

Entrepreneurship and Social Mobility: What's the Connection?



Inter-American Development Bank
Research Department

Volume 32
September – December, 2013

Decades of policies to support micro and small enterprises as a means of boosting incomes and promoting social mobility in Latin America have raised more questions than answers: Do Latin American entrepreneurs raise their incomes faster than non-entrepreneurs of their own generation? Do today's young entrepreneurs run into more barriers to social mobility than those of previous generations? Do entrepreneurs' prospects for mobility vary according to their social origin? What family and personal background factors seem to be more conducive to entrepreneurship? Should public policy promote entrepreneurial activity in order to increase social mobility and expand the possibilities of advancement for the lower classes?

Entrepreneurship is often considered a vehicle for upward social mobility, especially for the middle class. Countries with large middle classes strive to support a vigorous business class because middle-class values and attitudes are often conducive to investing and innovating. However, the alleged entrepreneurial spirit of the middle classes is debatable and contradicts the fact that more entrepreneurs come from the upper classes.

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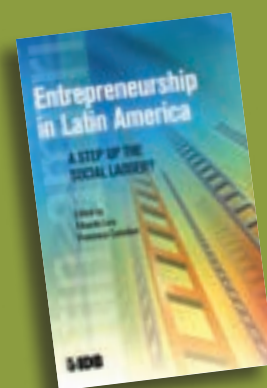
Similarly, although public policies in both developed and emerging economies often encourage entrepreneurship as a means of creating employment and promoting growth, the effectiveness of such policies is far from proven. This is especially true in developing countries, where entrepreneurship is the only recourse for many workers with no other opportunity to make a living, and where most firms are small and very unproductive.

This issue of IDEA summarizes recent research on these questions based on the book *Entrepreneurship in Latin America: A Step up the Social Ladder?*, recently published by the IDB. It provides interesting insights into the limits of policies to promote entrepreneurship as a vehicle for social mobility across heterogeneous segments of society. The dilemma in designing policies to promote social mobility and reduce inequality is whether to focus on policies that benefit specific socio-demographic groups or to facilitate mobility in general. General policies to facilitate firm creation and growth and foster education and the formation of productive capabilities may be necessary. But so too are specific measures to exploit the importance of role models for encouraging entrepreneurship, and strengthen social capital among potential entrepreneurs.

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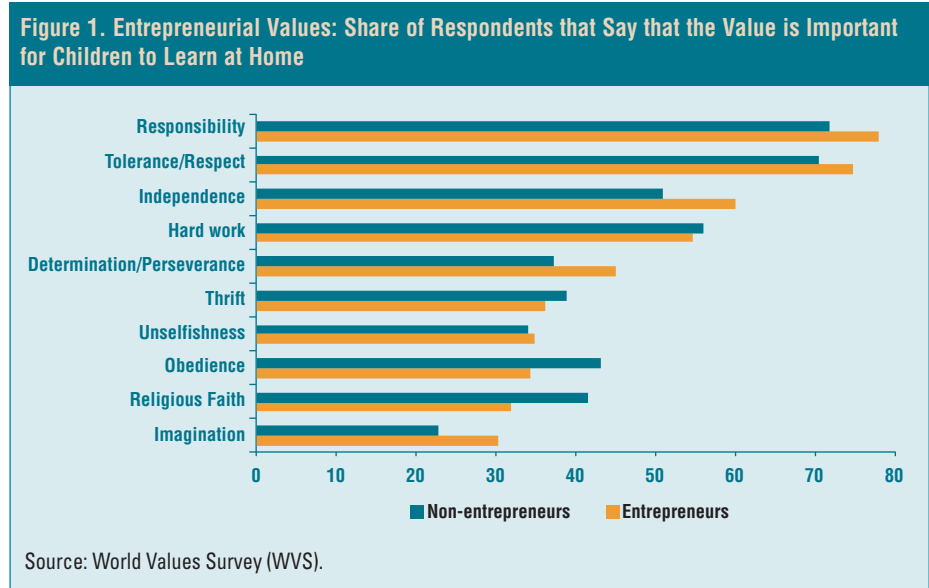


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It Starts at Home

An individual's place on the social ladder is the result of his efforts and achievements rather than his, or his parents', socioeconomic status—or is it? This idealistic adage is predicated on a society that offers equal opportunity for all, something that is more the exception than the rule in Latin America and the Caribbean.

A society offers greater social mobility when individuals in that society enjoy a substantially higher social standing than their parents. Unfortunately, in Latin America the opposite occurs more often than not: poor individuals are unable to provide their children with a good education and lack the connections to help them find good jobs and take advantage of good business opportunities. If the rich control the opportunities for success, their children will have a much greater chance of becoming successful. For this reason, countries where income is distributed in a very unequal manner



are also characterized by low mobility. Mexico is a case in point: with a Gini coefficient of 0.51, it also has one of the lowest levels of social mobility among OECD countries. At the

same time, Mexico is full of entrepreneurs, from some of the richest people on earth to millions of small artisans and street vendors.

