this question.

How bad is the popular perception of the state's performance in fiscal management? According to Latinobarómetro polls in 2003, 75% of Latin Americans believe taxes are not used efficiently, only 31% are satisfied with the quality of health services and 51% with the education system. According to polls from the same source for 1998, Latin Americans think the state should spend more on health (92% of interviewees), on basic education (57%), and on social security (75%). The opinions of the business sector reflected in World Competitiveness Report 2005 are no more favorable: on a scale from 1 to 7, the quality of public schools receives a 2.5 score, quality of infrastructure 3.1, and quality of public expenditure in general 2.6.

> The future of fiscal pacts in the region has never looked brighter but Latin American governments can adopt various policies and strategies to improve their chances of success even more.

Improving this perception is no easy task given the structure of income and spending as well as the economic, political and institutional factors that limit the flexibility of this structure. Fiscal pacts sound good in principle but how viable are they? Are there fiscal policies and institutional reforms that could improve the possibilities of success? Fiscal structures in Latin America are, above all, the result of strong political and institutional forces that are not easily modified. The search for consensus on which fiscal system is capable of achieving the desired objectives is a laudable goal in and of itself; however, the probability of successful fiscal pacts depends mainly on the political and social constraints the state faces in collecting taxes, public accountability for fiscal decisions, the competence of the tax administration, and the institutions

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Fiscal Structures in Latin America

In such a diverse region as Latin America, all generalizations are debatable; however some features of fiscal structures are common to most countries. Fiscal revenue has six major features:

- *Low tax burdens*. On average, tax collection (not including social security contributions) is 16.3% of GDP, practically the same as in the mid-1980s (15.4%), despite numerous reforms. Tax burdens in Latin America are below world standards by 6.8% of GDP. Brazil and Argentina, with tax burdens of 21% and 18% are the two countries with highest receipts, while Guatemala, Panama and Paraguay, with approximately 10% of GDP, are the countries with the lowest tax burden.
- *Limited tax bases*, with many exceptions and special treatment, result in highly complex systems with little neutrality (in the sense that they interfere in decisions on where, how and what to invest in), and in taxes of low productivity (that is they collect very little at the statutory tax rates).

- *Tax structures increasingly biased toward VAT*. While receipts from direct taxes have averaged around 4% of GDP in the last two decades (and are 3.5 points below the world standard), VAT receipts have risen from 2.9% of GDP in the late 1980s to 5% at present.

- *Very progressive personal taxation on paper but not in practice*. In the mid-1980s, maximum marginal income tax rates averaged 50%. Although they are currently below 30%, implying less progressivity, minimum taxable income has increased considerably (from 60% of income per capita in the mid-1980s to 230% in this decade) in an effort to compensate for decreasing progressivity. However, neither now nor in the past have personal taxes contributed an important share of receipts because of the many exceptions, deficient tax administration practices and outright evasion. Similarly, property or inheritance taxes do not generate significant receipts.

- *Important non-tax sources of (recurrent) fiscal revenue*. State ownership of certain natural resources is an important source of fiscal revenue in various countries. For example, in the 2000-03 period the governments of Venezuela, Ecuador, Bolivia and Mexico received revenue from their hydrocarbon companies equivalent to 9.8%, 6.8%, 4.9% and 2.1% of GDP respectively. In Panama revenue from the Canal and in Paraguay revenue from the hydroelectric plants are also very important (2.2% and 3.9% of GDP respectively). Although of a very different nature, foreign aid and debt relief are a very important source of non-tax revenue for some of the poorest countries: 17.5% of GDP in Nicaragua, 8.7% in Bolivia, and 7.6% in Honduras.

- *Very little tax decentralization*. Again except for Argentina and Brazil, which have a strong federal tradition, tax matters in Latin America are almost exclusively the competence of central governments and legislatures. Although decentralization of public expenditure is widespread in the region, it has not been financed by higher tax receipts at the provincial or municipal level but mainly by higher transfers from the central government and, in some countries, by increased borrowing.

The structure of *public expenditure* in Latin America is characterized by:

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This issue of IDEA is based on research conducted by Eduardo Lora and Juan Camilo Chaparro.

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IDEA (Ideas for Development in the Americas) is an economic and social policy newsletter published three times a year by the Research Department, Inter-American Development Bank. Comments are welcome and should be directed to *IDEA's* managing editor, Rita Funaro at Ritaf@iadb.org.

