I D E A
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A New Generation of Social Programs

Money isn't everything, especially when it comes to social policy designed to reduce poverty. Having little money is only one symptom of poverty, which has many causes. They include low levels of education and skills, social exclusion, malnutrition, ill health, and a mismatch between where people live and where job opportunities exist. Extended over time, these conditions can produce a cycle of poverty in which younger generations lack not only the means to improve their circumstances but also networks and role models for participating in mainstream society.

Money alone cannot break this cycle. At best, unrestricted cash transfers and subsidized prices provide short-term relief and boost consumption. Without careful targeting, though, benefits may be delivered to individuals who do not really need them. At worst, such benefits can lead to dependency rather than productivity. The resulting political backlash can jeopardize all social spending and not merely inefficient programs.

> Conditional cash transfer programs (CCTs) have replaced unrestricted cash payments and price subsidies in several Latin American countries.

A new generation of social policies and programs takes these complex realities into account. In several Latin American countries unrestricted cash payments and price subsidies are being replaced by conditional cash transfers (CCTs). CCT programs are distinguished from their predecessors in three ways. First, eligibility for receiving benefits is determined by stringent and closely monitored criteria. Requirements vary across countries, but programs target households with the lowest incomes, consumption levels, and assets. In many instances these programs also target geographical "poverty pockets."

Second, CCT programs focus on children in order to break the cycle of poverty by attempting to provide younger generations with the education, nutrition and health care that will enable them to become productive and self-sufficient adults. For this reason, CCT payments have so far been made only to mothers, the parents usually seen as most committed to and involved with children's wellbeing.

Third, as their name suggests, CCTs are not "money for nothing." To continue receiving payments, parents must demonstrate measurable commitment to a variety of child-care goals. These include regular school attendance—usually 85 percent or above—age-appropriate height and weight gain, and keeping children's vaccinations up-to-date. Failure to meet these objectives can lead to a loss of benefits. In addition to providing for children's wellbeing, these conditions prevent less conscientious parents from using program participation as merely another source of cash for personal use.

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The Research Department (RES) is pleased to present the first issue of *IDEA (Ideas for Development in the Americas)*, which replaces *Latin American Economic Policies.* Like its predecessor, *IDEA* will report on recent research on major economic and social problems affecting Latin America and the Caribbean. New features of the newsletter include information on recent RES publications and presentations, highlights from RES' macroeconomic monitor (LatinMacroWatch), and news from RES' numerous networks. Any and all comments are welcome and should be directed to IDEA's managing editor, Rita Funaro at Ritaf@iadb.org.

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A New Generation of Social Programs

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Perhaps the most famous and best-studied CCT program in Latin America and the Caribbean is Mexico's rural Progresa initiative, which has recently been renamed Oportunidades and expanded to include urban areas. This is far from the whole story, however. Brazil has two CCT programs in place. One, Bolsa Escola, addresses general concerns of child health, education and nutrition. A second program, known by its Portuguese acronym Programa de Erradicaçao do Trabalho Infantil (PETI), has the additional goal of reducing child labor in hazardous occupations in the country's poorest states. Elsewhere in the region, CCT programs are in pilot phases or being fully implemented in Colombia, Honduras, Jamaica and Nicaragua. (See accompanying box for a summary of programs in Latin America.)

Nor is interest in CCTs confined to the Americas. One of the world's largest initiatives in this area is the Food for Education program in Bangladesh.

When social policies are designed to affect future generations, assessing their impact after only a few years has limited value. The results of CCT programs in Latin America and the Caribbean so far are nonetheless promising. School attendance and retention rates have generally improved, particularly among adolescent girls, and children in participating households usually display improvements in physical development and lower levels of stunted growth due to malnutrition. Vaccination rates have increased notably, and families report an increase not only in total food consumption but also in the quality and variety of foods consumed.

Surprising unintended effects have occurred as well. As cash transfers have so far only been distributed to mothers, women in beneficiary households have been empowered by some programs. They report an increase in status and decision-making authority within the home, and a corresponding increase in self-esteem. In some communities, talks on health and nutrition offered to beneficiaries are also open to attendance by non-participants; local knowledge of public health issues and preventive medicine have thus improved without any additional government expenditures.

The unintended consequences of CCT programs have also included growing pains. As CCT programs are based on payments to nuclear households made up only of parents and children, participation can cause frictions in the multiple generation and extended family households common in the developing world; disputes on allocating money and food can arise when these households are composed of both beneficiaries and non-beneficiaries.

This issue of *IDEA* takes a look at CCT programs in the region and shows how countries have attempted to bridge the gap between theory and practice. Also discussed are issues relevant to the future design, implementation and evaluation of these programs so that they can best improve the conditions of target populations and of society as a whole.

This issue of *IDEA* is based on the research of Carola Alvarez, Fernando Regalia and Emmanuel Skoufias. John Dunn Smith contributed to writing and editing the articles in this issue.

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What's Going on in Latin America?

The following tables summarize the principal Conditional Cash Transfer (CCT) Programs in Latin America.

Table 1. Objectives, Components and Target Population of CCT Programs in Latin America and the Caribbean

Program	Objectives	Components		Target population	
		Education	Health and Nutrition	Education	Health and Nutrition
Programa Nacional de Bolsa Escola, Brazil	1. Increase the educational attainment of school-age poor children 2. Reduce current and future poverty	Cash grants		Poor children 6-15	
PETI, Brazil	Eradicate the worst forms of child labor (i.e. those involving a health risk), while increasing educational attainment and reducing poverty.	Income transfer After-school program		Children 7-14	
Familias **en Acción, Colombia**	Increase the human capital investment among extremely poor families	Bi-monthly school subsidy	1. Nutrition subsidy 2. Health education	Poor families with children 7-17 enrolled in school (2nd - 11th grade)	Poor families with children 0-6 not participating in other programs
PRAF II, Honduras	Increase the accumulation of human capital among children of the poorest families and thereby help to break the circle of poverty.	1. Demand incentives (educational voucher) 2. Supply incentives for primary schools	1. Demand incentives (nutrition and health voucher) 2. Supply incentives for health care centers 3. Nutrition training for mothers	Poor households with children 6-12 who have not yet completed the 4th grade of primary school	Poor households women and/or children under three
PATH, Jamaica	1. Increase educational attainment, improve health outcomes, and thus reduce poverty. 2. Reduce current poverty 3. Reduce child labor 4. Serve as a safety net	Education grant	1. Health grant 2. Health education	Poor children 6-17	Poor children 0-5; poor pregnant and lactating women; elderly poor over 65; poor persons with disabilities; and destitute adults under 65
Oportunidades/ PROGRESA Mexico	1. Improve the educational, health and nutritional status of poor families, particularly children and their mothers. 2. Create income generating opportunities for poor households through preferential access to microcredit, housing improvements and adult education.	1. Educational grants 2. Support for school materials 3. Strengthening the supply and quality of education services	1. Cash grant for food consumption 2. Basic health care services package 3. Nutrition and health education 4. Improved supply of health services 5. Nutrition supplements	Poor children 8-17	Cash grants are targeted to poor households while nutrition supplements are targeted specifically to pregnant and lactating women, children 4-24 months old and malnourished children 2-5 years old
Red de Protección Social (pilot), Nicaragua	Promote human capital accumulation among households living in extreme poverty	1. Education grant 2. Support for school materials 3. Supply incentive	1. Cash grant for food 2. Nutrition and health education 3. Basic health care package for children under 5 4. Supply incentive	Cash grants are targeted to poor households; health care services are targeted to children 0-5	Poor children 6-13 enrolled in primary school grades 1st to 4th