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This issue of *IDEA* was prepared by Francesca Castellani, Eduardo Lora and Rita Funaro. It is based on the recently published Inter-American Development Bank book entitled **Entrepreneurship in Latin America: A Step up the Social Ladder?** edited by Eduardo Lora and Francesca Castellani. The book presents research by José Anchorena, Elizabeth Arteaga, Juan Federico, Hugo Kantis, Xavier Ordeñana, Lucas Ronconi, Andrés Solimano, Luis Trajtenberg, Roberto Vélez-Grajales, and Viviana Vélez-Grajales.

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IDEA (*Ideas for Development in the Americas*) is an economic and social policy newsletter published here 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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It Starts at Home

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Against this backdrop, Viviana and Roberto Vélez-Grajales decided to analyze the role played by entrepreneurship in promoting social mobility in Mexico. They reasoned that becoming an entrepreneur surely depends not only on talent and effort, but also on family factors, such as parents' wealth, education or profession. Identifying such factors could offer clues to whether entrepreneurship is a channel for social mobility or just a mechanism for reproducing existing inequality. Furthermore, it could shed light on how public policies should be redesigned to help overcome the barriers faced by poor and middle class entrepreneurs.

For their research, they made use of a unique piece of data: the Mexican Social Mobility Survey of 2006, which collected detailed socioeconomic information for a representative sample of individuals, including retrospective information on their parents.

Some of their findings were entirely predictable, but others were quite novel. Their results show that entrepreneurial activity is a good vehicle for upward mobility, in the sense that entrepreneurs tend to have higher living standards than their parents. However, the effect of entrepreneurship on social mobility is not uniform across social groups. Although entrepreneurs with lower-income parents experience upward mobility, it is more difficult for them to reach the top end of the socioeconomic distribution compared to those with parents who belong to the middle- or high-income end of the socioeconomic distribution. Even more importantly, the individual's decision to become an entrepreneur and his chances of success are strongly influenced by his father's occupation, but not by his father's wealth or education

(being Mexico, the study was done only for males, so the gender reference here is intentional). This is remarkable indeed, since it suggests that the lack of social mobility in certain professions, including entrepreneurship, has family roots that relate not with wealth per se, but with a set of values and experiences that are acquired early in life and for which it must be difficult to compensate later. The study on Argentina, which is summarized in another article, sheds further light on this important topic.

The Mexican study also provided an answer to another apparently simple, but very elusive question: do entrepreneurs make more money than non-entrepreneurs? Answering this is technically tricky, because one cannot directly compare entrepreneurs and non-entrepreneurs without making sure that the two groups are similar in all the other aspects that may have an effect on income, from family background to years of experience. Making good use of the richness of their data, Viviana and Roberto tackled this question using "propensity score matching" techniques, which basically find, for each entrepreneur in the sample, one or more non-entrepreneurs with very similar characteristics (including, of course, family background and all the other variables that may matter for entrepreneurial success).

Using the propensity score matching method, they found that entrepreneurs have on average incomes 17% higher than *comparable* non-entrepreneurs. In essence, this value represents the extra income that entrepreneurs receive for the additional risks and effort involved in entrepreneurship. However, to the extent that some non-observable characteristics, such as talent, differ between entrepreneurs and

Entrepreneurship enhances income mobility, but only for the relatively few with the right family background.

otherwise comparable non-entrepreneurs, this value may also be capturing the economic return to having such characteristics.

Finally, when Viviana and Roberto replicated the exercise by socioeconomic classes, they encountered another surprise: the return to entrepreneurship was substantially lower for those with parents who belonged to the middle classes, than for the rest.

Taken together, this research and its conclusions leave a bitter sweet taste. Yes, entrepreneurship enhances income mobility, but only for the relatively few with the right family background, and certainly not for the vast majority of those from the middle class who lack the ability to take risks and to make good managerial decisions. There is room for policy action, but it is limited. Policies should not be aimed at increasing the number of entrepreneurs, but at identifying and removing entry barriers to entrepreneurial activities. Since entrepreneurs tend to be exceptional individuals, the challenge is to target public programs accordingly, so as not to waste public resources simply promoting entrepreneurship.

Values Count

Argentina is home to many entrepreneurs: nearly one-fourth of the employed population is not salaried workers, but independent workers whose earnings depend on their businesses' ups and downs. However, the type of entrepreneurship that dominates the landscape is not conducive to economic growth. There are many "necessity" entrepreneurs, but not so many "opportunity" entrepreneurs. "Necessity" entrepreneurs are those who choose entrepreneurship because they lack a decent salaried alternative, not because they see a business opportunity or have the skills and motivation to assume risks and continuously seek efficiency gains in their business or trade. Only opportunity entrepreneurship is conducive to economic growth, according to the theories of Schumpeter and many others after him. This means that entrepreneurship is a matter of quality, more than quantity.

Among many other factors that may affect the quality of entrepreneurship, personal values may be the most important, but also the most difficult to gauge. José Anchorena and Lucas Ronconi researched the topic, focusing on Argentina. They specifically posed two questions: What are typical worldwide entrepreneurial values? And, does Argentine society support those values? To that end they made use of the 2005–2007 waves of the World Values Survey (WVS), a dataset with more than 50,000 interviews in over 50 countries. The WVS asks about the "qualities that children can be encouraged to learn at home." Respondents have to choose up to five of 10 alternatives: independence, hard work, sense of responsibility, imagination, tolerance and respect for other people, thrift (saving money and

things), determination and perseverance, religious faith, unselfishness, and obedience.

