

# Clientelism: Poison for Public Policy



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In recent decades, economists and political scientists have struggled to find precise cures for the ills of Latin America. In many cases, attempts have been made to implement policies that had already proven successful in other countries, as if they were part of a blanket prescription to be applied anywhere, anytime. Some of these have revolved around limiting government intervention in the economy or opening up markets and increasing competition. These policies have sometimes changed frequently and drastically in response to shifting political winds.

Nevertheless, the failure of many of these policies and the search for better results in terms of economic development in the Latin American context, have prompted the IDB Research Department, starting in the early 2000s, to manage projects focused less on specific remedies and more on analyzing the basic ingredients necessary for successful policymaking, no matter the type. In this thinking, there are no universal cures for Latin America. Nor are there any technical fixes apt for each country at each moment in its history. More important is establishing sound fundamentals which, analysts say, should guarantee that policymaking is consistent over time, adaptable, well coordinated, efficient, effectively implemented and enforced, and oriented towards the public good.

**In Latin America, clientelism pervades civil services; bureaucrats entrusted with critical areas of national life are often hired more for their political value than professional competence.**

Unfortunately, Latin America has fared rather poorly in generating those qualities. Beginning with the 2006 edition of the IDB’s flagship publication, **The Politics of Politics**, on how countries design and implement effective programs, numerous comparative reviews have been conducted using surveys of experts and international databases. In a 2013

IDB update, researchers found that the quality of policymaking in Latin America and the Caribbean trailed behind high-income countries in the Organisation for Economic Co-operation and Development, as well as the regions of East Asia and the Pacific, Europe, Central Asia, and South Asia. It lagged slightly behind the Middle East, North Africa, and sub-Saharan Africa. In Latin America, Chile, Uruguay, and Costa Rica have the strongest policymaking practices, while Haiti, Paraguay, Bolivia, Ec-

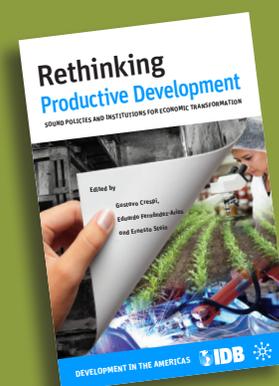
cuador, Guatemala, Nicaragua, and Venezuela have the weakest ones. As a result, the Latin American average is at a level comparable to that of most countries in sub-Saharan Africa (see Figure 1).

Why the shortcomings? Analysts looking at government systems conclude that good policymaking depends on key features, including a small number of well-developed political parties with clear, long-term agendas and a

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## COMING SOON!



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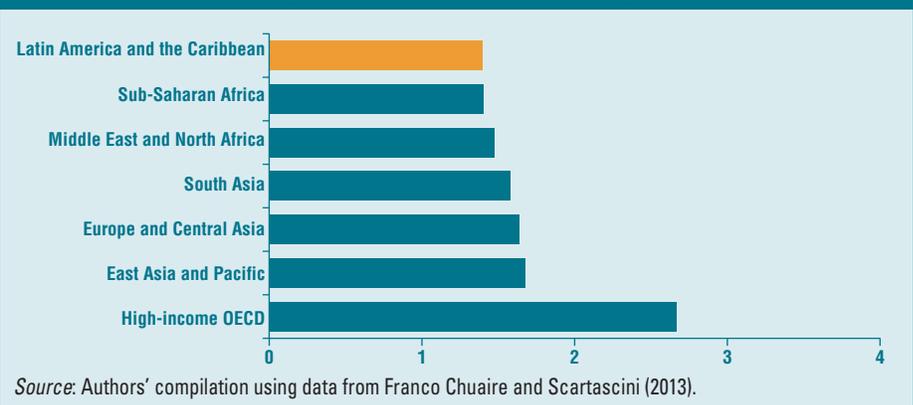
# Clientelism: Poison for Public Policy

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professional legislature with the ability to negotiate and enforce agreements. It also requires an independent judiciary and a technically competent civil service that acts not for private interests, but for society as a whole. Table 1 shows how Latin American and Caribbean countries fare in terms of these key features.

Not surprisingly, Latin America and the Caribbean also was found lacking in most of those categories. The region's parties scored higher than those of any other part of the world in terms of their institutional development. But the capabilities of its congresses were in last place among the world's regions, and the level of its judicial independence stood only above that of the Middle East, North and sub-Saharan Africa. The capacity of its civil services, long afflicted with clientelism, corruption, and technical incompetence, was hardly better,

**FIGURE 1. Government Capabilities: An International Comparison**



coming in second last of the world's regions.

At an IDB conference May 12 dedicated in part to governance issues, several experts on Latin America focused on civil services and the clientelism and corruption that taint them. This issue of *IDEA* presents some of

their findings. Using papers from the conference as well as others produced for the IDB, it looks at how clientelism can hurt the poor, how citizen monitoring can improve government performance, and how political and institutional factors can be crucial to reform.

Reform is anything but easy. In most of Latin America, clientelism, or patronage, pervades civil services so thoroughly that bureaucrats entrusted with critical areas of national life, like health, education, and economic affairs, are often hired more for their political value than their professional competence. A victorious political party demands the right to staff ministries with its followers. A president orders a bureaucratic expansion to increase the number of state employees who will vote and campaign for him at election time. Civil servants accept bribes and steal from the public coffers, knowing that they will be protected by patrons higher up. These cases of clientelism are deeply entrenched in Latin America, and they have severely impeded development.