Table 2. Conditionality and Transfer size of CCT Programs in Latin America and the Caribbean

Program	Conditionality[1]		Transfer size	
	Education	Health and Nutrition	Education	Health and Nutrition
			Local Currency	Local Currency
Bolsa Escola, Brazil	At least 85% school attendance in a 3-month period		R$15 – R$45 (US$6-19) per family	
PETI, Brazil	At least 80% school attendance and participation in the after-school program Jornada Ampliada		Varies across states between $R25-39 (US$11-17) per child per month[2]	
Familias en Acción, Colombia	At least 80% school attendance in a 2-month cycle	Regular health care visits for child's growth and development monitoring	Primary: Col$14,000 (US$6) per child per month Secondary: Col$28,000 (US$12) per child per month	Col$ 46,500 (US$20) per family per month
PRAF II, Honduras	School enrollment and maximum 7 days of school absence in a 3-month period.	Compliance with the required frequency of health center visits	Educational voucher: L$ 828 (US$58) per child per year Average supply incentive: L$57,940 (US$4,000) /school/year	Health voucher: L$660 (US$46.3) per family per year Avg. supply incentive L$87,315 (US$6,020)/ facility/year
PATH, Jamaica	Minimum school attendance of 85% (max 9 days of school absence per term)	Compliance with the required number of health visits per year, which varies by beneficiary age/status	J$500 (US$9)/child/mo[3]	J$500 (US$9) per eligible household member per month[7]
Oportunidades, Mexico	School enrollment and minimum e attendanc rate of 85%, both monthly and annually	Compliance by all household members with the required number of health centers visits and mother attendance at health and nutrition talks	Primary: varies by grade Secondary: varies by grade and gender[4]	Mex$125 (US$14) per household per month (1999)[5]
Red de Protección Social, Nicaragua	School enrollment; less than six days of school absence in a two-month period school; and school grade promotion	Regular health care visits for child's growth monitoring; satisfactory child's growth and development; up-to-date vaccinations, attendance to health and nutrition talks	Grant: C$240 (US$17) every 2 months per famil School material support: C$275 (US$20) per child per year Supply incentive: C$10 (US$0.7) per student every 2 months	C$480 (US$34) per family every 2 months

[1] In practice, some programs have not enforced all conditions. For example, delays in the development of the PRAF MIS prevented the enforcement of program conditions during the first months of program implementation. In Nicaragua, program administrators realized that some schools had automatic grade promotion, thus they decided not to withdraw program benefits to children who failed to pass to the next grade. Likewise, they did not enforce the condition of timely vaccination.

[2] In Bahia and Sergipe, the income transfer is R$25/month for each participating child. In Pernambuco, the monthly income transfer is R$50 for 1-2 participating children, R$100 for 3-4 children and $150 for 5 or more. The average transfer per month in this state is R$37.8.

[3] The level of monthly benefits per eligible household member will increase from J$300 during the first year of the program, to J$350 during the second year and J$500 afterwards.

[4] At the end of 1999, educational grants for primary school varied between Mex$80-165/child/month depending on the school grade (3rd to 6th); for secondary schools transfers varied between Mex$240-265/boy/month and Mex$250-305/girl/month. In addition, households received Mex$165 per year for each child enrolled in primary school (grades 3rd to 6th) and Mex$205 per year for each child enrolled in secondary school. The maximum monthly transfer per household including food support and educational grant is Mex$750

[5] The maximum monthly transfer per household including food support and educational grant is Mex$750

Evaluation as a Tool

The rationale for program evaluation is straightforward. Without it, there is no reliable means for determining whether a program is achieving its objectives, whether the situation of the intended beneficiaries has changed, and what that situation might have been without the program. Anecdotal evidence and casual impressions alone are insufficient to manage programs that operate on a large scale and in some cases nationwide. Evaluations of programs and their impacts represent an important tool for testing programs' design and effectiveness, and determining whether time and money are well spent.

Moreover, evaluation at an early stage of a project can improve program design or targeting. Evaluation at an intermediate stage can further modify program design and increase the effectiveness of service delivery. In any event, the costs of evaluation represent only a small share of program costs, often less than 1 percent. The returns in terms of increased effectiveness of social spending and greater accountability, though, are very high.

Two main methods of evaluation are used. Both compare a treatment group of beneficiaries with a control group of non-beneficiaries. When testing is conducted on a small scale, evaluators assume that the program has no impact on the economy as a whole. Evaluation of large-scale programs, however, should take macroeconomic effects into account.

The first method—and the statistically ideal method—is experimental design. In this approach, members of the treatment and control groups are randomly selected from a pool of eligible beneficiaries. Random selection serves both practical and ethical purposes. Many programs, particularly in their initial phases, simply do not have the resources to serve everyone who might benefit. Choosing members of the treatment group by what is in effect a lottery gives every member of the target population an equal chance of receiving benefits. The two groups can be compared for any indicator of interest, such as income, consumption, school attendance, or labor force participation, among many others. Randomization can also serve as a model for program expansion and later phases of testing.

The costs of evaluation often represent less than 1 percent of program costs but the returns in terms of increased effectiveness of social spending and greater accountability are very high.

A second approach is quasi-experimental design. Using a variety of statistical and econometric methods, analysts take survey information that is already available to construct approximations of treatment and control groups. As with experimental design, the groups are then compared according to the indicators of interest. This approach has both drawbacks and advantages in relation to experimental design. The most notable disadvantage is that this method does not permit precise selection of the control and treatment groups in advance. Consequently, evaluations conducted through quasi-experimental design yield less reliable results.

The quasi-experimental approach nonetheless enjoys several practical advantages. First, this approach is generally less costly to implement, as it does not call for new programs or bureaucracy. Second, quasi-experimental design can prevent delays in service delivery that would result from planning, carrying out and analyzing an experimental design. Third, a quasi-experimental approach accommodates political reality: politicians and members of the public are often—and understandably—more interested in receiving benefits than waiting for the most accurate findings. Finally, this method allows policymakers to improve existing programs rather than scrap them altogether or continue to use their resources ineffectively.