Rather than deciding a priori which values are entrepreneurial, Anchorena and Ronconi opted to infer them from the self-assessed values of entrepreneurs and non-entrepreneurs worldwide. The overall conclusion is that, worldwide, entrepreneurs place more emphasis—relative to non-entrepreneurs—on responsibility, tolerance and respect, independence, determination and perseverance, and imagination. They value obedience, religious faith and thriftiness less than non-entrepreneurs, and there is no significant difference between the groups as to unselfishness and hard work.

This classification seems eminently plausible. Some of the inferred entrepreneurial values are similar to those cited by Weber in his classic works on the subject, such as responsibility, independence, and perseverance. Weber and others also viewed obedience and religious faith as detrimental to the capitalist spirit insofar as they deterred rational economic behavior vis-à-vis traditional and non-scientific behavior. Meanwhile, tolerance has long been associated with nascent capitalism, emphasized by economic historians in the case of, for example, the vibrant seventeenth-century Dutch economy.

Given this background, which values characterize Argentine society? It is convenient to compare Argentina with other Latin American countries that share some historic and cultural traits (Brazil, Chile, Colombia, Mexico, Peru, and Uruguay), and with two countries rich in natural resources with populations of European descent (Australia and New Zealand).¹ In general, the values of Argentine society are better aligned with entrepreneurship than

those of the rest of Latin America, although this group is heterogeneous. Argentine society promotes more than the rest of Latin America six values supportive of entrepreneurship: higher independence, lower obedience, lower religious faith, lower thriftiness, higher determination, perseverance, and imagination. However, and maybe not surprisingly, Australia and New Zealand show values more aligned with those of entrepreneurs than Argentina: higher tolerance, higher independence, lower obedience, lower religious faith, and higher determination and perseverance. Only with respect to responsibility and thrift, does Argentine society display values more aligned with entrepreneurship than these two countries.

In sum, Argentine society overall promotes entrepreneurial values, but does so less than some successful, natural-resource-abundant economies, such as Australia and New Zealand. Although an exploration of the long-run determinants of these values must be left for future study, the authors conjecture that the periodic financial crises that Argentina has suffered have damaged the value of perseverance, while the country's authoritarian past has probably increased the value of obedience.

Values are shaped by history and public policy, and they are transmitted inter-generationally. In turn, they shape public policy because the electorate supports governments and institutions that reflect their values. Values certainly count.

¹Due to the fact that the question as to how many values the respondent can give (up to five) is an open one, only those respondents who mentioned exactly five values were compared across countries.

A Comparative Disadvantage: Latin American Entrepreneurs through a Global Lens

Entrepreneurship in Latin America bears no resemblance to that of other regions: beginning with size—most businesses are micro or small—and ending with motivation—entrepreneurs are what they are more “by necessity” than “by opportunity.” On top of these traits, Latin American entrepreneurs have little appetite for risk and innovation which, together with the limited availability of human capital, makes enterprises less sophisticated and innovative than their European or Asian counterparts.

Based on a survey designed to study the entrepreneurial process of dynamic new companies in select Latin American countries (Argentina, Brazil, Chile, Ecuador, El Salvador, Mexico and Peru), and countries in other regions (East Asia and Mediterranean Europe), Kantis, Juan, and Trajtenberg reveal the differences between entrepreneurial initiative in these regions focusing on middle-class entrepreneurs, who account for 55% of the total.

Middle-class entrepreneurs in Latin America have fewer resources and skills than their upper-class counterparts who have acquired more business experience at an early stage through their families and university education. Similarly, compared with other regions, middle-class entrepreneurs in Latin America are less exposed to the business world and to the business models to be followed. This lack of exposure results in greater reliance on a support network that is not appropriate for promoting business activities.

Access to finance is one of the most important restrictions when setting up a business. The lag from the moment the business idea is conceived

until the first business is set up is 4.4 years in Latin America compared with 1.5 years in Korea, 2.4 years in Taiwan and China, and 3.4 years in Italy and Spain. Middle-class entrepreneurs in other regions suffer fewer limitations with respect to financing a start-up than their counterparts in Latin America. Although personal savings remain the main source of financing in all regions of the world, access to external resources is more difficult in Latin America, providing a weaker platform for business creation. In Italy, Spain and Korea, middle-class entrepreneurs use private banks significantly more than in Latin America. Public sector support is also more accessible outside our region.

With this limited access to financing, plus high transaction costs and lack of continuing training for entrepreneurs, the region’s business fabric is unable to create dynamic enterprises that contribute to growth, industrial diversification and income mobility.

In Latin America, these enterprises tend to base their competitive advantage on product differentiation (56 percent). Lower prices and innovation strategies are much less frequent (27 percent and 38 percent, respectively) but the contrast is more apparent in relation to enterprises in other regions. In Taiwan and Spain, enterprises created by middle-class entrepreneurs tend to be more innovative (70 percent and 54 percent, respectively). Two-thirds (66 percent) of enterprises created by middle-class entrepreneurs in Latin America tend to operate in traditional sectors such as metallurgy, furniture, food and textiles and are less dynamic in exporting and job creation.