Yet moving to systems in which hiring, firing, and promotion are based on merit requires more than the passing of civil service laws. Laws can always be ignored or manipulated. More important

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This issue of *IDEA* was prepared by Steven Ambrus and Rita Funaro, and is based largely on research conducted at the IDB on governance issues. The articles presented in this newsletter are based on the research of Paulo Bastos, Paolo Buonanno, María Franco Chuaire, Daniel Gingerich, Enrique Kawamura, Sebastián Miller, Virginia Oliveros, Sebastián Saiegh, Carlos Scartascini, Christian Schuster, Jorge Streb, and Juan Fernando Vargas.

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**TABLE 1: Government Capabilities and Overall Index of Policymaking**

Country by Policy Index Level	Congress Institutionalization Index	Party System Institutionalization	Judicial Independence	Bureaucratic Quality	Government Capabilities Index
<b>High</b>					
Brazil	Medium	Low	Medium	High	Medium
Chile	High	Medium	High	High	High
Costa Rica	Medium*	High	High	High	High
Uruguay	High	High	High	Medium*	High
<b>Medium</b>					
Argentina	Low	Low	Medium	Medium	Medium
Colombia	Medium	Medium	Medium	High	Medium
Dom. Rep.	Medium	Medium	Medium	Medium*	Medium
Guyana	High	Medium	Medium	Medium	Medium
Jamaica	High*	High	High	High*	High
Mexico	Medium	Medium	Medium	Medium	Medium
Panama	Medium*	Medium	Medium	Low	Medium
Peru	Low	Low	Medium	Medium	Medium
El Salvador	Medium	Low	Medium	Low	Medium
<b>Low</b>					
Bolivia	Low*	Medium	Medium	Low	Low
Ecuador	Low*	Low	Low	Medium	Low
Guatemala	Low	Low	Medium	Low	Low
Honduras	High*	Medium	Medium	Medium	Medium
Haiti	Very low <sup>^</sup>	Very low <sup>^</sup>	Low	Low	Low
Nicaragua	Low*	Low	Low	Medium	Low
Paraguay	Low*	Medium	Low	Low	Low
Venezuela	Low	Low	Low	Low	Low

Source: Authors' compilation using data from Franco Chuaire and Scartascini (2013).

Note: Countries were classified, first, according to their policy index values and then alphabetically within those groupings. For each institutional variable, light blue represents "high" values, pale orange represents "medium" values, and pale yellow represents "low" or "very low" values.

\* Countries missing half or more of the components of the given index. In particular, Jamaica's Government Capabilities Index has lower confidence than the rest of the countries because its construction lacks more than half of the components for two of the indices.

<sup>^</sup> Haiti was excluded from the cluster analysis for the Congress and Party Institutionalization Indices and classified as "very low" due to an exceptionally low score compared to other countries.

are incentives that force key players towards renewal. If politicians rarely act from pure altruism, they can be pushed to make the right choices. Specifically, they may mend corrupt systems when they are deprived of their ability to use those systems for electoral gain. Successful initiatives take that into account. In Chile, for example, reforms enacted in January 2004 reduced the number

of appointed positions in the public administration by nearly 70%. They also created a council that provides the president with a list of qualified candidates for top positions from which he can choose, taking away his ability to choose agency leaders purely on the basis of politics. Chile, along with Uruguay and Costa Rica, stand out as exceptions in Latin America, with high-performing

civil services. As donor agencies try to nudge the rest of Latin America towards more professional bureaucracies, with permanent, autonomous employees who feel free to offer their opinions and act in the greater public good, they may look to see what worked in those countries. They may also look to see where incentives lie for transformation in other areas of the region. The challenge is huge.

# Politics under the Weather

The predictions are grim and the challenges enormous. With temperatures rising 1.6 to 6.7 degrees Celsius, Latin America will see more intense storms, water shortages, drought, and disease during the 21st century, according to the most recent report by the United Nation's Intergovernmental Panel on Climate Change. New tasks will be urgently required. Engineers increasingly will be compelled to erect sea walls, agronomists to develop drought-tolerant crops, and doctors to confront new epidemics. Huge demands will be placed on professionals of all sorts to create new technologies to adjust to the changing world. But climate change also will test political institutions. As governments dole out large sums to help their citizens adapt to the new weather and recover from climate disasters, they will need to ensure that disbursements are done in a fair and equitable way. They will have to guarantee that much-needed resources help the citizenry at large instead of being used to buy votes, redistribute power, and pervert democracy.

Until now, relatively little research has been done on the political implications of climate change. Some scholars have looked at the problem of fraud and corruption in the allocation of international relief funds. Others have appraised the impact of disasters on internal political dynamics. But few studies have been done to scrutinize how relief spending can affect elections and voter preferences or what might be done to design and manage relief-related activities to shield them from political influence.

That, however, is beginning to change. Recent research at the IDB looks at the impact of the

disbursement of drought relief in Brazil. It considers how party affiliation impacts the likelihood of receiving emergency funds and how the delivery of those funds affects the prospects of mayors seeking reelection. The results give reason for pause. They suggest that partisan considerations can indeed play a role in deciding who gets emergency relief. Moreover, they demonstrate that receiving such aid can give an incumbent mayor a real advantage, perhaps, in some cases, determining an election.

Drought affects nearly every region of Brazil, with the exception of the Amazon, and the money distributed in response provides an essential lifeline. Municipal governments use it to hire water trucks, drill wells, provide credit for farmers, subsidize animal feed, and provide a host of other services without which many citizens might not survive. As climate change worsens, those services become ever more essential. Beginning in 2010, northeastern Brazil has experienced prolonged periods of low or nonexistent rainfall that have killed hundreds of thousands of cattle, withered all types of crops, and ignited water conflicts among desperate farmers.