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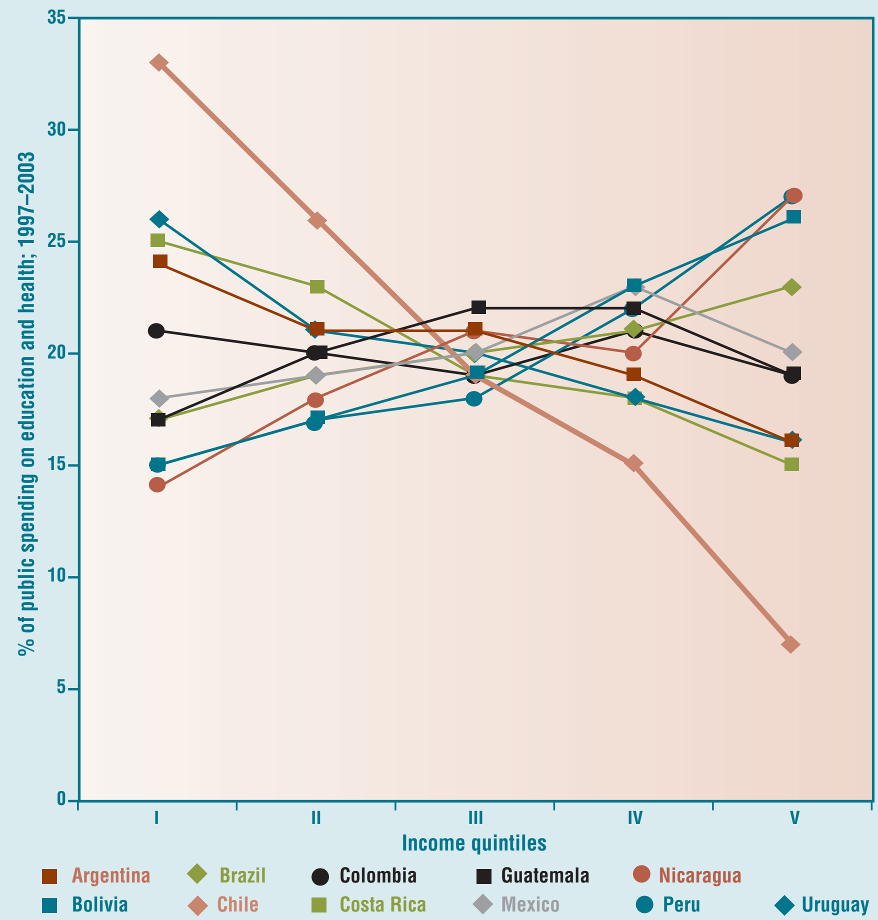
- *Modest amounts of total public expenditure*, which are significantly below current world standards but not below the historical standards of developed countries. Considering the levels of development of the countries, on average total public expenditure in Latin America could be expected to represent 31.8% of GDP, but in fact it is only 23.1% of GDP, or 20.4% excluding Argentina, Brazil and Uruguay, which do not fit this generalization. However, these international comparisons are biased by the inclusion of developed countries whose public expenditure increased especially between 1960 and 1980. A comparison of current levels in Latin America with developed countries when they had levels of development similar to LAC's today gives very different results. The average share of consolidated public expenditure in developed economies during the 1930s was approximately 22%, the same average level for the economies of Latin America in 2000. Naturally, in both contexts a few countries have been relatively distant from this parameter (El Salvador and Guatemala currently, and Norway and Spain in the 1930s all had levels of public expenditure under 13% of GDP).

Figure 1. Distribution of Public Social Spending (Education and Health) by Income Quintiles



Source: ECLAC (2005).

- *High and growing share of social expenditure*. Contrary to conventional wisdom, Latin American governments allocate a higher share of fiscal resources (6.2% more of the budget) to social spending (education and health) than other regions of the developing world. However, since total public expenditure in the region is below current world levels, as a share of GDP total social expenditure is 1% lower than in other developing regions. But in comparison with developed countries when they had the current income levels of Latin American countries, social expenditure on both education and health in Latin America is again higher than expected. Average public social expenditure in Latin America, as a percentage of GDP, increased about three percentage points between 1990 and 2003 from 9.6% to 12.8%. At real levels per capita, this indicator also grew strongly from $314 per capita (in constant US dollars of 2000) in the early 1990s to $457 per capita 13 years later. (ECLAC, 2005).

- *Inadequate targeting of social expenditure*. With the exception of Chile where social spending is clearly progressive, total spending on education and health tends to be distributed approximately equally by income level (see figure 1). In general, spending on primary education is distribut-

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An Unfinished Comedy in Five Acts

Fiscal or tax problems are not resolved simply by designing a new tax system or imposing rules to control spending or the fiscal deficit. Another factor that plays an important role is something that is vaguely defined as "lack of political will," which implicitly assigns responsibility for fiscal problems to the government or congress but which is actually a complex web of political, institutional and social restrictions that make up the political economy of a country and that limit the usually well-intentioned actions of governments and congresses. Using a less academic style, the main elements of political economy that explain the fiscal structures of Latin America can be presented as the plot of an unfinished comedy in five acts.

In the first act it is election day in a very unequal society. There is much popular rejoicing, although not all those who are on stage go to vote. At the end of the day, the winner of the election is the party that proposed the heaviest taxes on the rich to finance higher social spending for the benefit of all.

In the second act, while the politicians are handing out beer to some *campesinos* in one corner of the stage, small groups of rich people are discussing how to arrange not to pay the new taxes: some decide that they will bribe tax officials; others that they will talk to the politicians to obtain an exemption because they are convinced that their companies are crucial for press freedom, generation of jobs, or exports; a third group leaves the stage to never return.