Whatever method is used, some kind of evaluation is far better than none at all. Planning, managing and expanding social programs without the tools of evaluation is inconceivable. When rigorous and thorough evaluations take place, though, policymakers and administrators can make the best use of limited funds and personnel to serve the greatest possible number of beneficiaries.

A Pioneer Program: Mexico's Oportunidades

Oportunidades is different. Its multisectoral focus provides an integrated package of education, nutrition and health services to poor families. And it is not a simple cash transfer program. Rather, Oportunidades requires the active participation of recipient households in exchange for benefits. Oportunidades is also different because it has been the subject of a rigorous evaluation that provides important clues as to what works and doesn't work with this new approach to social programs.

In 1997, the government of Mexico embarked on a new program aimed at alleviating extreme poverty in rural areas. Oportunidades, originally called PROGRESA, seeks to break the entangling web of poverty in which malnutrition, morbidity, high infant mortality, high fertility, junior high school dropout rates and unhealthy living conditions prevail. By late 2002, the program included nearly 4.2 million families in 72,00 localities in all 31 states. This constitutes around 20% of all Mexican households and 77% of those in extreme poverty. The total annual budget of the program in 2002 was around US$1.8 billion (US$2.3 billion in 2003).

Oportunidades consists of three components: education, health, and nutrition. The education component is designed to increase school enrollment among youth in Mexico's poor rural and urban communities by making education grants available to pupils' mothers, who are then required to have their children attend school regularly. In localities where Oportunidades currently operates, poor households with children enrolled in grades 3-9 are eligible to receive these educational grants every two months. How much do they get? Among other factors, the benefits are calculated based on what a child would earn in the labor force or contribute to family production. Girls at the secondary level receive slightly higher grants, given their propensity to drop out at earlier ages. Every two months, school officials confirm whether children of beneficiary families attend school more than 85% of the time; this triggers the bi-monthly cash transfer for school attendance.

In the area of health and nutrition, Oportunidades promotes health care through free preventative interventions, such as nutritional supplements, education on hygiene and nutrition as well as monetary transfers for the purchase of food. Receipt of monetary transfers and nutritional supplements are tied to mandatory health care visits to public clinics. This aspect of the program is targeted to children under five, and pregnant and lactating women. It is administered by the Ministry of Health and by IMSS-Solidaridad, a branch of the Mexican Social Security Institute that provides benefits to uninsured individuals in rural areas.

Nutritional supplements are given to children between the ages of four months and two years, pregnant and lactating women, and malnourished children between the ages of 2 and 5. The nutritional status of beneficiaries is monitored by mandatory visits to the clinic. Upon each visit, young children and lactating women are measured for wasting (weight-for-height), stunting (height-for-age), and weight-for-age. An appointment monitoring system is set up and a nurse or doctor verifies adherence. Every two months, health care professionals certify that beneficiaries have made their requisite visits to clinics; this triggers a cash transfer for food support.

Does it Work?

The International Food Policy Research Institute (IFPRI) conducted an independent evaluation of the original Oportunidades when it only covered rural areas that provided convincing evidence of a major shift in Mexico's poverty alleviation programs. In spite of the politically charged environment, the evaluation generated independent and credible measures of program impact that contributed significantly to the continuation of the program despite a change of government in Mexico.

The evaluation provided valuable information on the program's outcomes but it also left some important issues outstanding. First, the evaluation of Oportunidades or any other social program, requires a clear definition of its objectives to provide a benchmark against which the performance of the program can be evaluated. A simplified statement of the objectives of Oportunidades is to alleviate poverty by inducing households through conditional cash transfers to invest in their human capital, such as health, education and nutrition. Clearly, these are long-run objectives that can only be evaluated over the lifetime of program participants while the evaluation data are limited to only two years of observations.

Second, the educational and health services of the program as well as the nutritional supplements are all provided as a package. This feature makes it impossible to evaluate the impact of individual program components (e.g.,

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the impact of the health component on school attendance) or shed any light on program design (e.g., what if the cash transfers were awarded to fathers instead of mothers). Certainly, households could choose to comply with some requirements of the program such as visiting health centers and not with others, such as enrolling their children in school. The evaluation does not address this issue.

Third, Oportunidades is a demand-side program, meaning that its main objective is to induce households through cash transfers to make more intensive use of existing educational and health facilities. However, it is important to note that the program is accompanied by complimentary efforts and resources to strengthen the supply and quality of the educational and health services. These efforts serve only an auxiliary role as a means of easing potential capacity constraints that might arise from greater use of existing facilities. Thus, the program and its evaluation can provide little direct evidence of whether a demand-side intervention is more effective (in terms of impact and/or cost) than a supply-side intervention.

The majority of the evaluation findings suggest that Oportunidades' combination of education, health, and nutrition interventions into one integrated package has a significant impact on the welfare and human capital of poor rural families in Mexico. In the area of education, the program has significantly increased the enrollment of boys and particularly girls, above all at the secondary school level (see Figure 1). The results imply that children will have on average, about 0.7 years of extra schooling because of the program, although this effect may increase if children are more likely to go on to senior high school as a result of Oportunidades. Since higher schooling is associated with higher levels of income, the estimations imply that children have lifetime earnings that are 8% higher due to the education benefits they receive through Oportunidades.

Both children and adults are also experiencing improvements in health. Specifically, children receiving Oportunidades' benefits have a 12% lower incidence of illness (see Figure 2) and adults report a 19% decrease in sick or disability days. In the area of nutrition, Oportunidades has significantly reduced the probability of stunting for children aged 12 to 36 months. It has also had important impacts on food consumption. Program beneficiaries report higher calorie consumption and are eating a more diverse diet, including more fruits, vegetables, and meat.

Oportunidades' design feature that gives control of the monetary benefits to women has increased their household decisionmaking. Women report a greater level of empowerment, defined as increased self-confidence and control over their movements and household resources. Additionally, there is no evidence that adults are working less in response to the monetary benefits. This implies that the program does not create dependence on its benefits by reducing an individual's self-sufficiency efforts.

A detailed cost analysis also provides strong evidence that the program is generally administered in a cost-effective manner. For example, for every 100 pesos allocated to the program 9 pesos are "absorbed" by administration costs. Given the complexity of the program, this level of program costs appears to be quite small and relatively low compared to other programs.

Whether the vicious cycle of poverty and its intergenerational transmission are indeed broken can only be determined by continuing with Oportunidades and continuing to evaluate in the medium and long run its impact on the livelihood of Mexico's poor.