While most mayors and federal officials genuinely want to relieve that suffering, they are not immune to the temptation of manipulating their access to money and goods for political gain. When a drought strikes, a mayor must request a drought declaration from the state governor who then forwards the petition to the federal Ministry of National Integration, which can declare a state of emergency or public calamity for up to 180 days and authorize the disbursement

of cash and other resources. But the process of declaring such states of emergency is not scientifically rigorous or clearly defined by criteria like the amount of rainfall or soil moisture. There is always room for partisan meddling. Indeed, in municipalities where the mayor was affiliated with the president's party and thus likely to enjoy privileged political connections, the chance of receiving a drought declaration in the two years before the municipal elections of 2004 and 2008, increased by an average of 4%. That, in turn, improved the mayor's chances of reelection by about 3% as the cash began to flow.

Many nongovernmental organizations and newspapers in Brazil have denounced what they dub the "drought industry" in which large landowners and their allies access emergency funds to make improvements on their properties and increase their economic standing in ways that are utterly unrelated to emergency conditions. They allege that the emergency funds, in effect, buy the votes of influential constituents, who then compel their employees to go out and vote for generous, money-disbursing mayors.

The research at the IDB makes no such claims. It does, however, suggest that grateful voters reward mayors who can provide relief in their hour of need, just as they would doom a mayor who seemed ineffectual or indifferent to their suffering. And it advances the notion that since access to a drought declaration and its accompanying benefits is not determined by clearly objective factors, there is all too much room for gaming the system, so that members of the dominant party

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# Presidents and Patronage

Patronage can lead to corruption, low economic growth, poverty, and even higher child mortality. It also is a tenacious foe. Donor agencies pump huge amounts of money into rooting it out. They fund civil service and public administration reform. Yet, those well-intended efforts typically have little impact. Despite myriad attempts at technical solutions, 10 out of 18 Latin American nations were found to have classically clientelist bureaucracies in a 2005 Inter-American Development Bank study.

Not surprisingly, institutional and political factors may be more important than technical ones in improving public administrations. Citizens' groups and lending agencies may press to ensure that governments appoint, promote, and give tenure to the most qualified personnel. Donors may provide expertise. But one of the greatest predictors of success is the extent to which political systems either allow or restrain presidents from controlling patronage.

Two examples from recent history illustrate the point: the governments of Paraguayan President Fernando Lugo from 2008 to 2012 and the Dominican Republic's President Leonel Fernández from 2004 to 2012.

Both presidents arrived in office under politically difficult circumstances. Lugo, a former bishop, was the first head of state from outside the dominant Colorado Party (ANR) in more than 61 years, and controlled only one seat in the senate and one seat in the chamber of deputies. Fernández similarly commanded few seats in congress and came from a party that owed its victory to an alliance whose future loyalty was questionable.

Both presidents faced pressure to improve their civil services. The bureaucracies of Paraguay and the Dominican

Republic rank among Latin America's least meritocratic in the IDB's 2005 study, and both nations had committed to greater transparency and professionalization through the 2003 Latin American Civil Service Charter. They also had received international funds to do so. Citizen demands for reform were tepid in Paraguay. But by 2008, a broad civil society coalition of NGOs, religious organizations, and private sector associations in the Dominican Republic was clamoring for change.

Paradoxically, however, it was Paraguay, not the Dominican Republic, that began to professionalize its public administration. Between 2008 and 2013, the Dominican Republic passed landmark legislation, including a public service law, a public salary law, and 2010 constitutional reform with merit and tenure protections. But in Paraguay, where legislative reform languished, new policies affecting public sector performance steamed ahead. Competitive exams for civil service posts rose from a cumulative total of seven before 2008 to a maximum of more than 11,000 per year between 2008 and 2012, filling 26% of vacancies. The ministries of health, education, and agriculture especially benefited, and Paraguay improved in the World Bank's Control of Corruption indicator from the seventh to the 25th percentile rank. In the Dominican Republic, by contrast, the number of positions filled through competitive exams never exceeded 475 per year. The country, under Fernández, fell in the World Bank's corruption indicator from the 42nd to the 23rd percentile rank.

Why the different outcomes in countries with such long histories of entrenched clientelism? Recent research suggests that a determining factor may have been the extent to which each president had discretion to make budget

and personnel decisions affecting electoral success.

If Fernández's government pushed through legislation oriented, at least formally, at improving the quality of public servants, his weak political position also encouraged him to fill the bureaucracy with people whose primary qualification was their willingness to vote for him in subsequent elections. His dominance of the civil service under the nation's laws and regulations gave him every right to do so. At least until the 2010 constitutional reform, the president had the legal authority to approve every single public servant in the executive branch, from the lowest clerk to the most senior administrator, and dismiss any employee at will. He could increase the budget and size of the bureaucracy, raise salaries, and demand promotions. That dominance over the public administration paid off. During the 2008 elections, 13 of the nation's 16 ministries mobilized in support of Fernández's Partido de la Liberación Dominicana (PLD), and the president was reelected with around 54% of the vote. Membership in his party soared from around 33,000 in 2000 to 2.7 million in 2013. The new norms intended to increase merit in the civil service were never enforced. With so much to gain from using the bureaucracy as an electoral tool, there simply was no incentive to do so.