In the third act, public sector employees and workers in the largest companies realize what is happening and organize a demonstration to demand that the rich practice civic solidarity and the politicians keep their election promises. The frightened politicians offer to set up a social security system with very low contributions in exchange for the promise of very generous pensions for all who want to join. The politicians explain to the demonstrators that until the day they retire the money will be used to finance the promised general spending programs. The demonstrators are not entirely convinced but they leave the stage, some laughing, others threatening with sticks.

In the fourth act, workers of all types are scattered around the stage. A team of tax collectors arrives on the right demanding higher contributions from all who are close by. A few, mainly dressed as office workers, courteously give in to the demands but others leave gradually by the left side of the stage.

In the fifth and last act, the group of workers who agreed to pay contributions has aged and is now accompanied by their grown-up children who are dressed as office workers as their parents were before. Suddenly they begin to argue with the tax collectors and politicians who are at the back of the stage (their faces are not seen), demanding to be paid the pensions they were promised. The collectors try to explain that the only way to pay them would be to raise the taxes paid by themselves or their children because almost all the other actors have disappeared from the scene without paying their taxes. The comedy is unfinished, but those still on stage decide that a social pact would be the only reasonable way of bringing the others back on stage. Will they return? Will they reach an agreement? Will they find a way to put the agreements into practice?

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and practices that contribute to or conspire against the transparency and integrity of fiscal management.

Despite this note of caution, the evolution of these factors in recent decades suggests that the future of fiscal pacts in the region has never looked brighter. To improve their chances for success even more, Latin American governments can adopt various policies and strategies. In particular, governments can promote standards and practices that help improve fiscal transparency. They can also take the lead in a broad and frank discussion on fiscal problems, support institutions with political independence and technical expertise to enrich the debate, and stimulate innovative ways in which citizens can participate directly in fiscal decisions.

This issue of IDEA examines the future of fiscal pacts. The main features of the region's fiscal structures are summarized and a fictitious, but very typical, story serves to illustrate the political economy factors that govern these structures. It then identifies the factors that facilitate the emergence of fiscal pacts and suggests policies and strategies that governments can adopt to improve their viability.

Ingredients of a Successful Fiscal Pact

The success of a fiscal pact cannot be measured only by tax receipts, the degree of social consensus on the objectives of fiscal policy, or the capacity of political leaders to reach agreement. All these are necessary but not sufficient ingredients for a successful pact. A social fiscal pact also needs citizens who are willing to comply with their tax obligations, and who want to, and can, be regularly involved, directly and through their representatives, in monitoring management of public funds. As in any contract, the success of a fiscal pact depends on the incentives of the parties to participate and on the mechanisms available to monitor and enforce the agreement. More specifically, some of the factors that can help to produce or reinforce this type of social contract are:

- On the government side, incentives for building a fiscal pact depend on the *need to collect taxes* to meet financial and political commitments. This need will be less to the extent that the state has alternative sources of fiscal revenue, such as grants or non-tax revenue (for example, from oil or other natural resources). Access to credit or funds from monetary issues can also decrease (or delay) the need to collect taxes. The need to collect taxes will increase as the electorate, representative organizations or interest groups pressure to assert their demands on public expenditure.
- On the part of politicians, the incentives to become involved in a fiscal pact depend on the role they play in processes of decision-making and implementation of fiscal policies. In general, incentives will be greater the more *fiscal decisions have to be openly negotiated in institutional fora*, particularly in Congress, provided its members are closer to their voters than to party hierarchies. When Congress acts as an effective counterweight to government, it imposes limits on requests for resources from the executive, and contributes to overseeing the use of resources. Congresses that do not exercise this function, grant excessive tax powers to government or fail to exercise control over certain taxes and revenue (traditionally, taxes on imports or exports are fixed by government without legislative control; and specific allocations, known as "para-fiscal," are still a common source of revenue that is not controlled by the legislature even though it may have been approved by it).
- As for citizens and organized civil society, the incentives to participate depend on the *public accountability* of fiscal decisions, which is the ability to question tax decisions and allocation of fiscal resources through public discussion. Public accountability is essential for taxes to be perceived as legitimate by the majority of citizens and for "quasi-voluntary compliance" with tax obligations. Public accountability of fiscal policy depends on various factors:
  - *Tax visibility* helps give tax matters a prominent role in public political debates and, through this channel, favors the emergence of social fiscal pacts. Taxes on international trade or on production are less visible than VAT, which in turn is less visible than income and property taxes.
  - Public accountability increases with *tax systems that are simpler* and where there is less space for individual interests to exercise influence through covert mechanisms. However, in their quest for support from different groups of voters, politicians tend to make fiscal tax systems increasingly complex.
  - Public accountability is greater in *consolidated democracies* which tolerate very little fiscal indiscipline.
- Finally, the success of a fiscal pact depends on whether it is respected and whether its results are verifiable. Various factors affect the possibility of compliance with fiscal agreements:
  - *Competence of the tax administration and public administration* in general to routinely enforce tax and expenditure decisions.
  - *Fiscal transparency* so that lawmakers and the public know the real state of fiscal accounts.
  - *Fiscal integrity* which means financial control and independent audit of fiscal operations.