These findings offer ideas for policies to strengthen the contribution of middle-class entrepreneurial initiative to economic growth and are aimed at improving:

- **Education.** The processes for developing entrepreneurial skills need to be promoted at all levels of the educational system (from primary and secondary school on up) as a way of overcoming the disadvantages associated with social origins at the start of an entrepreneur’s career. In universities, this means promoting entrepreneurship among students in public institutions, which are those most used by the middle class.
- **Technical assistance.** An institutional platform for technical assistance can support business projects. This platform would help all entrepreneurs but could be especially useful for counteracting the disadvantages that middle-class entrepreneurs face compared with their counterparts in a higher social class and in other regions.
- **Networks.** Strategies for developing networks of entrepreneurs can be a tool for overcoming the potential disadvantages faced by middle-class entrepreneurs. Contacts and closer relationships with SME owners and executives of large companies are keys to creating dynamic new enterprises.
- **Finance.** Access to finance is the key to any effort to provide equal opportunities for the middle-class to start up businesses. Specifically, business capital is needed along with mechanisms to connect this finance to the entrepreneurs who need it.

The Power of Networks

Although experience and family values exert a strong influence on the decision to become an entrepreneur, support networks are essential for the survival and growth of small business projects. These are the findings of research conducted by Xavier Ordeñana and Elizabeth Arteaga on the role of social capital in the dynamism of businesses in Ecuador. Based on a new business survey and secondary data from other official sources, the study confirms that who you know is as important as what you know when it comes to entrepreneurial success.

Although the problems facing upper- and middle-class entrepreneurs are very similar, the tools to solve them are not. While Ecuadorian entrepreneurs have relatively weak support networks, middle-class entrepreneurs turn to external support more often than upper-class entrepreneurs. The resources of middle-class entrepreneurs revolve around friends and family, suppliers and customers, other entrepreneurs, business associations and universities. On the other hand, upper-class entrepreneurs depend more on colleagues and consultants. However, in neither case is networking a major factor. When it comes to dealing with either internal or external problems, 40 percent of middle-class entrepreneurs seek a solution by themselves compared to 51 percent of upper-class entrepreneurs.

In countries like Ecuador, entrepreneurial initiative, defined as owning a business, can play an important role in a country's economic performance. This definition excludes the self-employment that has been the focus of much research in the literature. When developing their

businesses, entrepreneurs face similar obstacles irrespective of their social origins; however, middle-class entrepreneurs are more affected by the availability of finance. All entrepreneurs must create networks to reach more customers, suppliers and partners and most place more confidence in their family or friends than on outside investment partners. Some 34 percent of entrepreneurs from the middle class look to family and friends for help while only 27 percent of those from the upper class take advantage of these relationships.

This lack of networking creates a space that is favorable for public support: public institutions can help entrepreneurs access new investment capital and new technologies to improve their businesses. Government agencies, including export promotion agencies such as the recently created Pro Ecuador, (Export Promotion Institute) can support entrepreneurs by improving their access to financing options, better technology, and a larger network. To date, however, few entrepreneurs (just 1 to 2 percent) use government agencies to start up or manage their businesses.

Most enterprises are small and have few opportunities for significant growth. Consequently, social capital, mainly in the form of family and friends, is crucial to the dynamics of their businesses. Entrepreneurs' capacity to build networks can have a significant impact on the size of their businesses and their probability of success.

Networks of family, friends and colleagues increase the likelihood of creating a dynamic enterprise. Entrepreneurs with access to this type of network have 0.177 more

Entrepreneurs' capacity to build networks can have a significant impact on the size of their businesses and their probability of success.

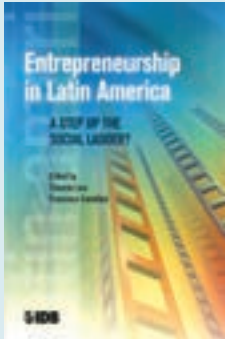
probability of owning a dynamic business. Overall, the resources used by entrepreneurs have a marginal effect on business results. Only resources associated with support networks (friends, family and colleagues) increase the likelihood of a fledgling company becoming dynamic.

The results presented herein are consistent with the literature, which finds that Latin American entrepreneurs often look to their private circle for advice. Although Ecuadorian entrepreneurs generally have a weak network, that network has a significant effect on their business success. This finding confirms other research on the importance of social capital that suggests that entrepreneurs with greater social capital have better access to resources and information that can affect the business process, and are likely to be more effective in recognizing business opportunities.

New Publications

Available in English only unless otherwise stated.

BOOKS



Lora, Eduardo, and Francesca Castellani, editors

Entrepreneurship in Latin America: A Step up the Social Ladder?

This book looks at the potential and the limits of policies to promote entrepreneurship as an important vehicle for social mobility in Latin America and the Caribbean, as well as steps to remove the constraints that hamper entrepreneurship.