By contrast, Paraguayan President Lugo faced huge constraints on his control over the bureaucracy. In Paraguay, ultimate control over personnel expenditures, employment, and promotions lies not with the presidency but with congress, where Lugo had little support. As a result, the president could not use appointments on a mass scale to build political support for future elections.

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# Citizens as Watchdogs

Governments and international donors have long struggled to ensure accountability in large projects where patronage, inefficiency, or outright corruption can lead to misallocation of resources and funds. One innovation has been the creation of community-monitoring initiatives that allow citizens to provide feedback on projects. Proponents believe such social audits not only improve project performance, they facilitate communication between communities, service providers, and politicians while boosting transparency and accountability long term.

To date, however, the efficacy of such initiatives has not been fully tested. International aid agencies and nongovernmental organizations stress the importance of involving citizens in development endeavors. More than 60 governments, including 15 in Latin America, have committed to increase citizen participation through the Open Government Partnership, to which the IDB provides support. But the extent to which community oversight can actually improve services while cutting down on corruption and waste remains an open question.

A recent experience gives reason for hope. In 2008, the Colombian government launched the Citizen Visible Audit (CVA) program to involve communities in the fight against corruption in education, health, housing, sanitation, water, and energy endeavors. A typical CVA employs several steps. Newspapers, radio, and television outlets announce forums at which the communities' rights and the executing firm's responsibilities are explained. Representatives of the firm, supervisors, and local authorities meet with the community and commit to resolve problems. The community

monitors the project, and facilitators serve as a bridge to higher authorities, communicating problems, if they persist, to the level of the local or national government.

By the time the program was inaugurated in 2008, Colombia already had tried to fight corruption on many fronts. The new initiative looked impressive on paper. But would it work? Would citizens receive enough information about projects to do the monitoring? Would they find the time to become involved? Would politicians respond?

Recent research provides encouraging answers on all fronts. The CVA program did increase information, citizens did take an interest, and citizens were willing to sacrifice other activities to become involved in monitoring-related activities. Indeed, the tracking or monitoring of projects was 51% greater among participants than nonparticipants.

Most importantly, perhaps, the monitoring was having an impact. According to surveys, the CVA program

resulted in a 21% increase in the number of citizens reporting that projects had adequate resources and a nearly 23% increase in overall satisfaction with the projects. CVA communities also were more likely to rate their politicians as good or very good, rewarding their representatives with a 15% increase in performance as a result of the monitoring program.

A certain self-fulfilling prophecy did affect the dynamic. In places where citizens had little belief in the ability to hold politicians accountable, they were less likely to participate in monitoring. That meant that the project received less visibility, and, in turn, politicians had less incentive to behave better.

But overall, the results were highly encouraging: citizen engagement and oversight can significantly boost the quality of projects affecting citizen well-being. They can increase citizen satisfaction, and they can help elevate the quality of political representation. Corruption and inefficiencies may be hard to combat. But open government, it seems, can work.

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## Politics under the Weather

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are favored in their reelection bids in ways that potentially smack of patronage and clientelism.

What can be done? Researchers suggest that, in the first instance, the evaluation process for declaring a drought be tightened so that resources flow to the most afflicted regions rather than those with the most politically connected leaders. They also advocate improving mechanisms of oversight in the financing and administration of elections to ensure that recipients of

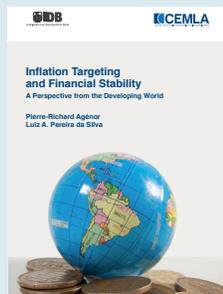
emergency funds are the most affected and destitute rather than the biggest contributors to a mayor's reelection efforts.

Climate change will not wait. Brazil, like the rest of the world, may well face climate disasters on its coasts and in its interior such as it has never experienced before. The challenge is to address those threats in ways that not only provide citizens with physical safety, but also strengthen their political institutions.

## New Publications

Available in English only unless otherwise stated.

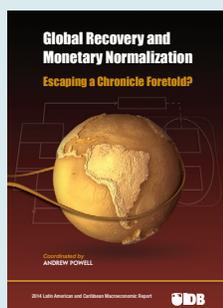
### MONOGRAPHS



*Agénor, Pierre-Richard, and Luiz A. Pereira da Silva*  
**Inflation Targeting and Financial Stability: A Perspective from the**

#### Developing World (IDB-MG-175)

This paper provides a brief review of the financial system in middle-income countries, the domestic effects of capital flows, and the link between excessive credit growth and financial crises. It describes the features of the inflation-targeting regime, highlighting the challenges the inflation-targeting framework has faced in recent years (e.g., fiscal dominance, fear of floating, and imperfect credibility). The paper then discusses the role of monetary policy in achieving financial stability in the context of a proposed “integrated” inflation-targeting regime.



*Powell, Andrew*  
**Global Recovery and Monetary Normalization: Escaping a Chronicle Foretold?**  
*(Also available in Spanish)*

#### (IDB-AR-109)

Monetary normalization may be a chronicle foretold, but countries still have the power to influence the outcome for their own economies. This report focuses on the risks Latin American and Caribbean countries face and how they can reduce vulnerabilities and enhance opportunities.

### WORKING PAPERS

*Agüero, Jorge M.*

#### Long-Term Effect of Climate Change on Health: Evidence from Heat Waves in Mexico (IDB-WP-481)

This paper estimates the long-term effects of climate change on health outcomes in Mexico by using year-to-year variation in temperature. Combining temperature data at the district level and three rounds of nationally representative household surveys, an individual’s health as an adult is matched with the history of heat waves from birth to adulthood. A flexible econometric model is used to identify critical health periods with respect to temperature. It is shown that exposure to higher temperatures early in life has negative consequences on adult height. Most importantly, the effects are concentrated during those periods when children experience growth spurts: infancy and adolescence.