Although all these conditions seem impossible to achieve, the reforms of political systems, tax regimes and fiscal institutions in the last two decades have increased the possibility of successful fiscal pacts. Election reforms have improved incentives for voters to be directly related to their elected officials and have generally strengthened the representativeness of political parties in parliament. The capacity for deliberation and scrutiny of the proposals made by the executive has increased. Latin American congresses have ceased to be formal bodies of approval of government initiatives and become their active counterparts. The judicial branch has also acquired appreciable independence with capacity to effectively challenge the actions of government and decisions of Congress which could be considered contrary to constitutional principles and rules of procedure. All this means that the political class now has more incentives to become involved in fiscal pacts.

How to Foster Fiscal Pacts

Agreeing on a fiscal pact and making it work is easier said than done, but there are some policies that can improve the probability of success. The most obvious is strengthening fiscal institutions, especially improving fiscal *transparency and accountability*. Specific recommendations include:

- Passage of laws to grant free access to information and disclosure of fiscal results (as some countries have done as part of the fiscal responsibility laws).
- Inclusion of the operations of decentralized public bodies and para-fiscal resources in the budget.
- Explicit inclusion in the budget of "tax expenditures" which result from exemptions and special tax treatments granted to a group or sector, and quantification of the tax cost of any new exemption or incentive proposed in Congress. (The fiscal cost of exemptions is calculated at 9.2% of GDP in Colombia, 7.3% in Guatemala, and 6.3% in Mexico, to mention three critical cases.)
- Fixing explicit dates for termination of public expenditure programs so as to reduce bias toward the status quo and raise the political cost of continuing expenditure programs (especially spending financed from specific use taxes).
- Strengthen institutions of fiscal control and accountability mechanisms. Ex-post fiscal control by legislative bodies, which is practically non-existent in the region, should be a cornerstone of accountability systems.

However, development of true social pacts has to be seen as a long-term objective requiring patient work on several fronts, only one of which is improvement of fiscal institutions.

First of all, fiscal pacts cannot exist without *political leadership*. A fiscal pact requires the involvement of social groups, not only in the fiscal debate or enjoying the benefits of public expenditure, but also in "quasi-voluntary" compliance with tax obligations. The fewer social groups involved in a fiscal pact, the more likely it is to fail because it does not offer sufficient benefits to all. The talent of a leader lies in guaranteeing that benefits exceed costs for a sufficiently broad number of social groups, so that all gain from being part of the pact. To bring in the largest possible number of social groups, a leader has to recognize the fiscal and tax challenges and limitations not only in relation to the objective of macroeconomic stability (which is usually the bias of finance ministers) but also in relation to the goals of social equity, efficient expenditure, and control of corruption.

Various *institutions outside government* can contribute to the fiscal discussion and to public oversight of fiscal matters. Governments should not only tolerate but encourage the participation of these organizations in the fiscal debate:

- Specialized congressional committees responsible for presentation of tax reform proposals and budget bills.
- Independent central banks whose knowledge of fiscal problems in some countries is better than that of government or Congress.
- Universities and non-party think tanks with technical capacities and a long-term horizon that other actors in the fiscal debate lack.
- Congressional offices of independent technical support in fiscal matters, along the lines of the Congressional Budget Office in the United States, which can contribute to a well informed debate on fiscal matters inside and outside Congress. The limited experience of this type of office in Latin America (particularly in the cases of Venezuela and Mexico) suggests that their effectiveness depends not only on technical capacity but also fundamentally on the political incentives they have to face.
- Audits and comptrollers, which as a general rule are linked to parliament, should not be limited to overseeing compliance with processes and control rules but should move toward control of management and results.

Finally, a promising strategy for promoting social fiscal pacts is the mechanism of *direct democracy*, especially at the local level. When some level of macroeconomic culture exists, referenda and other mechanisms of direct popular consultation can contribute to fiscal discipline and the political sustainability of tax policy and public expenditure. In Latin America there is no tradition of direct consultation of voters on fiscal matters through referenda. The only country that has held popular consultations with some frequency on matters that have important fiscal implications is Uruguay, where decisions on privatization of state companies, for example, have been submitted to referenda. The evidence from developed countries on the effects of popular consultation on fiscal matters shows that it helps moderate public expenditure, and reduce deficits and levels of public debt. Direct democracy on tax issues should also help cut evasion and improve tax administration. Direct democracy can also limit the power of interest groups to receive fiscal transfers and other benefits at the cost of the public.

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How to Foster Fiscal Pacts

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In Latin America, participative budgets are the nearest approach to direct democracy in fiscal matters. The experience of Porto Alegre in Brazil offers important lessons:

- Direct community participation can resolve the blockade and consequent tendency to the fiscal status quo that characterizes very fragmented political systems.
- Community participation can counteract the bias of public expenditure toward the more economically and politically influential sectors.
- Community influence in decisions on public expenditure facilitates control of expenditure, reduces corruption and improves the effectiveness of public programs.
- As these results are achieved, the public becomes more willing to pay taxes, generating a virtuous fiscal circle.
- However, as is usually the case with institutional innovations, participative budgets have not been easy to transplant to communities with varied social or cultural conditions. But this does not mean that other mechanisms of participation cannot be found for very different communities.
- However, it should be borne in mind that direct democracy can harm institutions if it generates expectations that the public administration is not capable of satisfying.