WORKING PAPERS

Bassi, Marina, Matías Busso, and Juan Sebastián Muñoz

Is the Glass Half Empty or Half Full? School Enrollment, Graduation, and Dropout Rates in Latin America (IDB-WP-462)

This paper uses 113 household surveys from 18 Latin American countries to document patterns in secondary school graduation rates between 1990 and 2010. During that period, enrollment and graduation rates increased dramatically, while dropout rates decreased. The paper provides two explanations for these patterns. First, countries implemented supply-side measures to improve access to education by increasing funding for education and designing policies to help students remain in school. At the same time, returns to secondary education went up during the 1990s, creating an economic incentive to stay in school. Despite this progress, graduation rates remain low, and significant gaps in educational outcomes persist with re-

spect to gender, income quintiles, and regions within countries. In addition, wage returns have recently stagnated, and educational quality in the region is low, casting doubts on whether the positive trend is sustainable in the medium term.

Bastos, Paulo, and Sebastián Miller

Politics under the Weather: Droughts, Parties and Electoral Outcomes (IDB-WP-455)

The increasing occurrence of extreme weather conditions leading to drought is a key development challenge. Using rich, administrative data for drought declarations and mayoral elections in Brazil, this paper studies how these extreme events impact the political process at the local level. While accounting for current and historical rainfall patterns, the paper finds that: (i) municipalities led by a mayor affiliated with the incumbent president's party are more likely to receive formal drought declarations prior to municipal elections; and (ii) receiving a drought declaration reinforces the electoral advantage of incumbent mayors running for reelection.

Bastos, Paulo, and Odd Rune Straume

Preschool Education in Brazil: Does Public Supply Crowd Out Private Enrollment? (IDB-WP-463)

Using data for municipalities in Brazil from 2000 to 2006—where federal transfers to local governments change discontinuously with given population thresholds—this paper examines whether an expansion in the supply of public preschool crowds out private enrollment. Results from a regression-discontinuity design reveal that larger federal transfers lead to a significant

expansion in local public preschool services, but show no effects on the quantity or quality of private provision. These findings are consistent with the theory that households differ in their willingness to pay for preschool services, and that private suppliers react to an expansion in lower-quality, public supply by optimally adjusting their prices.

Chisari, Omar, Sebastián Galiani, and Sebastián Miller

Optimal Adaptation and Mitigation to Climate Change in Small Environmental Economies (IDB-WP-417)

This paper compares the optimal, dynamic choices between mitigation and adaptation policies for the Brazilian, Chilean, and U.S. economies. The focus is on the optimal role of mitigation and adaptation for “environmentally small economies” (i.e., economies that are witnessing an exogenous increase in emissions to which they contribute very little). The simulations lead to three main conclusions. First, small economies should concentrate their environmental efforts, if any, on adaptation. Second, small economies that are unable to spend enough on adaptation may end up spending less on mitigation, as negative climate shocks take a financial toll on them. Third, higher mitigation expenditures may arise not only because of greater optimal adaptation expenditures, but because richer countries provide incentives for mitigation.

Focanti, Diego, Mark Hallerberg and Carlos Scartascini.

Tax Reforms in Latin America in an Era of Democracy (IDB-WP-457)

The literature on taxes and public finance generally focuses on revenues,

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but revenues depend on many determinants other than the political will and policy objectives of the government. It is therefore important, when studying the politics of taxation, to evaluate specific changes to the tax code such as rates, bases and exemptions. With the underlying goal of exploring the political process and the determinants of tax policy, this paper compiles a novel and highly comprehensive database of tax reforms for Latin America between 1990 and 2004. It presents a description of the database as well as the stylized facts of tax reforms in Latin America. Examples of the database's uses are discussed, as is motivation for future research.

Gingerich, Daniel W.

Can Institutions Cure Clientelism? Assessing the Impact of the Australian Ballot in Brazil (IDB-WP-428)

This paper examines how Brazil's adoption of the Australian ballot (AB) transformed its electoral system from one of nominal voting to one of secret voting, thereby changing the nature of Brazilian party politics. Referring to the literature on political clientelism, the AB's impact on three outcomes is analyzed: (1) voters' ideological leanings at the ballot box; (2) degree of electoral control enjoyed by local vote brokers (i.e., local elites who direct the voting decisions of a subset of the electorate); and (3) citizens' capacity to effectively participate in the electoral process. The paper utilizes an original dataset containing municipal-level vote returns for federal deputy and senate contests during the period before and after the AB's introduction in Brazil (1958–62). The study finds that the AB: (1) shifted the ideological balance of power from right to left; (2) did not greatly weaken the hand of vote brokers; and (3) greatly increased the proportion of wasted votes cast in elections.

Ingtec and USP Research Group Productive Development Policies and Innovation Spillovers through Labor Force Mobility: The Case of the Brazilian Innovation Support System (IDB-WP-459)

This paper focuses on two research problems: (1) measuring the direct impact of innovation support measures in Brazil; and (2) testing whether innovation policies' indirect effects on non-beneficiary firms through the labor mobility channel are the result of direct support programs or of indirect support via tax incentives. For this purpose, mobility is defined as the movement of workers in technico-scientific occupations. It is found that, with the exception of subsidy programs, direct support in the form of credit or cooperative projects fosters more innovative effort than tax incentives. Nonetheless, direct and tax-based incentives for innovation have different purposes, and sound innovation relies on both types of incentives.