Figure 1. School Attendance of Boys and Girls 12–17 Years Old

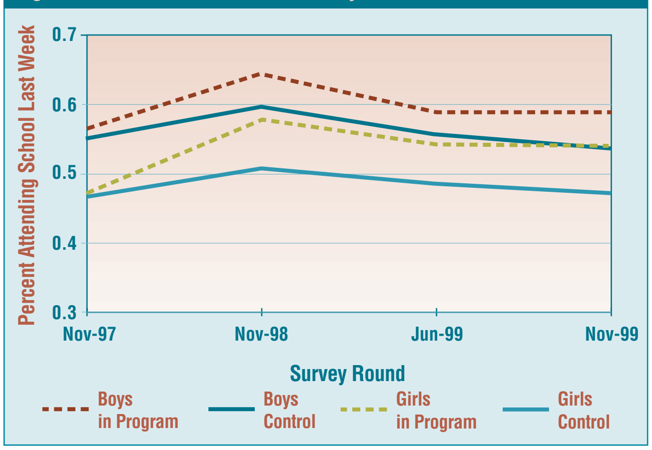
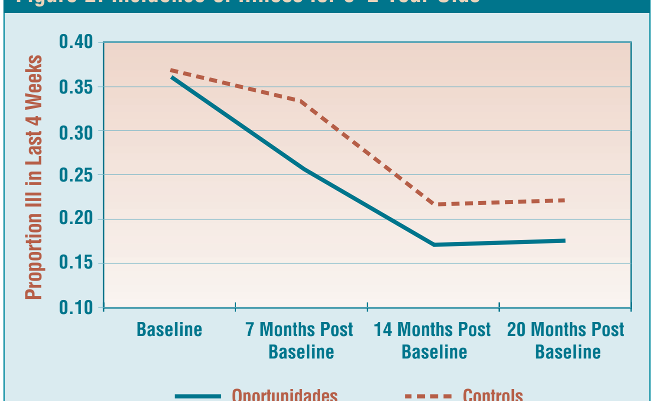


Figure 2. Incidence of Illness for 0–2 Year Olds



Pilot Phase Evaluation: Lessons and Surprises from Nicaragua

Social assistance programs are based on good intentions, but translating those good intentions into results and making the best use of scarce resources depends on careful design and evaluation. In many cases, the pilot phase of a program provides an opportunity to combine theory and practice on a limited basis before a government commits to launching a large-scale effort.

The results of a pilot phase can hold a variety of surprises. Speaking at the first meeting of the Inter-American Development Bank's Social Policy Monitoring Network in November, Mireille Vijil of Nicaragua's Family Ministry presented the findings of Phase I of that country's Social Protection Network, a conditional cash transfer program that offers families short-term monetary rewards for making long-term investments in children's education, health and nutrition.

The first challenge was in designing the experimental phase to ensure that the impact of the program was measured rather than outside factors. An intensive evaluation process led to the random selection of 21 test areas and 21 treatment areas drawn from comparable census tracts with a high incidence of poverty, but with access to health facilities and public schools.

A second challenge was to select the households to observe within those census tracts, making sure that only families who had the greatest potential to benefit were chosen. For this reason, households whose members owned vehicles, businesses, or more than 14 hectares of land were excluded.

Once households were selected, they were obliged to take specific measures regarding their children's health and education in order to receive cash payments equal to US$17 per family every two months, with additional payments of US$20 per year for every child in school, with a small bimonthly supplement for school supplies. These measures included regular medical check-ups, satisfactory progress in children's growth and development, maintaining up-to-date vaccinations, regular school attendance for children of school age, and regular attendance by parents (generally mothers) at government-sponsored health and nutrition talks.

The results of the pilot phase, undertaken in 2000 and 2001, proved impressive. Compared to the control group, family food expenditures rose significantly, with increases in quantity, quality and variety of food. Child height and weight gain also increased, as did the percentages of children receiving vaccinations and iron supplements. Perhaps most impressive were the pilot phases' improvements in school attendance and retention in all age groups, which exceeded expectations. In addition, the timing of the pilot phase was particularly fortunate: because of depressed coffee prices and the Central American drought crisis, the food security of many of these families was threatened.

Unlike many programs, though, the pilot phase of the Social Protection Network recorded participants' qualitative impressions as well as quantitative results. The results included unexpected findings with major implications for future programs. One of the unforeseen positive results was that women participating in the program reported an increase in status and influence within their families, as well as higher levels of self-esteem; in addition, communication between parents and teachers improved. A much less pleasant surprise was that participation sometimes led to friction in extended families composed of both beneficiaries and non-beneficiaries. The program's implicit targeting of nuclear families had not taken this possibility into account.

The lessons learned from the pilot phase of the program will be carried over into the next phase of the Social Protection Network. This will involve an expansion of the geographic area served, with new sites selected on the basis of poverty maps. The target population of the next phase will also be expanded. In addition to the families with children already served, the second phase will encompass women of child-bearing age and adolescents. New types of medical attention will also be introduced into the program: children will be monitored for anemia, and children from 6 months to six years of age will be provided with Vitamin A supplements. Additional forms of coverage will involve prenatal and perinatal care, as well as family planning.

The second stage of the Social Protection Network is likely to bring new findings, and new surprises, but the successful completion of the program's pilot phase has represented an essential first step toward improving the conditions and prospects of some of Nicaragua's most vulnerable citizens.

More Questions than Answers

Evaluation does not provide all the answers. In fact, many times it generates more questions than it resolves. Clearly this is the case with the conditional cash transfer (CCT) programs being studied in Latin America today. And that is a good thing. Even in the most successful programs, there is considerable room for improvement. The right questions can help highlight key issues and continually raise the bar for social programs in the future.

A prime example is the finding that the highly touted Oportunidades/Progresa program in Mexico has had no measurable impact on the achievement test scores of children in beneficiary localities. This suggests that if the program is to have a significant effect on the human capital of children, more attention needs to be directed to the quality of education provided in schools. Currently, the award of the program's educational benefits is conditional on regular school attendance but not performance. But attending school regularly is only one necessary condition for improving children's human capital. The question is whether benefits should also be linked to performance; for instance, bonuses could be granted for successful completion of a grade.

A number of other questions have also come out of the evaluation experience. Is it possible for unconditional cash transfers with no strings attached to have a similar or higher impact on the human capital investments of poor rural families? Is the amount of the cash transfer given to families too high? Perhaps a lower cash transfer could achieve the same impact. If so, what is the minimum amount required to achieve acceptable results?

Is simultaneous intervention in the areas of education, health and nutrition preferable to intervening in each of these sectors separately? The Oportunidades program has shown promising outcomes but it has been accompanied by complimentary efforts to strengthen the supply and quality of educational and health services. In this way, the program has averted capacity constraints that might arise as a result of the more intensive use of existing facilities and resources. Is this feature critical to the success of the program? Programs that do not pay sufficient attention to warding off capacity constraints may be less effective. In areas with capacity limitations, wouldn't building a school have a greater effect on school attendance than paying families to send their children to overcrowded or distant schools?

The right questions can help highlight key issues and continually raise the bar for social programs in the future.