The possibility of achieving fiscal pacts in Latin America has improved in recent years, and additional efforts by governments could help move the balance so that they become reality. However, it is important to close on a note of caution regarding what these initiatives can and cannot do. They can awaken the interest of citizens in public affairs, improve oversight of the actions of politicians, and facilitate achievement of social agreements on the priorities of public expenditure and ways of financing them. But however successful they are in these aspects, attempts to achieve fiscal pacts are not sufficient to overcome the limitations of the political processes of public decision-making or the deficiencies of the public administration. If political systems are prone to fiscal gridlock because some key actors tend to have veto power, the strategy of promoting a fiscal pact with the intention of overcoming these political barriers can be risky. In the end, fiscal pacts are only one component of the process of decision-making and implementation of fiscal policies.

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Fiscal Structures in Latin America

ed progressively but with a tendency to concentrate on higher income groups at the other levels of education. In health, spending distribution differs greatly from one country to another: it is clearly progressive in Argentina, Chile, Costa Rica, El Salvador and Honduras; approximately flat in Colombia and Uruguay; and strongly regressive in Bolivia.

- *In the area of social security, high benefits for very few and high current and actuarial deficits*. Only 27% of Latin Americans in the workforce are members of social security systems, and only one quarter of those over 65 receive pensions. Since in Latin America social security membership rates are higher in the higher income groups, spending on pensions is the most regressive of all types of social spending. Although the retirement-age population in Latin American countries represents a lower proportion than in developed countries when they were at our current level of development, and although pension coverage rates in Latin America are very low, pension systems are already overwhelmed by high current (or cash) and actuarial deficits (that is, the difference between accumulated reserves and vested obligations).

Finally, it is useful to debunk some myths on the debt situation in Latin America. Levels of indebtedness in the region are not systematically different from the rest of the developed or developing world. What is different is the composition of the debt. In Latin America, unlike other regions, borrowing is very concentrated in dollar securities and short-term local currency instruments. Contrary to what might be expected from simple principles of accounting, enormous fluctuations in the borrowing levels of Latin American countries are not mainly due to excessive fiscal deficits. Only 5% of changes in debt are explained by traditional fiscal results. The rest come from exchange rate devaluations (which raise the value of the debt in dollars), banking crises, and contingences and unforeseen or non-budgeted expenses, due to negligence or lack of transparency in fiscal accounts. (IDB, 2007)

New Publications

RESEARCH DEPARTMENT WORKING PAPERS

(All are in English only unless otherwise noted)

Aid and Growth: Politics Matters (WP-601)

Matteo Bobba and Andrew Powell

The literature on aid effectiveness has focused more on recipient policies than the determinants of aid allocation, yet a consistent result is that political allies obtain more aid from donors than non-allies. This paper shows that aid allocated to political allies is ineffective for growth, whereas aid extended to countries that are not allies is highly effective. The result appears to be robust across different specifications and estimation techniques. The paper suggests that aid allocation should be scrutinized carefully to make aid as effective as possible.

Returns to Private Education in Peru (WP-603)

Sebastian Calonico and Hugo Ñopo

Private education represents an increasing fraction of the Peruvian school system, especially in recent decades. Despite many claims about the differences in quality between private and public schools, there is no complete assessment of the varying impacts of these two providers on labor markets. This paper provides such a comprehensive overview by exploring private-public differences in the individual returns to education in urban Peru. The results indicate higher returns to education for private school attendees compared to public school students, particularly at the secondary level. Nonetheless, these higher returns also show higher dispersion, reflecting wider quality heterogeneity within the private system.

Corporate Governance in Latin America (WP-591)

Alberto Chong and Florencio Lopez-de-Silanes

This paper analyzes recent trends in investor protection in Latin America. The evidence, based on firm-level data for six countries, shows that, like legal protection of investors, appropriate firm-level corporate governance is linked to lower costs for capital, better valuation, performance, and dividend payments across countries. Firms can compensate for their countries' legal deficiencies with improved corporate governance practices, thus increasing transparency and limiting potential conflict between large and minority shareholders. Firms and regulators must improve their governance structures and shareholder protections if they are to meet the improved benchmarks of developed nations brought about by Asian, European, and U.S. scandals in recent years.

Money Laundering and its Regulation (WP-590)

Alberto Chong and Florencio Lopez-de-Silanes

The recent wave of terrorist attacks has increased attention to money laundering activities. This paper investigates empirically the determinants of money laundering and its regulation in over 80 countries by assembling a cross-country dataset on proxies for money laundering and the prevalence of feeding activities. The paper additionally constructs specific money laundering regulation indices based on available information on laws and their mechanisms of enforcement and measures their impact on money laundering proxies. The paper finds that tougher money laundering regulations, particularly those that criminalize feeding activities and improve disclosure, are linked to lower levels of money laundering across countries.