Kuusela, Olli-Pekka, Gregory S. Amacher, and Kwok Ping Tsang

Intensity-Based Permit Quotas and the Business Cycle: Does Flexibility Pay Off? (IDB-WP-450)

Tradable permit markets for carbon dioxide emissions respond to short-term fluctuations in the economy. To provide stability, both price and quantity interventions have been proposed. This paper focuses on the relative performance of fixed-versus-intensity allowances in the presence of both productivity and energy price uncertainty. Both instruments achieve the same steady-state emissions-reduction target of 20 percent (similar to current policy proposals), and the regulator then chooses the allowance policy that has the lowest expected abatement cost. A standard real business cycle (RBC)

model is used to solve for the expected abatement cost under both policies. Expected cost outcomes are compared using data from the U.S. economy as the baseline scenario. Unlike previous studies, this paper's results show that under a reasonable model calibration, fixed allowances outperform intensity allowances by a cost difference of as much as 30 percent.

Miller, Sebastián, and Mauricio Vela

Are Environmental Taxes Affected by Legislatures' Ideological Positions? (IDB-WP-443)

Environmental taxes have been discussed as one of the main mechanisms for dealing with environmental problems. Nevertheless, instruments of this type have rarely been implemented, and the adoption of new or higher environmental taxes has faced resistance in some countries. This paper identifies one possible political answer to why adoption of environmental taxes varies. One explanation is that legislatures' ideological position affects the degree of usage of taxes generally and environmental taxes, in particular. For example, right-wing parties tend to be less associated with environmental concerns and more associated with lower government intervention. This paper presents evidence that reflects this relationship, showing the positive association of more left-wing legislatures with higher levels of environmental taxation. A panel of data for 37 developed and developing countries over 16 years is used considering the percentage of total revenue from environmentally related taxes, the ratio of this revenue to total energy use and tax levels in industry and household sectors. The results show that most of these impacts involve environmentally related taxes in the industry sector. Proportional representation electoral

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systems and high seat concentration by few parties appear to be necessary conditions for the negative relationship of right-wing ideology with environmental taxes.

Miller, Sebastian and Mauricio Vela.

Are Environmentally Related Taxes Effective? (IDB-WP-467)

This paper focuses on the question of whether the magnitude of long-established environmentally related taxes (ERT) is related to countries' environmental performance. While environmental taxes efficiencies have previously been discussed, those taxes' contribution to reducing pollution and improving environmental quality has not been fully explored. This paper therefore analyzes the effectiveness of environmental taxes by examining the environmental performance of 50 countries from all regions in association with the amount of revenues from environmentally related taxes each country collects. Using a cross-section regression and a panel dynamic regression, the paper finds that countries with higher revenues from these types of taxes also exhibit higher reductions in CO₂ emission, PM₁₀ emissions, and energy consumption and production from fossil sources.

Robles, Gustavo, Gabriela Calderón, and Beatriz Magaloni

Economic Consequences of Drug-Trafficking Violence in Mexico [Las consecuencias económicas de la violencia del narcotráfico en México] (available only in Spanish) (IDB-WP-426)

This study contends that in Mexico there is a threshold above which drug-trafficking-related violence causes a general slowdown in the economy. Before that threshold is reached, firms and individuals pay for the increase in violence via protective security costs, a

decision that is reflected in the job market. Once violent conflict has escalated to a substantial degree, economic agents' medium- and long-term decision making is negatively affected, revealing a significant contraction in the economy. Using two different empirical strategies, this study proposes electricity consumption as an indicator of local economic activity. It is found that an increase in the levels of violence has significant, negative effects on labor force participation and employment. It is also found that cities that experienced a dramatic spike in violence between 2006 and 2010 sharply curtailed their energy consumption in the years following the spike.

Schneider, Ben Ross

Institutions for Effective Business-Government Collaboration: Micro Mechanisms and Macro Politics in Latin America (IDB-WP-418)

What makes for effective cooperation between government and business in industrial policy? Core research questions on the institutional design of arrangements for business-government interactions focus on three main functions: (i) maximizing the benefits of dialogue and information exchange; (ii) motivating participation through authoritative allocation; and (iii) minimizing unproductive rent seeking. Countries with more experiences of public-private collaboration (PPC) tend to have more pragmatic governments, and better organized and informally networked private sectors. Effective cooperation also depends on the macro context, in particular the nature of the political system and the alternative avenues it provides for business politicking, especially through parties, networks and appointments, the media, and campaign finance. Lastly, the structure and strategies of big domestic businesses—mostly diversified, family-owned business groups—affect

their preferences and interest in collaborating in industrial policy.

TECHNICAL NOTES

Borensztein, Eduardo, Eduardo Cavallo, Paula Cifuentes, and Oscar Valencia

Integrated Template for Debt Sustainability Analysis: Version 2.0, Instruction Manual, Revised Version [Plantilla integrada para análisis de sostenibilidad de deuda: versión 2.0, versión revisada del manual de instrucciones] (Available in both English and Spanish) (IDB-TN-576)

This technical note covers the Instruction Manual for Version 2.0 of the IDB Debt Sustainability Template. This updated template includes a new interface, more analytical functions, and greater flexibility for the researcher.