There are also questions surrounding the optimal target population. The evaluation finds a larger program impact on the schooling attendance of children of secondary school age. Is it not preferable to reorient funds from families of primary school children to families with children of secondary school age? Or are programs aimed at younger children preferable to programs targeted at older children? Since analyses show that the program has had a greater educational impact on girls than boys, the question arises whether there should be any differentiation between boys and girls as beneficiaries? What about how and to whom the benefits are distributed? To date, benefits have been given to the mothers in the household. What if the benefits were distributed to fathers instead?

As policymakers now have a better sense of the basic elements of a program that can be effective in alleviating poverty in the short and long run, the list of questions and concerns about program choices and design cannot help but grow longer. Hopefully, the early involvement of researchers in the design and evaluation of programs implemented in many Latin American countries including Brazil, Honduras, Nicaragua, Colombia, Jamaica and Argentina can shed some light on these critical questions for policy.

Sharing what has been learned about evaluations and policy is then the next step. Toward this end, the IDB's Research Department created the Social Policy Monitoring Network to improve the ability of Latin American and Caribbean countries to evaluate the impact of social policies and to improve their design. The Network brings together renowned experts in the evaluation field, regional researchers interested in evaluation and policymakers from social ministries and relevant agencies. Ultimately, the goal is to promote the value of evaluation, enhance understanding of the effects of social policies and build the technical capaci-

New Publications

BOOKS

Who's In and Who's Out: Social Exclusion in Latin America

Edited by *Jere R. Behrman, Alejandro Gaviria* and *Miguel Székely*

Social exclusion is closely linked with many economic problems in Latin America, yet seldom does it take the form of a "keep out" sign. More commonly, groups are excluded because they lack access to opportunities enjoyed by others in health care, education, housing and employment. These barriers prevent people from reaching their full productive potential, in turn constraining growth and revenues. *Who's In and Who's Out* explores various forms of social exclusion, including residential segregation in Bolivian cities, exclusion from health care in Brazil, barriers to legal status of Nicaraguan immigrants in Costa Rica, geographic isolation in El Salvador, and educational inequality among the indigenous in Mexico.

Quienes son los maestros? Carreras e incentivos docentes en América Latina

Edited by *Juan Carlos Navarro*

(available in Spanish only)

Quienes son los maestros? aims to contribute to a better understanding of the characteristics and incentives of teachers in Latin America. It explores a myriad of relevant issues including training, certification, recruitment, professional development, and teacher supervision and evaluation. Policy recommendations emphasize an integral approach to the effort to improve the quality of the teaching profession in the region.

RESEARCH DEPARTMENT WORKING PAPERS

Better the Devil that You Know: Evidence on Entry Costs Faced by Foreign Banks (WP-477)

By *Arturo Galindo, Alejandro Micco* and *César Serra*

Institutional and legal differences between countries increase entry costs and reduce banks' ability to expand abroad. Using bilateral foreign banking data for 176 countries, it is found that foreign banking is negatively affected by absolute differences in the legal setup and in basic institutions between source and host countries.

Trade Intensity and Business Cycle Synchronization: Are Developing Countries Any Different? (WP-478)

By *César Calderón, Alberto Chong* and *Ernesto Stein*

This paper attempts to determine whether trade intensity increases business cycle correlation in developing as well as industrial countries. On the basis of annual information for 147 countries from 1960 to 1999, it is found that countries with higher bilateral trade exhibit higher business cycle synchronization. The effect is not as great as in the case of industrial countries, however, and the effect is mitigated by asymmetries between countries' production structures.

The Cyclical Nature of North-South FDI Flows (WP-479)

By *Eduardo Levy-Yeyati, Ugo Panizza* and *Ernesto Stein*

This paper examines how the business and interest rate cycles in developed countries affect FDI to developing countries. It is found that FDI flows are countercyclical with respect to both output and interest rate cycles in the United States and Europe, whereas in Japan they display either no cyclical behavior or mild procyclical behavior.

Streamlining and Privatization Prices in the Telecommunications Industry (WP-480)

By *Alberto Chong and Virgilio Galdo*

This paper investigates determinants of privatization prices by focusing on one industry—telecommunications— across many countries. The findings are consistent with the little existing work on privatization prices; the resulting best policy prescription is primarily to concentrate on the transparency of the privatization process, as sale methods do matter. Government administration of labor downsizing may result in adverse selection, as the best workers are the first to leave when given the opportunity.

Should State-Owned Firms Change CEOs before Privatization? The Case of the Telecommunications Industry (WP-481)

By *Alberto Chong and Virgilio Galdo*

Should state-owned enterprises change their chief executive officer before privatizing? This paper finds that CEO replacement will improve performance in the telecommunications industry before privatization as measured by penetration, operating efficiency, and profitability. Moreover, these findings are consistent with previous research that links CEO replacement with an increase in privatization prices.

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New Publications

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Corporate Governance and Private Capital Flows to Latin America (WP-482)

By *Alberto Chong, Alejandro Izquierdo, Alejandro Micco* and *Ugo Panizza*

This paper suggests that corporate governance is a crucial determinant of capital flows in Latin America. While the region is characterized by relatively low levels of corporate governance, it shows highly volatile capital flows. By implementing better corporate governance the region could reduce the sensitivity of capital flows to external shocks and hence reduce the volatility of its economy.

Do State-Owned Banks Promote Growth? Cross-Country Evidence for Manufacturing Industries (WP-483)

By *Arturo Galindo* and *Alejandro Micco*

This paper tests the efficiency of different structures of bank ownership in targeting manufacturing sectors in need of credit. It is found that state-owned banks do not play a significant role in the development of industries that rely more on external finance and/or that have less tangible assets to pledge as collateral.

Sudden Stops and Exchange Rate Strategies in Latin America (WP-484)

By *Arturo Galindo* and *Alejandro Izquierdo*

This paper finds that countries' ability to sustain a credible monetary policy depends on how vulnerable countries are to the impacts of sudden stops. Four factors are of vital importance in this regard: i) opening up the economy so there is an increased supply of tradables; ii) reducing indebtedness to limit the real exchange rate depreciation required to adjust to a sudden stop; iii) lowering currency mismatches in the composition of debt relative to output to reduce vulnerability to valuation effects and iv) addressing exposure to possible fiscal contingencies to reduce the vulnerability of fiscal accounts.

Privatization and Labor Force Restructuring around the World (WP-485)

By *Alberto Chong* and *Florencio López-de-Silanes*

Using worldwide data, this paper finds that adverse selection plagues downsizing programs carried out by governments before privatization, and several labor retrenchment policies yield a negative impact on net privatization prices. Moreover, various types of voluntary downsizing lead to a higher frequency of re-hiring of the same workers by the new private owners. A qualified "do not intervene" appears to be the safest bet with respect to labor retrenchment before privatization.