*Armas, Adrián, Paul Castillo, and Marco Vega*

#### Inflation Targeting and Quantitative Tightening: Effects of Reserve Requirements in Peru (IDB-WP-499)

This paper provides an overview of the reserve requirement measures undertaken by the Central Bank of Peru. It provides a rationale for the use of these instruments as well as empirical evidence of their effectiveness. In general, the results show that tightening reserve requirements has the desired effects on interest rates and credit levels at both banks and smaller financial institutions.

*Barajas, Adolfo, Roberto Steiner, Leonardo Villar, and César Pabón*

#### Inflation Targeting in Latin America (IDB-WP-473)

Estimates for Brazil, Chile, Colombia, and Peru show that central banks increase their repo rate in response to increases in the output gap and—except in Peru—to deviations of inflation expectations from their targets. In the presence of external shocks, Chile, Colombia, and Peru temporarily abandoned their conventional reaction function. There was limited evidence that the countries studied have used some form of integrated inflation targeting. Strong evidence exists that intervention in foreign exchange markets is determined by exchange rate misalignments rather than by exchange rate volatility, and that most countries seem particularly affected by a strong currency. Central banks appear to have pursued an inflation objective using a standard Taylor rule and an exchange rate objective through interventions in the foreign exchange market.

*Bazdresch, Santiago, and Alejandro M. Werner*

#### Finance and Employment Formalization: Evidence from Mexico’s Income-Expenditure Surveys, 2000–2010 (IDB-WP-324)

This paper studies the relationship between financial slack and employment formalization by using heterogeneity in industry-level financial dependence. Heterogeneity, along with time-series variation in aggregate credit, is used to determine industry-level financial slack and measure its relationship to employment formality. Also discussed are two basic models of formality and finance as a tool for interpreting the results. In contrast to similar studies, these estimates suggest that more financial slack in an industry results in lower formality in that industry. This result is consistent with a model where formal employees and/or informal firms are capital-constrained agents affected by policy. The results

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## New Publications

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are consistent with the notion that financial slack, rather than employment formality, allows employees to become informal independents and/or allows informal firms to grow. Descriptive statistics on age, schooling, and formality, as well as estimates from samples conditioned on these variables, also support this notion.

*Castillo, Victoria, David Giuliodori, Alessandro Maffioli, Alejandro Rodríguez, Sofía Rojo, and Rodolfo Stucchi*

### **El impacto del apoyo al cluster de TIC de la ciudad argentina de Córdoba [The Impact of ICT Cluster Support in the Argentine City of Córdoba] (Available only in Spanish) (IDB-WP-460)**

This paper estimates the direct and indirect effects of support received between 2003 and 2007 by ICT producers in the city of Córdoba under the Supply Chain Development in the Province of Córdoba Program. Two complementary approaches were considered for estimating indirect effects: externalities associated with job mobility and externalities associated with geographic proximity. The direct-effect and indirect-effect estimates were calculated using a random effects model in which lagged dependent variables control for selection bias. The model is based on the assumption that companies consider past performance when deciding whether or not to participate in the program. Direct and indirect effects were found to be positive and significant on sales as well as on employment, wages, and exports.

*Frisancho, Verónica, Kala Krishna, Sergey Lychagin, and Cemile Yavas*

### **Better Luck Next Time: Learning through Retaking (IDB-WP-483)**

This paper provides evidence that retaking competitive exams several times may reduce the impact of a disadvantaged background on educational out-

comes. Using administrative data from the university entrance exam in Turkey, the paper estimates cumulative learning between the first and  $n$ th attempt at retaking the exam while controlling for selection in terms of observed and unobserved characteristics. We found substantial learning gains in terms of improved test scores, especially among less-advantaged students.

*García-Cicco, Javier, and Enrique Kawamura*

### **Central Bank Liquidity Management and “Unconventional” Monetary Policies (IDB-WP-484)**

Using a small, open-economy model, this paper analyzes the role of central bank liquidity management in implementing “unconventional” monetary policies within an inflation-targeting framework. In particular, the paper models the facilities used by the central bank to manage liquidity in the economy, creating a role for the central bank balance sheet in equilibrium. Such modeling enabled us to analyze two “unconventional” policies: sterilized exchange-rate interventions and an expanded list of eligible collaterals to be accepted by the central bank’s liquidity facilities. These policies have recently been implemented by several central banks; the former policy was adopted as a way to counteract persistent appreciations in the domestic currency, and the latter was adopted in response to the global financial crisis of 2008. As a case study, the paper provides a detailed account of the Chilean experience with these alternative tools, as well as a quantitative evaluation of the effects of some of these policies.

*Mariscal, Rodrigo, and Andrew Powell*

### **Commodity Price Booms and Breaks: Detection, Magnitude and Implications for Developing Countries (IDB-WP-444)**

There has been much interest of late regarding the current commodity “super cycle.” However, even sizing the current boom implies knowledge of long-run trends that are notoriously difficult to estimate. This paper uses new techniques to identify breaks in commodity prices and estimate trends and cointegrating relationships, and argues that the weight of evidence is against stable and declining commodity terms of trade. The results are used to characterize the current boom and, assuming no new break, how commodity prices would be expected to return to the estimated “equilibrium.” The paper also discusses implications for commodity-dependent developing countries.