DATASETS

Berkman, Heather, Diego Focante, Maria Franco, Carlos Scartascini, Ernesto Stein, and Mariano Tommasi. **Political Institutions, State Capabilities, and Public Policy: An International Dataset (2013 Update).**

This document presents the codebook for an updated version of the 2008 database on Public Institutions, State Capabilities and Public Policy. While most databases have emphasized either the content of policies (e.g., size of government) or countries' formal institutions (e.g., political regime, electoral system), the main variables in this database reflect the policymaking capabilities of different polities. As such, this database includes indicators on key features of public policies (such as stability, adaptability, coordination, efficiency, and public regardedness)

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and on government capabilities (such as congress capabilities, judicial independence, political party institutionalization, and civil service). The value added of this database is not so much having generated new data as having compiled and aggregated existing data in a useful manner for empirical analysis.

Focante, Diego, Mark Hallerberg and Carlos Scartascini.

Tax Reforms in Latin America in an Era of Democracy. A Database.

This database compiles every tax reform that took place in Latin America between 1990 and 2004 according to the Worldwide Tax Summaries of PriceWaterhouseCoopers (PwC). As presented in the accompanying paper “Tax Reforms in Latin America in an Era of Democracy”, this database can be used for understanding the determinants of tax reforms in Latin America. Exact variable definitions as well as a summary of the reforms coded can be found in the codebook.

OUTSIDE PUBLICATIONS

Arizala, Francisco, Eduardo Cavallo, and Arturo Galindo

Financial Development and TFP Growth: Cross-Country and Industry-Level Evidence. *Applied Financial Economics* 23(6): 433–48, 2013.

This article estimates the impact of financial development on industry-level total factor productivity (TFP) growth using a largely unexploited panel of 77 countries, with data for 26 manufacturing industries for the years 1965 to 2003. A significant relationship is found between financial development and industry-level TFP growth when controlling for country-time and industry-time fixed effects. The results are both statistically and economically significant. TFP growth can accelerate up to 0.6%

per year, depending on the external finance requirement of industries, following a one SD increase in financial development. The results are robust to different samples and specifications.

Busso, Matías, John DiNardo, and Justin McCrary

New Evidence on the Finite Sample Properties of Propensity Score Reweighting and Matching Estimators. Forthcoming in *The Review of Economics and Statistics* 95(5), December 2013.

When comparing the finite sample properties of reweighting and matching estimators of average treatment effects, the existing literature concludes that reweighting performs far worse than even the simplest matching estimator. We argue that this conclusion is unjustified. Neither approach dominates the other uniformly across data-generating processes. By examining data-generating processes that mimic standard microeconomic datasets, we conclude that reweighting is more effective than matching estimators when overlap is good, but that nearest neighbor matching—possibly with bias-correction—is more effective when overlap is sufficiently poor.

Busso, Matías, Lucía Madrigal, and Carmen Pagés

Productivity and Resource Misallocation in Latin America. *The B.E. Journal of Macroeconomics* 13(1): 30, June 2013.

Total factor productivity (TFP) in Latin America has declined relative to the U.S. since the mid-1970s. This article applies a comparable methodology to firm-level data of 10 Latin American countries to quantify the heterogeneity of firm productivity and the extent to which resource misallocation can explain lower aggregate TFP. In general, productivity heterogeneity and resource misallocation are found to be

much larger than in the U.S. Achieving an efficient allocation of resources could boost manufacturing TFP between 41% and 122%, depending on the countries and years considered.

Cavallo, Eduardo, and Eduardo Fernández-Arias
Coping with Financial Crises: Latin American Answers to European Questions. *Revue internationale de politique de développement* 5.1: 7–28, 2013.

Europe faces challenges reminiscent of Latin American financial crises, namely unsustainable sovereign spreads, banking system distress, sudden stops in capital flows, and growth rate collapse. The failure of recent liquidity support to normalize the situation suggests the need to refocus the policy debate on fundamentals: structural reform for growth and, where needed, restructuring to resolve banking crises and the debt overhang. Latin America’s experience yields relevant policy lessons for Europe on all these fronts, tempered only by the slight exception that sharp real devaluation—key to spearheading recovery in Latin America—is unfeasible in the eurozone. Nevertheless, contemporary Europe stands a better chance of recovery because, unlike Latin America, the European Union possesses greater avenues for international cooperation, namely a resourceful European Central Bank, compared to the weaker, and less reliable, IMF. Arguably, limited external support strongly contributed to the depth of Latin America’s great collapses. European cooperation can exhaust alternatives to a euro exit to the benefit of all union members and, if dissolution becomes unavoidable, ensure amicable support to ease the transition. The path to success remains uncharted, however, and implementation of the necessary re-

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New Publications

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gional mechanisms will require innovation and political will. If the available means of cooperation are not used effectively, crisis countries in Europe may fare worse than those in Latin America.