LATIN AMERICAN RESEARCH NETWORK WORKING PAPERS

Access to Credit and the Effect of Credit Constraints on Costa Rican Manufacturing Firms (R-471)

By *Alexander Monge-Naranjo* and *Luis J. Hall*

Using a 2001 survey of manufacturing firms, this paper finds that while banks are the main source of credit for larger firms, trade and informal credit remains the leading source of funds for smaller and newly created firms. In addition, the probability of accessing bank credit and the proportion of banking credit/total debt is mostly influenced by the characteristics of firms, not their owners. The firm's value and age, and whether it keeps formal accounting procedures are the most relevant determinants of access to bank credit.

The Effects of Unions on Productivity: Evidence from Large Coffee Producers in Guatemala (R-473)

By *Sigfrido Lee* and *Carmen Urizar H.*

This paper provides an econometric analysis of the impact of unions on productivity in Guatemala, specifically on the production of coffee. Although union density is low, there is evidence that unions have a negative effect on the productivity of large coffee plantations. Also, it seems that capital has a larger effect on unionized farms' productivity than on non-unionized farms. The presence of permanent workers on farms, both in unionized and non-unionized settings, has a negative effect on productivity.

Teacher Unionization and the Quality of Education in Peru: An Empirical Evaluation Using Survey Data (R-474)

By *Eduardo Zegarra* and *Renato Ravina*

This paper analyzes the evolution and current profile of teacher unionization and estimates the impact of unionization on the quality of public education in Peru. There is evidence that the rate of teacher unionization has dropped during the last three decades, but especially during the 1990s, due basically to the hiring of temporary teachers. It is also found that unionized teachers are older and more experienced, and that males are more common in the union membership. The data indicate that unionization does not currently seem to be a major factor affecting the quality of services in the Peruvian public education system.

OTHER PUBLICATIONS

Calvo, G., O. Celasun and M. Kumhof. 2003. A Theory of Rational Inflationary Inertia. *In Knowledge,*

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***Information and Expectations in Modern Macroeconomics: In Honor of Edmund S. Phelps*, eds. P. Aghion, R. Frydman, J. Stiglitz and M. Woodford. Princeton: Princeton University Press.**

This paper develops a theory of inflationary inertia based on forward-looking staggered price setting in the nontradable goods sector of a small open economy. Unlike current theories of sticky prices, transitions to a lower steady state inflation rate take time even if they are fully credible, and they are associated with significant losses in output of nontradables. The same is true for temporary programs, but recessions in nontradables at the beginning and the end of the program are alleviated by a full recovery of output in between. Empirical results using Mexican data are consistent with the theory.

Chong, A. and A. Micco. 2003. The Internet and the Ability to Innovate in Latin America. *Emerging Markets Review.* 4: 53-72.

This paper provides an overview of the situation of the Internet in Latin America and argues that while Latin American countries are latecomers to the industry, they could catch up at a faster pace and a lower cost. That will depend, however, on the environment for innovation in the countries; in that respect, the Internet may prove to be no different than other technological changes. Importantly, the paper demonstrates that the capacity to innovate and assimilate new technologies is not just a matter of income or infrastructure endowment.

Cowan, K. and H. Bleakley. 2002. *Corporate Dollar Debt and Devaluations: Much Ado About Nothing*. Working Paper Federal Reserve Bank of Boston (02-5). *http://www.bos.frb.org/economic/wp/wp2002/wp025.pdf*

Much has been written recently about the problems for emerging markets that might result from a mismatch between foreign-currency denominated liabilities and assets or income flows denominated in local currency. In particular, several models suggest that a ballooning "peso" value of "dollar" liabilities resulting from a devaluation could, via a net-worth effect, offset the expansionary competitiveness effect. This paper uses a new database with accounting information for close to 400 non-financial firms in five Latin American countries to assess which effect dominates. Interestingly, the average effect of a devaluation was on net positive, and the contribution of the net-worth effect was small.

Gaviria, A., U. Panizza, J. Seddon and E. Stein.2003. Political Particularism Around the World. *World Bank Economic Review*. March.

This paper presents a new data set on electoral systems and outlines its potential uses in further research on the connections between electoral systems and economic outcomes. The data set provides indicators of the degree to which individual politicians can further their careers by appealing to narrow geographic constituencies on the one hand, or party constituencies on the other.

Hausmann, R., U. Panizza, and E. Stein. 2002. Original Sin, Passthrough and Fear of Floating. In *Financial Policies in Emerging Markets*, M. Blejer and M. Skreb, eds. Cambridge: MIT Press.

This paper considers a set of countries with a *de jure* floating exchange rate and finds substantial differences in their exchange rate policies. In particular, the paper explores how the ability to borrow in own currency and the degree of passthrough from exchange rate to prices affect the degree of exchange rate management. The authors find strong evidence for a negative link between exchange rate flexibility and ability to borrow in own currency, and a much weaker link between passthrough and exchange rate flexibility.

Lora, E. and U. Panizza. 2003. Structural Reforms in Latin America: Is the Pendulum Swinging Back? *Journal of Democracy* 14(2).

This article synthesizes the facts and opinions that underlie the debate over the future of structural reforms in Latin America. It shows that the reform process has been incomplete and uneven, both across countries and different areas of reform. It also analyzes public opinion of the reform process. Growing disillusionment stems largely from the corruption that has tainted the privatization process in some countries. In reviewing the effects of the reforms, their impact on growth seems to have been positive, albeit temporary, but the effects on employment and income distribution have varied. The article concludes with a summary of the main proposals to expand or reorient the reform agenda in the region.

Panizza, U., E. Stein and E. Talvi. 2002. Assessing Dollarization: An Application to Central American and Caribbean Countries. In *Dollarization*. Cambridge: MIT Press.

This paper develops a set of criteria for assessing the benefits and costs of forming a monetary union with the U.S. that incorporates the traditional criteria found in the OCA literature, and that expands them in directions considered relevant to such a decision. To illustrate the type of analysis necessary to assess dollarization in practice, these criteria are then applied to a set of countries from Central America and the

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LatinMacroWatch

Country Risk: Who is to Blame?

Country risk in many Latin American countries began to climb alarmingly in mid-2002. In Brazil, many pointed an accusing finger at Luis Inacio Lula da Silva, the labor leader turned president whose leftist campaign talk raised the hair of more than one investor. In Colombia, fears over the sustainability of the public debt and escalating violence in this war-torn country seemed to be giving the market jitters. And in Venezuela, a short-lived coup against populist President Hugo Chávez and escalating tension between the government and the opposition seemed reason enough to boost that country's interest spreads.

As legitimate as these explanations may seem, are they really to blame for the steep rise in interest spreads?