*Miller, Sebastián J., and Mauricio A. Vela*

### **Is Disaster Risk Reduction Spending Driven by the Occurrence of Natural Disasters? Evidence from Peru (IDB-WP-500)**

This paper studies the allocation of public spending on total disaster risk reduction among regions in Peru. Its objective is to identify the main determinants of how these resources are distributed. For that purpose, an index of historical physical impacts of natural disasters, social vulnerability, and institutional capacity was created. The paper finds that historical impacts of climatological disasters are positively correlated with the per capita amount the regions receive to prevent future natural disasters. On the other hand, the impacts of geological disasters adversely affect the amount of resources budgeted and expended to cope with the effects of previous disasters. Prevention expenditures are mainly driven by climatological effects on the agriculture sector. In addition, results confirm that higher social vulnerability—a major determinant of how prevention spending is distributed—is dependent on climatological disasters. Institutional capacity seems to affect the amount of recovery expenditures only;

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## New Publications

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regions with greater institutional capacity receive more recovery spending when ravaged by geological disasters but less recovery spending when devastated by climatological disasters.

*Pereda, Paula C., Tatiane A. de Menezes, and Denisard Alves*

### Climate Change Impacts on Birth Outcomes in Brazil (IDB-WP-495)

This paper attempts to predict the potential impact of climate change by identifying the climatic effect on birth outcomes in Brazil. Panel data models show that excessive and insufficient rainfall has the most significant harmful effects on newborns' health; temperature stresses and low relative humidity also have an adverse impact. Climate change forecasts for Brazil suggest a possible increase of 305 neonatal deaths annually and, for families in the Primary Care Program, 3,000 additional low-weight births each year. The paper further examines the role of public policy in minimizing the effects of extreme weather. Mothers' education, sanitation access, and health care assistance to pregnant women represent the main instruments for addressing neonatal health problems.

*Urrutia, Miguel, Marc Hofstetter, and Franz Hamann*

### Inflation Targeting in Colombia, 2002–2012 (IDB-WP-487)

After decades of using monetary aggregates as the main instrument of monetary policy and having different varieties of crawling-peg exchange rate regimes, Colombia adopted a full-fledged inflation-targeting regime in 1999. This regime involves a floating exchange rate, inflation as the nominal anchor, and short-term interest rates as the primary instrument. This paper examines the Colombian central bank's performance over the last decade—a period of consolidation and innovation of its infla-

tion-targeting strategy. It studies the increasing number of instruments used by the Colombian central bank, such as systematic foreign exchange interventions, announcements, capital controls, changes in reserve requirements and, sporadically, macro-prudential policies. Using a small-scale, open-economy policy model, the paper also examines some political economy dimensions that help explain the behavior of the Colombian central bank during that period.

## POLICY BRIEFS

*Fernández-Arias, Eduardo, and Jorge Eduardo Pérez Pérez*

### Grading Fiscal Policy in Latin America in the Last Decade (IDB-PB-216)

Fiscal policy in Latin America has been historically imprudent and continues to be viewed with skepticism. At the same time, most countries have remained out of trouble for several years and were able to successfully conduct proactive, countercyclical fiscal policy to fight the Great Recession, a historical first. This paper examines the last decade to assess progress, highlight weaknesses, and chart the way forward. It looks at structural fiscal balances, filtering out the business cycle and commodity price fluctuations to assess prudent fiscal policy concerning cyclical management and long-run sustainability. Up to the Great Recession, countries deserved good grades—in the “B” range—on both counts. Afterwards, satisfactory cyclical management continued but, critically, extraordinary circumstances led to regime change at the level of the underlying structural balance. Successful, countercyclical fiscal policy was prudently undertaken during the crisis but not decisively unwound in its aftermath, leaving behind an unsatisfactory fiscal stance. With this “Incomplete,” grades slipped to the “C”

range and may end up as an “F” unless there is normalization to pre-crisis levels, to regain sustainability. On a constructive note, the paper distills lessons from experience and charts the path of fiscal reform to reach an “A” grade.

*Scartascini, Carlos, and Mariano Tommasi*

### Government Capabilities in Latin America: Why They Are So Important, What We Know about Them, and What to Do Next (IDB-PB-210)

This policy brief takes stock of the research on government capabilities undertaken at the Inter-American Development Bank. In addition to highlighting the relevance of government capabilities for achieving better policies and higher levels of development, it summarizes what has been learned about the origins of those capabilities. The paper also suggests avenues for further exploration, and derives lessons (and caveats) for institutional reforms and for the operational work of the Bank.

## TECHNICAL NOTES

*Támola, Alejandro*

### Credit, Labor Formality and Firm Size: Analytical Framework and Regional Evidence in the Context of the IDB's Country Strategy Dialogue (IDB-TN-627)

This technical note summarizes the results of a series of papers prepared under the “Credit, Formalization, and Firm Growth” project. Those papers were prepared to enlighten the overall policy dialogue and the IDB's technical assistance work with its borrowing members, particularly with regard to financing the lending programs of small and medium enterprises. The main results can be summarized as follows: i) a positive association between formality and

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## New Publications

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credit conditions in the region appears to be empirically relevant but dependent on idiosyncratic conditions and unevenly distributed depending on firm size; ii) the positive associations between credit conditions and other measures of firm performance (e.g., size, growth, and investment) appear to be heterogeneous depending on firm size; and iii) the empirical assessment of the links between formal credit and the various measures of firm performance may benefit from considering alternative sources of funding, such as internal funds.