The Determinants of Corporate Risk in Emerging Markets: An Option-Adjusted Spread Analysis (WP-602)

Eduardo Cavallo and Patricio Valenzuela

This study explores the determinants of corporate bond spreads in emerging market economies. The paper finds that corporate bond spreads are determined by firm-specific variables, bond characteristics, macroeconomic conditions, sovereign risk, and global factors. Firm-level characteristics account for the larger share of the variance. In addition, the paper finds two asymmetries. The first is in line with the sovereign ceiling "lite" hypothesis that states that the transfer of risk from the sovereign to the private sector is less than one to one. The second is consistent with the popular notion that panics are common in emerging markets where investors are less informed and more prone to herding.

Targeting the Structural Balance (WP-598)

Laura dos Reis, Paolo Manasse and Ugo Panizza

This paper discusses whether a country should conduct fiscal policy by targeting a structural (or cyclically adjusted) fiscal balance. It discusses the concept of cyclically adjusted balance (CAB) and points out practical and conceptual problems with interpreting and measuring CAB. The paper also discusses the theoretical rationale for having a fiscal rule in general and a rule defined in terms of a cyclically adjusted balance in particular as well as the problems associated with adopting either one.

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New Publications

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Procyclicality or Reverse Causality? (WP-599)
Dany Jaimovich and Ugo Panizza

There is a large literature showing that fiscal policy is either acyclical or countercyclical in industrial countries and procyclical in developing countries. This paper argues that most of this literature is based on a methodology that does not permit the identification of the effect of the business cycle on fiscal policy and hence cannot be used to estimate policy reaction functions. The paper proposes a new instrument for GDP growth and shows that, once GDP growth is properly instrumented, procyclicality tends to disappear.

Public Investment in Infrastructure in Latin America: Is Debt the Culprit? (WP-595)
Eduardo Lora

Panel data for seven Latin American countries are used to assess the influence of public indebtedness on public investment in infrastructure in the period 1987-2001. Debt increases are associated with higher public infrastructure investment. This paper also finds some evidence of complementarity between public and private investment and of the negative effect of IMF adjustment loans on infrastructure expenditures. No evidence is found that debt defaults affect public investment in infrastructure.

La vulnerabilidad fiscal del gasto social: ¿Es Diferente América Latina? (The Fiscal Vulnerability of Social Expenditures: Is Latin America Different?) (WP-597)
Eduardo Lora
(In Spanish only)

This paper uses a panel of 50 countries for the period 1985-2003 to evaluate the vulnerability of public social spending (on education and health) to fiscal variables and public debt in Latin America as compared with the rest of the developing world. Social spending is significantly lower in Latin America (although it absorbs a larger proportion of primary spending) and is more vulnerable to higher debt interest payments but less affected by variations in other public spending. As in other developing countries, social spending declines as public debt increases, and more so if the debt is with multilateral banks. Unlike the rest of the world, when Latin America fails to meet its debt payments, social spending declines as a share of total public spending.

Becoming an Entrepreneur (WP-605)
Hugo Ñopo and Patricio Valenzuela

This paper analyzes the impact on income of the switch from salaried employment to entrepreneurship (self-employment and leadership of micro-enterprises). The results indicate that the income gains associated with the switch from salaried employment to entrepreneurship are positive, statistically significant and financially substantial. Additionally, the income changes associated with the reverse switches (from self-employment to salaried jobs) are negative. The results also suggest interesting gender differences, as females show higher gains than males on the switch from salaried jobs to entrepreneurship and lower losses on the reverse switch.

RESEARCH NETWORK WORKING PAPERS

Does Society Win or Lose as a Result of Privatization? The Case of Water Sector Privatization in Colombia (R-525)
Felipe Barrera and Mauricio Olivera
(In English only)

This paper studies the effects of water sector privatization on consumers' welfare in 46 municipalities in Colombia and finds positive effects, particularly in urban areas. There are four main results: (i) Privatization in urban areas increases access, improves quality and health outcomes and betters the frequency of service for the lower quintiles. (ii) Privatization increases the price of water in the lower quintiles, although this may reflect both privatization and the elimination of cross subsidies. (iii) In privatized municipalities with better governmental technical capacities there are positive effects on access, prices and quality. (iv) in rural areas, the positive impact on the frequency of service and health outcomes is outweighed by the negative impact on access and prices. These results suggest that the benefits found in urban areas should be expanded to rural areas, and that service should be more targeted toward the poorest.

Water Expansions in Shantytowns: Health and Savings (R-527)
Sebastian Galiani,
Martin González-Rozada and
Ernesto Schargrodsky

This paper examines the effects of the expansion of the water network in urban shantytowns in Argentina. It finds large reductions in the presence, frequency, and severity of diarrhea episodes among children in the households reached by network expansions. Moreover, expanded water connections induce savings, as these families are able to substitute piped water for more expensive and distant sources of water. These health and savings effects are also important for households that previously had clandestine self-connections to the water network, which were free but of low quality.