Cavallo, Eduardo, Sebastián Galiani, Ilan Noy, and Juan Pantano

Catastrophic Natural Disasters and Economic Growth. *The Review of Economics and Statistics* 95(5), December 2013.

This paper examines the short- and long-term average causal impact of catastrophic natural disasters on economic growth by combining information from comparative case studies. Bearing in mind that the timing of large, sudden natural disasters is an exogenous event, we assess the counterfactual of the cases studied by constructing synthetic control groups. Only extremely large disasters have a negative effect on output both in the short and long term. However, this phenomenon results from two events where radical, political revolutions followed the natural disasters. Once we control for these political changes, even extremely large disasters do not reveal any significant effect on economic growth. Smaller (but still large) natural disasters have no discernible effect on output, either in the short or the long term.

Cavallo, Eduardo, Arturo Galindo, Alejandro Izquierdo, and John Jairo León

The Role of Relative Price Volatility in the Efficiency of Investment Allocation. *Journal of International Money and Finance* 33(2013): 1–18.

Using panel data for 26 manufacturing industries in 65 countries between 1985 and 2003, this article estimates the impact of relative price volatility on sector-level investment allocation. Re-

sults indicate that volatility distorts efficient investment allocation, in that investment is not necessarily allocated to relatively more productive sectors—especially in emerging market economies that are highly exposed and may lack the necessary institutions to deal with it successfully. The findings bolster the theory that relative price volatility provides incentives for entrepreneurs to adopt more “malleable” (but less productive) production technologies, enabling entrepreneurs to adapt more easily to abrupt, frequent changes in relative prices—albeit at the cost of using less productive technologies.

Cavallo, Eduardo, Andrew Powell, and Roberto Rigobón

Do Credit Rating Agencies Add Value? Evidence from the Sovereign Rating Business. *International Journal of Finance and Economics* 18(3): 240–65, July 2013.

The debt crisis in several European Union nations has resulted in downgrades in sovereign ratings, sparking a lively debate on whether these opinions actually matter. Ratings and bond spreads may both be considered as noisy signals of fundamentals. Ratings only add value if, controlling for spreads and observable country fundamentals, they help explain other market variables. Using a unique dataset of over 75,000 daily observations on emerging countries around rating actions by the three major agencies, we found that ratings do indeed add information.

Chang, Roberto, and Andrés Fernández **On the Sources of Aggregate Fluctuations in Emerging Economies. *International Economic Review* 54(4): 1265–93, November 2013.**

Recent research on macroeconom-ic fluctuations in emerging economies

has advocated introducing a stochastic productivity trend, or allowing for interest rate shocks and financial frictions. We estimate a model that encompasses these two approaches, shedding light on their relative merits and on how financial frictions affect the transmission of shocks. The model accounts for aggregate fluctuations by assigning a dominant role to financial frictions in amplifying conventional (temporary) productivity shocks, whereas trend shocks play a minor role. A link between spreads and expected future productivity emerges as essential for a reasonable approximation to the data.

Scartascini, Carlos, and Mariano Tommasi

Institutionalization of Political Institutions and their Impacto on Public Policy) *Institucionalización de las instituciones políticas y su impacto sobre las políticas públicas. In Nuevo institucionalismo: gobernanza, economía y políticas públicas, X. C. Arias and G. Caballero (eds.), Madrid, Spain: Centro de Investigaciones Sociológicas, 2013.*

This book chapter argues that institutionalization is an equilibrium phenomenon associated with better policies and better results in terms of economic development. To support this argument, we present a theoretical model that extends the space of feasible action for political actors, including the possibility of investing in both institutionalized and non-institutionalized arenas. This way, we can perceive the process of institutionalization as endogenous to the functioning of political institutions. In addition to this conceptual model, quantitative results suggest that low institutionalization in the context of traditional political institutions, particularly those de jure measures, may not be relevant in explaining policy outcomes.

Network News

The following proposals were selected for the project:
Building Institutional Capabilities for Productive Development Policies.

Argentina	Centro de Implementacion de Politicas Publicas para la Equidad y el Crecimiento (CIPPEC)	Building Institutional Capabilities for Productive Development Programs. Evidence from Argentina.
Argentina	Universidad de San Andres - UDESA	Building Capabilities for Productive Development Policies: The Argentine Case.
Brazil	Fundacion Getulio Vargas (FGV)	Learning from Productive Development Agencies in Brazil: Policies for Technological Innovation
Costa Rica	Consejos Economicos y Financieros, S.A. (CEFSA)	Building Institutional Capabilities for Productive Development Policies. The Case of Costa Rica
Ecuador	Stratega BDS	PDA's in Ecuador: What Works? Public vs. Private; Local vs. National; SMEs and social inclusive?

Econnet Seminars

Monetary Reform in Cuba through 2016: Between Gradualism and “Big Bang”

Presenter: *Pavel Vidal* (Universidad Javeriana Cali)

Jan. 9, 2014; 12-1:30 pm

IDB Headquarters, Room SE-1035

Emerging Sustainable Cities Initiative

Presenters: *Ellis Juan* and *Horazio Terrazas* (IDB)

Jan. 23, 2014; 12-1:30 pm

IDB Headquarters, Room SE-1035

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