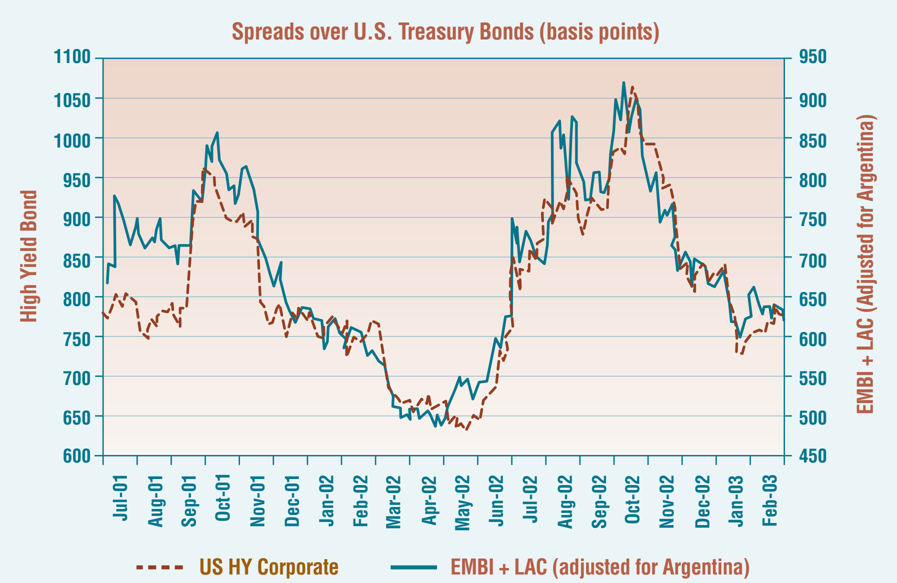
Actually, data from LatinMacroWatch suggest that the source of the problem may lie in the United States, not Latin America. Certainly, domestic factors may have played a role, but the correlation in the behavior of U.S. high-yield corporate spreads with the EMBI+ for Latin America (adjusted for Argentina) is just too close to ignore (See Figure 3). Apparently, perceptions of business risk in the United States have had a profound impact on country risk in Latin America.

The September 11, 2001 attacks and the corporate scandals of 2002 rattled the nerves of U.S. investors—and with good reason. They were dramatic, unexpected events with repercussions that could linger for the long term. The collapse of Enron and subsequent scandals at Arthur Andersen, MCI and others had an economy-wide effect. Moreover, they occurred at a time when families and firms were over-indebted and the speculative bubble on Wall Street had burst.

The perception of greater risk in the U.S. high-yield corporate bond market spread to Latin America. How did this happen? One theory is that as Enron et al cast its shadow over Corporate America, the decline in foreign direct investment (FDI) to emerging markets accelerated and precipitated outflows of financial capital. The reason for this is twofold: higher spreads increase the cost of financing FDI projects and investing in emerging markets does little to boost confidence in balance sheets. Since FDI is about the only source of financing left in emerging markets, cutting this off leaves these economies high and dry for capital and naturally increases EM spreads.

After spiking in September-October 2001 and then again in the fall of 2002, U.S. high-yield corporate bond spreads and the EMBI+ have come down, a trend only partly interrupted by the War in Iraq. Even though the fighting has ended quickly, several risks still haunt the U.S. economy. Should the U.S. economy suffer any more tremors, Latin Americans should brace themselves for the inevitable aftershocks.

Figure 3. Emerging Market Risk or U.S. Risk?



Look Who's Talking

This section of the newsletter spotlights presentations or events sponsored by RES in the past quarter.

Globalization, Institutional Choice and Development

Dani Rodrik (Harvard University) addressed IDB's Board of Directors, March 14, 2003.

Creativity and flexibility rather than a strict menu of policy prescriptions may be the key to growth. Developing country governments, international institutions and lenders should keep this in mind and learn from novel approaches around the world. This was one of Dani Rodrik's main messages in his presentation to the Board on *Globalization, Institutional Choice and Development.*

Rodrik opened with a summary of Latin America's growth performance from 1960 to 2000, which has proven disappointing in comparison to other regions. Latin America recorded average annual growth of 2.9% from 1960 to 1980, average negative growth of 0.8% during the "lost decade" of 1980-1990, and 1.6% annual growth during the structural reform decade of the 1990s. Moreover, the ratio of the region's GDP to that of developed countries fell from 20% in 1960 to 13% in 1990.

This performance stands in marked contrast to other developing regions. East Asia has grown at an annual rate of 4.4% since 1960, South Asia, particularly India, has exhibited accelerating growth since 1980, and according to official figures China has grown more than 8% annually since 1980.

Several lessons can be drawn from developing regions' experience. First, the growth evidence of all these regions is broadly consistent with three "higher-order" economic principles: Macroeconomic stability; the importance of private-sector incentives; and social protection to minimize conflict following shocks. Second, periods of high growth hardly ever result from the adoption of Washington Consensus policies. Third, periods of high growth are hardly ever caused by policies aimed at deep integration into the global economy; in fact, integration may represent an effect rather than a cause of growth.

The recent experience of China provides a concrete alternative to Washington Consensus policies, showing that higher-order principles can be observed through a variety of institutional arrangements. While a Washington Consensus approach calls for institutional reforms that take into account a web of economic causes and effects, the Chinese approach has involved institutional innovations or shortcuts that have in effect provided property rights, financing, appropriate pricing, incentives, and macro stability. China's household responsibility system and township and village enterprises have obviated the need for ownership reforms, two-track pricing has maintained subsidies while allowing for market prices at the margin, and latitude for policy experimentation within China's federal structure has generated incentives for policy competition and institutional innovation.

The widely differing labor market institutions in advanced economies provide a further example of plausible diversity in institutional arrangements. Sweden, Finland, the United Kingdom and the United States, for instance, have increased their divergence in union density rates since 1950, and continue to diverge in other areas of labor policy. As in the Chinese experience, this suggests that countries do not need to take only one path toward growth.

The empirical record of high-growth countries in the developing world, moreover, provides several lessons for policymakers and lenders. First, growth spurts are associated with only a relatively narrow range of reforms, which vary across countries, rather than a comprehensive approach. Second, the policy changes that initiate growth typically combine orthodox policy measures with unconventional institutional innovations. Third, institutional innovations are often country-specific and cannot necessarily be applied elsewhere. Fourth, initiating growth is easier than sustaining growth, and high growth periods that are not accompanied by institutional follow-up leave countries prone to growth collapses and vulnerable to shocks.

Whatever specific policies are chosen, a growth strategy should include two principal features: an investment strategy to stimulate short-run growth and an institution-building strategy to sustain medium-run growth. The implementation of these strategies should include both "carrots" and "sticks." Carrots consist of incentives for entrepreneurs to invest, such as short-term protection, credits, and subsidies, while sticks include motivations for discipline such as monitoring of beneficiaries and withdrawal of support from those who do not comply with agreed-upon terms.

The experience of developing countries, particularly Latin America, in recent decades illustrates what happens when only half of this two-pronged prescription is implemented. The import substitution industrialization (ISI) period in Latin America was characterized by provision of incentives without discipline; the result in many countries was an overly diversified industrial sector, with some firms permanently dependent on subsidies rather than markets. Conversely, the recent period of structural adjustment monitored by interna-

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tional financial institutions has featured discipline without incentives, even though some developing countries still need incentives for investment and/or to continue industrialization.