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New Publications

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The Impact of Electricity Sector Privatization on Public Health

Martín González-Eiras and Martín Rossi

This paper uses provincial-level data for Argentina to test for the causal relationship between electricity distribution and health. It examines the impact of privatization on two output measures: incidence of low birth weight and child mortality rates caused by food poinsoning. The evidence indicates that privatization reduced the frequency of low birth weight and child mortality rates caused by food poinsoning due to its impact on improving and increasing refrigerator use. The results are strong enough to inform the policy debate on the benefits of privatization for the welfare of the poor.

OTHER PUBLICATIONS

The Unexplained Part of Public Debt

Camila F.S. Campos, Dany Jaimovich and Ugo Panizza. Emerging Markets Review, Volume 7(3). September, 2006.

This paper shows that budget deficits account for a relatively small fraction of debt growth and that stock-flow reconciliation, which is often considered a residual entity, is one of the key determinants of debt dynamics. After having explained the importance of the stock-flow reconciliation, the paper shows that this residual entity can be partly explained by contingent liabilities and balance sheet effects.

Inequality and Informality

Alberto Chong and Mark Gradstein. Journal of Public Economics 91, 1-2, February, 2007.

This paper presents theory and evidence on the determinants of the size of the informal sector. It proposes a simple theoretical model in which the informal sector is positively related to income inequality, more so under weak institutions, and is negatively related to the economy's wealth. These predictions are then empirically validated using different proxies of the size of the informal sector, income inequality and institutional quality.

Trade Intensity and Business Cycle Synchronization: Are Developing Countries any Different?

Cesar Calderon, Alberto Chong, and Ernesto Stein Journal of International Economics. 71, 1, March 2007.

This paper studies whether trade intensity increases business cycle synchronization in developing countries as it does in industrial countries. Using annual information for 147 countries for 1960-99 (33,676 country pairs), the paper finds: (i) countries with higher bilateral trade exhibit higher business cycle synchronization; (ii) countries with more asymmetric structures of production exhibit a smaller business cycle correlation; (iii) the impact of trade integration on business cycles is higher for industrial countries than both developing and industrial-developing country pairs; (iv) the impact of trade intensity on cycle correlation is smaller the greater the production structure asymmetries between the countries.

Valieron la Pena las Privatizaciones?

Alberto Chong and Eduardo Lora. Nueva Sociedad, 207, January-February 2007.

Poor management of state companies and deficits in the provision of public services have inspired many Latin American countries to pursue privatization programs that have varied in geographic and sectoral scope across countries. This article argues that private participation has improved the efficiency of these firms and that overall, their social impact has been positive. However, the popular perception is quite different. Stronger regulatory mechanisms would help expand the benefits of privatization and change negative perceptions.

Effects of Economic Shocks on Children's Employment and Schooling in Brazil

Suzanne Duryea, David Lam and Deborah Levison. Journal of Development Economics. 2007

This paper uses longitudinal employment survey data to analyze the impact of household economic shocks on the schooling and employment transitions of young people in metropolitan Brazil. The paper compares households in which the male household head becomes unemployed during a four-month period with households in which the head is continuously employed and finds that an unemployment shock significantly increases the probability that a child enters the labor force, drops out of school, and fails to advance in school. The effects can be large, implying increases of as much as 50% in the probability of entering employment for 16-year-old girls. In contrast, shocks occurring after the school year do not have significant effects. The results suggest that some households are not able to absorb short-run economic shocks, with negative consequences for children.

Look Who's Talking

This section of the newsletter spotlights presentations or events sponsored by RES in recent months.

Violence and Displacement in Colombia

Orazio Attanasio presented a policy seminar to the IDB on December 7, 2006.

The population displacement resulting from civil conflict in Colombia has entailed substantial costs in terms of assets, human capital, and poverty, and policymakers have shown interest in curbing population flows resulting from conflict. Under these circumstances it is necessary to understand the determinants of mobility in a violent context and how welfare programs affect migration in that context.

Of particular importance is understanding the microeconomic underpinnings of household migration. These include social capital, risk exposure, shocks, liquidity constraints, and violence, as well as policy interventions; all of these factors may be seen as interacting with one another rather than as isolated phenomena. Moreover, policy interventions may have different impacts on migration depending on the level of violence. In the presence of low levels of violence, receiving benefits from the conditional cash transfer program Familias en Acción deters households from moving, as transfers mitigate the effects of aggregate risk and spill-over effects; in other words, families experience less pressure to move in order to support themselves. At high levels of violence, however, Familias en Acción benefits are associated with increased levels of migration. The prospect of receiving future benefits does not offset the risks associated with remaining in a violent place, and the funds acquired through initial participation can be used to finance a move to another location. Like a high incidence of violence, adverse income shocks also increase migration from conflict zones.

These results bear an interesting set of policy implications. If policymakers wish to curb migration from conflict zones, interventions oriented toward rural development and improving household insurance—particularly against income shocks—may prove highly effective. Welfare programs including conditional cash transfers may also prove effective, but they can be expected to curtail migration only at relatively low levels of violence.