### OUTSIDE PUBLICATIONS

*Bonvecchi, A., and C. Scartascini*  
**The Organization of the Executive Branch in Latin America: What We Know and What We Need to Know.** *Latin American Politics and Society* 56(1): 144–65. Spring 2014.

This article proposes a research agenda for organizing the executive branch in Latin America by reviewing the literature on the U.S. and Latin American presidencies and outlining the research gap between them. The study finds that while strong, region-wide patterns have been established about cabinets in Latin America, research is

lagging behind on the presidential center, presidential advisory networks, and their effects on policymaking. The article sets forth a series of research questions and suggests a combination of quantitative, social network, and case study strategies to address them.

*Cristiá, J., A. Czerwonko, and P. Garofalo*

**Does Technology in Schools Affect Repetition, Dropout and Enrollment? Evidence from Peru.** *Journal of Applied Economics* 17: 89–112. May 2014.

Many developing countries are allocating substantial resources to expand technology access in schools. Whether these investments will translate into measurable educational improvement remains an open question due to limited evidence. This article helps fill the knowledge gap by evaluating the impact of a large-scale public program that increased computer and Internet access in public secondary schools in Peru between 2001 and 2006. Using the rich, longitudinal, school-level data generated by this program and a differences-in-differences framework, it was found that increased technology access in schools has no statistically significant effects on repetition, dropout, and initial enroll-

ment. Large sample sizes allowed us to rule out even modest effects.

*Tommasi, M., C. Scartascini, and E. Stein*

**Veto Players and Policy Adaptability: An Intertemporal Perspective.** *Journal of Theoretical Politics* 26(2): 222–48. April 2014.

The capacity to sustain policies over time and to adjust policies in the face of changing circumstances are two desirable properties of policymaking systems. Veto player theory, a very influential approach in comparative politics, has suggested that polities with more veto players will have the capacity to sustain policies at the expense of the ability to change policy when necessary. This article argues that once intertemporal considerations are explicitly included, it is not necessarily true that polities with more stable and credible policies have more difficulty adapting their policies, nor that polities with more veto players have more difficulty adjusting policies to new circumstances. More generally, the article argues that, when studying the effects of political institutions on policy outcomes, an intertemporal perspective might lead to predictions different from those emanating from more atemporal approaches.

## Presidents and Patronage

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Instead, he sought to professionalize ministries with the goal of improving performance, increasing benefits to all citizens, and winning support on the basis of good governance. Areas where meritocracy advanced included high-profile, socially oriented programs like the health care program in the Ministry of Health, the family agriculture program in the Ministry of Agriculture, and the child and adolescent support

program in the Ministry of Children. The media responded positively, and Lugo, at least for a while, benefited. Irrespective of his personal desire to make the system more accountable, political and institutional restraints had pushed him down the road to reform.

It is yet to be seen how relevant Paraguay's experience is to other countries where laws and institutions put brakes on the presidential use of

patronage. But the recent histories of both Paraguay and the Dominican Republic suggest that institutional and political factors matter; that they matter profoundly; and that no matter how well intended the international community might be, it can only help countries achieve civil service reform if it considers that politicians may well use patronage if it helps them earn votes and win elections.



## Look Who's Talking

### *2014 Latin American and Caribbean Macroeconomic Report*

#### **Andrew Powell presented this year's edition of the Latin American and Caribbean Macroeconomic Report: *Global Recovery and Monetary Normalization: Escaping a Chronicle Foretold?***

The current recovery presents risks as well as opportunities. In spite of recovering global growth, which is particularly strong in the United States, a notable slowdown has occurred in emerging markets. In Brazil and Mexico, this slowdown can largely be explained by suppressed growth in the advanced economies, while in China and India it was more related to country-specific factors. Looking forward, there are three significant risks: i) a positive risk to U.S. growth; ii) potential road bumps on the path to monetary normalization, with episodes of interest rate volatility; and iii) risks to growth in China as a result of a strong increase in credit. Depending on the specific scenario considered, the net effect of these risks may be nearly neutral for Latin America and the Caribbean as a whole. The combined shock, though, may have different effects across countries, with a negative impact on South America and a positive impact on Mexico and Central America.

In general, the region remains vulnerable to external shocks, and its response capacity needs to be enhanced. A first factor to consider is that the region's fiscal position has weakened in recent years, and countries that increased fiscal spending during the global financial crisis did not retreat thereafter. This suggests that the region has not truly graduated from

pro-cyclical fiscal policy; to engage in countercyclical policy, countries must not only allow structural deficits to rise in bad times but also ensure that those deficits fall when better times resume. In addition, while public debt ratios are considerably lower than in the 1990s (and more often denominated in local currency), they have been increasing in recent years.

A second vulnerability lies in the increase in external private sector bond financing and its greater composition in foreign currency. At the same time, domestic credit has also displayed strong growth. This growth offers benefits to the region, which remains under-banked, but it may also entail risks depending on how credit is allocated and financed. Domestic credit has recently been financed by banks' external financing and by the deposit of nonfinancial firms that have also issued overseas, largely in U.S. dollars.

Third, capital flows and monetary policy are vulnerable to the recent decline in net purchases of Latin American and Caribbean bond and equity funds. Such a decline can have strong impacts, most notably on output. Exchange rate adjustment can cushion these shocks, but this is not an option for all countries in the region.

Fourth, while the region's risk of experiencing a sudden stop in capital inflows is lower than in the 1990s, it is higher than in 2007. Since then, the region's larger economies have become more vulnerable in terms of domestic dollarization, current account balance, and fiscal balance. In addition, reserves remain below optimal levels.