A country's choice of development strategy, however, is constrained by what has been called the political trilemma of the world economy. In theory, countries might wish to maintain simultaneously the integrity of the nation state, democratic politics and deep integration into the global economy; in practice, however, countries must choose two of these three goals. Within this trilemma, countries pursuing growth strategies must develop market-supporting institutions, as markets neither create, maintain nor legitimize themselves without assistance.

Given the diversity that exists among countries, these institutions are unlikely to take the same form in all places. While growth policies of the 1990s were often characterized by a conflation of general goals and specific arrangements, particularly from the point of view of international financial institutions, there is currently more acknowledgment that experimentation and country-specific strategies are valid if they are undertaken in accordance with higher-order principles. For instance, although lending conditions prevented Latin American countries from engaging in extensive experimentation at the national level during the 1990s, significant experimentation took place at the subnational level, and with interesting results.

In light of the experience of recent decades, it seems there is a desirable diversity in the range of countries' institutional arrangements to encourage and sustain growth. This experience holds particular relevance for international institutions and lenders: it may be better to operate on the basis of "thin" rules that allow experimentation rather than "thick" rules that discourage diversity and in turn constrain growth strategies and policies.

Argentina: From Tragedy to Triumph

Federico Sturzenegger (Universidad Torcuata di Tella) was lecturer at the IDB, January 16, 2003.

Professor Sturzenegger began with a survey of conditions prior to Argentina's late 2001 default and abandonment of the Convertibility regime. International conditions proved increasingly unfavorable to Argentina's efforts. Both the International Monetary Fund and the United States Treasury Department became increasingly skeptical of Argentina's ability to maintain a fixed exchange rate, and prevailing opinion in the international financial community was that Argentina should float its exchange rate. In addition, the U.S. Treasury expressed concern that efforts by international financial institutions to prop up the Convertibility regime might contribute to moral hazard. At the same time, investment banks increasingly took short positions on Argentine bonds, signaling a lack of confidence in the country's economy and perhaps creating a self-fulfilling prophecy.

These external conditions brought pressure to bear on a particularly vexing domestic situation in late 2001. In addition to the inherent difficulties of the fixed exchange rate, Argentina experienced an unusual fiscal tightening as dictated by the Zero Deficit Law, adopted largely to satisfy international lenders. However, when the government was obligated to pay the customary thirteenth monthly wage, it became clear that the tightening was not enough to reach the zero deficit target. This further reduced the support of international lenders leading to Argentina's default, abandonment of Convertibility, and pesoification of debts.

While such an abrupt change in policy is not without precedent—the United States effectively dollarized its debts in 1933 by abandoning the gold standard—the aftermath of Argentina's change in policy has proven particularly difficult. The assessment of different exchange rates for different classes of liabilities has undermined confidence, and the prospect of a Supreme Court ruling that may lead to redollarizing some deposits has contributed to an atmosphere of uncertainty.

The consequences of these changes have been dramatic. In a volatile political and economic environment, the driving force of the Argentine economy has at least until recently been capital outflow, estimated at 50% of GDP for the first half of 2002. The poor have been particularly hard-hit by devaluation, as the sudden change in the real exchange rate greatly diminished purchasing power. Moreover, the shock to provincial finances led to the issuance of quasi-monies that have complicated the country's efforts to formulate coherent fiscal and monetary policies.

The present situation, however, bears signs of hope. The Central Bank has so far prevented hyperinflation through its use of reserve funds, and the Plan Jefe de Hogar program has helped to promote social stability by providing a subsidy to low-income workers. While unemployment remains high, labor demand appears to be rising, particularly in the provinces that produce tradable goods and benefit from a devalued exchange rate; agricultural export sectors such as wine, meat, and grain are similarly benefiting. Additional reactivation and growth, though from a modest base, are associated with growing import substitution in goods and service sectors such as tourism and education.

Argentina faces a variety of policy challenges in translating the present

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bottoming-out into a viable recovery. The first is continuing to contain inflation, especially in light of recent increases in the money supply. Second, Argentina must continue to chalk up primary budget surpluses that are large enough to facilitate debt restructuring, a task complicated by the prospect of redollarization. Moreover, in an atmosphere of low aggregate demand and increasing business profitability, the question remains of how to turn those profits into the basis of investment and growth rather than a source of capital outflows.

Sturzenegger noted that a potentially more intractable problem is the conflictive nature of Argentine society. The inability to build consensus and support for Convertibility may have made that model unworkable, and the fractiousness of the country's politics and culture may similarly undermine subsequent growth strategies, regardless of their intrinsic merits. These risks are exacerbated by what Sturzenegger called "chronic" and "structural" pessimism, as well as a public tendency to make high demands on the government and political system, then to protest and punish officials when expectations are not met. Periodic readjustments in the political and economic system, with compensation of "losers" in the process, have destroyed meritocracy, promoted a non-universal view of the law, and diminished the country's governability. Moving from the current equilibrium to one in which Argentines support a shared paradigm may represent the country's greatest challenge.

Network News

Latin American Research Network Call for Proposals

The Elasticity of Substitution in Demand for Non-tradable Goods in Latin America

The objective of this Research Network project is to estimate the elasticity of substitution between tradable and non-tradable goods, as well as associated price elasticity of demand for non-tradable goods.

To access information pertaining to this call, please visit the Research Network Web Site: www.iadb.org/res/researchnetwork. Institutions interested in submitting proposals should inform Raquel Gómez before April 25, 2003, email: red@iadb.org. Research proposals must be received by May 16, 2003.

Latin American Research Network Conference at Boston College

An international conference on the "Balance Sheet Effects of Exchange Rate Fluctuations in Latin America", sponsored by the IDB Research Department and the Department of Economics at Boston College will be held on the Boston College campus in late May. The conference brings together six teams of researchers from the Latin American Research Network who have gained access to firm level data on the currency composition of debt. Using these data, the researchers have empirically investigated the importance for firms' investment decisions of the balance sheet effects of exchange rate fluctuations. The conference agenda is available at http://fmwww.bc.edu/ec/ec.php

The conference will take place on May 23 and 24 at the Lynch Executive Conference Center, Fulton Hall, Room 513.

New Publications

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Caribbean, which are among the most likely in Latin America to take the first steps toward full dollarization of their economies.

Panizza, U. 2002. The Strange Case of the Public Sector Wage Premium. *Public Finance Management.* 2(3) 334-355.

Empirical work suggests the presence of a public sector wage premium. This paper investigates the theoretical reasons for the presence of such a premium. The results of the paper are consistent with the higher premium paid to women and with the fact that the premium decreases with skills. The key insight of the paper is that job security undermines the incentive to work hard and forces the public sector to pay higher wages.