Further research is needed in several areas. The first involves further work in experimental risk-sharing games to explore the effect of social capital on how individuals and households assess and manage risk. Second, a greater understanding is needed of how households choose to allocate their investments among physical assets, human capital and migration under conditions of extreme violence. Particular areas of interest involve the relationship of these factors with child labor and a more detailed understanding of the impact of conditional cash transfers under conditions of uncertainty. A final area that calls for additional research is intra-household risk diversification; in other words, do households manage risk by mechanisms such as migration by individual household members followed by transfers of income to the original household, or do household members change their allocation of time among different activities? The effect of conditional cash transfers on these mechanisms must be determined as well.

Evaluation Results of Chile Solidario: With Their Effort and One Opportunity

Emanuela Galasso spoke to the IDB on Feb. 20, 2007.

During the 1990s Chile's sustained economic growth reduced the overall incidence of poverty but nonetheless failed to benefit the extremely poor. In spite of increased social spending and highly targeted assistance, the extremely poor have displayed a low take-up rate of social programs due to constraints such as lack of information, social stigma, and a combination of transaction costs and administrative barriers. Additional cognitive and behavioral issues include short time horizons and difficulties in addressing the time-inconsistency between incurring present costs and realizing future benefits.

In 2002 the Chile Solidario anti-poverty program was introduced to target the extremely poor. The approach specifically addresses the traditionally low take-up rate of programs among the extreme poor, who are often unaware of their eligibility to participate. Chile Solidario aims i) to increase demand by modifying behavior and providing psychosocial support to address multiple dimensions of poverty, and ii) to increase the supply of social assistance for this population's needs. Households are targeted on the basis of correlates of chronic poverty, and of households invited to join the program; 96 percent accept.

Participation in the program consists of two phases. An initial intensive phase involves two years of intensive psychosocial support in which families begin by meeting with social workers to determine both their assets and their deprivation along a range of seven dimensions. Families subsequently identify their highest-priority needs and sign contracts with social workers to meet specific goals. In addition to receiving assistance in accessing other social assistance and transfer programs for which they are already eligible, households receive monthly cash transfers that taper off toward the end of the two-year period. A subsequent imple-

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mentation phase entails three years of efforts to help households increase their assets, skills, knowledge and autonomy. At the end of the five-year program, beneficiaries will ideally be able to sustain their exit from poverty through increased productivity and self-sufficiency as well as through the ability to access appropriate forms of social assistance in the event of shocks to household income and welfare.

On the basis of research undertaken so far, Chile Solidario has displayed only mixed results. Positive short-term outcomes include an increased uptake of social programs, increased enrollment in preschool, primary and adult education, and an increased use of preventive visits to health facilities by women and children. Perceptual benefits of the program include greater awareness of available social services and greater optimism in regard to the family's future prospects. (Interestingly, though, not all beneficiaries share the same reasons for optimism. Among rural residents, optimism is associated with improvements in health and education, while optimism among urban residents is associated with gains in labor income.)

Chile Solidario's ability to increase beneficiaries' self-sufficiency and earning ability, however, remains unclear. On average, participation in the program seems to have raised neither households' labor supply nor their labor income in the short term, though differences among households and observation of households who have not yet exited the program may affect these results.

Future evaluations of Chile Solidario will attempt to track medium and long-term outcomes. In addition, upcoming surveys will attempt to measure additional participants' affiliation with social networks, their degree of orientation toward the future, and the psychological distress they experience.

Network News

www.iadb.org/res/researchnetwork

Consulta de San José de Costa Rica

The Consulta de San Jose de Costa Rica is being conducted by the IDB Research Department in conjunction with the Copenhagen Consensus Center. The overall objective of this program is to help the region develop a clear and well-argued list of proposals for efficient solutions to some of the most important challenges facing Latin America today. To accomplish this objective, the project will draw upon the experiences of the worldwide Copenhagen Consensus 2004, but adapt them to the Latin American and the Caribbean context.

A key aspect of the process is the identification of the major challenges facing the region. Through an electronic survey sent to approximately 1800 people in the region, the following ten challenges have been identified: Poverty and Inequality; Education; Democracy; Lack of Infrastructure; Violence and Crime; Public Administration and Institutions; Fiscal Problems; Employment and Social Security; Health, and; Environment. A group of experts will write "solutions papers" and "alternative views" outlining the extent of each problem, the feasible solutions and their scope, and their costs and benefits. These papers will be subsequently submitted to a panel of highly esteemed economists, who will thoroughly discuss and rank the potential solutions during a roundtable to be held in San Jose, Costa Rica between October 21st and 25th, 2007. The final ranking constitutes the set of problems that, in the opinion of the panel of economists, could be most efficiently addressed.

For further information on the Consulta de San Jose, please visit our website at: http://www.iadb.org/res/ConsultaSanJose/index.cfm

Latin American and Caribbean Research Network

The IDB approved a $1,250,000 technical cooperation grant for the sixth phase of the Bank's ***Latin American and Caribbean Research Network***, which finances applied research and contributes to development policy agendas in the region. In its new phase, the Research Network will concentrate on identifying and studying mechanisms to promote **sustainable development** and improve the conditions for **social inclusion**. Topics will include: growth, investment and job creation; labor organizations and labor-management relations; institutions critical to enhancing innovation, competitiveness and productivity; governance and inclusion.