The region nonetheless displays strengths that depart from previous trends. These strengths include the following: i) a lower level and better structure of public debt than in the 1990s;

ii) increased use of the exchange rate as a cushion against shocks; iii) high solvency and liquidity ratios for financial systems; iv) improved financial regulation and supervision; and v) high levels of reserves in dollar terms.

A major remaining challenge in Latin America and the Caribbean is the creation of sustainable economic growth. Such growth is normally associated with increasing productivity, and the region's gains in productivity have proven low and variable.

Several conclusions emerge from the analysis. First, if monetary normalization is smooth, the region is set to gain from the global recovery. Second, countries have less room to respond to negative shocks than in 2007. Third, in order to improve their resiliency, countries should: i) strengthen their fiscal and external accounts; ii) deepen automatic stabilizers and institutions to bring about a genuinely countercyclical, discretionary fiscal policy; and iii) carefully monitor private sector balance sheets. Finally, countries should undertake reforms to promote sustainable medium- and long-term growth.

### Panel

#### **Steven B. Kamin Federal Reserve**

There is broad agreement with the Macro Report's main points, particularly the following: i) the outlook for Latin America and the global economy; ii) the importance of productivity growth and fiscal control; iii) concerns about balance sheets and credit growth; iv) implications of monetary policy normalization in advanced economies; and v) risks of sudden stops.

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## Look Who's Talking

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More particularly, the global outlook is likely to be characterized by a normalization of economic activity, the convergence of inflation to normal rates, and the normalization of monetary policies. The effects of monetary policy normalization on emerging market economies (EMEs) should be manageable, as central banks are likely to communicate policy intentions clearly. This will have the effect of allowing investors to unwind exposed positions and, in the context of a stronger global economy, boosting EME trade. Moreover, EMEs themselves are less vulnerable than in the past. Nevertheless, risks remain, as monetary policy normalization can interact with EMEs' remaining vulnerabilities, and these vulnerabilities will be exacerbated if growth flags.

### Ernesto Talvi, CERES (Centro de Estudios de la Realidad Económica y Social) and Brookings Institution

The report's expectations of growth for the region are based on two assumptions: i) an orderly monetary normalization in the United States; and ii) a low probability of the occurrence of tail risk events. These caveats aside, the report rightly notes the determinants of countries' fiscal positions and the risks associated with those determinants.

Four features of current conditions should be noted. First, the current situation is different from the monetary normalization of 2004, as the forthcoming normalization is expected to lead to a significant increase in long-term interest rates, i.e., policy rates. Second, while the 2004 normalization was preceded by a long drought in capital that had only recently begun to ease, current conditions in Latin America and the Caribbean are marked by high liquidity, asset and commodities booms and appreciated currencies. A U.S. interest rate increase may consequently necessitate macro adjustment in the

region. Third, a significant macro adjustment is unlikely to lead to a crisis because of i) high liquidity ratios; ii) the availability of multilateral institution financing to countries with sound fundamentals; and iii) remaining gains from de-dollarization measures. Nonetheless, in light of high credit growth and extensive bond issuance in international markets, significant deleveraging could take place, dampening consumption and investment. Fourth, it is important to monitor deteriorating fundamentals, as increasing public deficits and debt may create incentives to delay reforms, especially in the case of countries that can put off reforms through access to international capital markets.

### Vladimir Werning J.P. Morgan

While markets admittedly have different emphases than academics and policymakers, particularly due to a short-term bias, several observations can nonetheless be made.

First, while the markets generally concur with the Macro Report's outlook and assessment of risks, several points of difference should be noted. Notable among these points is that markets do not see much flexibility available in demand-side policies, especially given low slack in labor markets. In terms of particular countries, the market sees Brazil as a victim of its own policies, including economic micromanagement, rather than reflecting world trends. Mexico, in contrast, has experienced success on the supply side, though its growth may not prove sufficient to meet social demands, especially as the country's growth may be declining. Nonetheless, Mexico is well equipped to benefit from U.S. growth and is on track with structural reforms. Unlike certain other commodity-exporting countries in the region, Mexico is unlikely to be affected by China's shift

away from investment to consumption and slower growth. An increase in China's manufacturing competitiveness, however, may affect Mexico.

Second, markets share the Macro Report's concern with structural balances. These balances remain little discussed in many quarters, even though countries in the region display significant vulnerabilities in their terms of trade.

Third, the markets see the impending monetary normalization as somewhere between the adjustments of 1994 and 2004, and may already have priced in a basic rate change scenario. Moreover, markets are attempting to consider transmission channels, which are not clearly discernible at present, even though central bank communication has improved. Private sector banks are meanwhile dealing with increased regulatory burdens.

A final area worth noting is public and private debt. While governments of all ideologies in the region have improved their fiscal management, the markets share the Macro Report's concerns that countries have little room to adjust by means of exchange rates. The private sector, on the other hand, seems less vulnerable to foreign exchange risks. Several features of corporate debt merit particular consideration. First, there is presently a strong appetite for Latin American and Caribbean corporate issues, many of which are of good grades. Second, debt is being issued by firms that are paid in dollars, such as Petrobras and Pemex, rather than participants in the carry trade. Third, the markets generally see the shift to bonds from bank loans as healthy, particularly as banks are facing increasing capitalization requirements; bonds are additionally moving firms to longer-term debt profiles. Fourth, recent corporate failures in the region have stemmed from factors other than debt profiles, and those failures have not had systemic effects.