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The Politics of the Budget Process

For nations, just as for households and firms, budgets are a means of allocating scarce resources among different uses. Families use budgets to ensure they have money left over to eat and pay the rent after buying that new car or television; societies use government budgets at all levels, from national to local, to decide how to distribute available public revenue across the spectrum of public responsibilities. In even the smallest country, the tasks undertaken by the government are many, ranging from maintaining roads and bridges, to staffing embassies, to caring for the poor. Sorting out these responsibilities and assigning appropriate funding to each is no easy task, even when funds are plentiful—which they seldom are. Making the process harder still are the many interested participants involved: everyone—ministers, legislators, bureaucrats, voters—has a stake in the outcome.

Government budgets and the processes that decide them are often full of arcane rules and complicated details, giving the impression that budgeting is a purely technocratic matter: follow the rules, apply standard cost-benefit analysis, and you will get the budget "right." But the reality is far different. There is no "right" allocation of society's resources. Rather, public budgeting is a way of reaching a consensus—a collective judgment—about that allocation. Thus, ultimately, it is about nothing less than the determination of a society's priorities. For developing countries, it is also about how development shall proceed and whom it shall benefit.

> Public budgeting is a way of reaching a consensus about the allocation of society's resources.

All this makes budgeting intensely political. In the budget arena, politicians come together to debate and negotiate the difficult trade-offs among the competing needs and aspirations of the different elements of society. At the same time, hopefully at least some of the participants are keeping an eye on the bottom line: is the budget sustainable, or will it impose a heavy debt burden on future generations? As this consensus is forged, the foundation may also be laid for a durable political coalition, which will help implement the agreed agenda once enacted. Indeed, the budget itself sometimes becomes the mechanism that holds a delicate and hard-won set of political compromises together: by setting out a comprehensive plan for all public initiatives and their financing, the budget can facilitate and embody "grand bargains" across widely different policy areas. Groups that will be adversely affected by cutbacks in one area can be compensated by increased funding for others that they favor, and thus won over. Because it brings together in one document all of the many activities that constitute the public sphere, the public budget lies at the core of the policymaking process itself.

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The Politics of the Budget Process

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Each participant in the budget process brings to it a unique set of motivations and incentives. Each has his or her own views about the needs of society and about the benefits and costs of certain policies. Most legislators and government officials also represent one or another identifiable constituency, whose needs and goals may not align with those of other constituencies or of the country as a whole. Each participant also has personal goals and ambitions—legislators hope for reelection, ministers seek to expand their turf, presidents are mindful of how history will depict them. The budget process is largely about the interplay and resolution of the inevitable conflicts among them.

Of course, the budget drama is not enacted on a bare stage. In every country a preexisting set of institutions shapes the process. These have various origins: the country's constitution, its laws and judicial history, rules and protocols internal to the legislature and the bureaucracy, traditional alliances (and enmities) between established interest groups, and others. Institutions also differ from country to country, with implications, positive or negative, for budget outcomes and for the ease or difficulty of achieving them. For example, in some countries the constitution concentrates budget authority in the president's office; this may streamline the process but tends to favor those constituencies from which the president and the president's party draw support. A more decentralized budget process, on the other hand, gives legislators considerable discretion and may produce more representative outcomes, but it may also unleash excessive spending because no one legislator has the power or the incentive to make sure the budget balances.

Given the central importance of the budget in determining policy, and of institutions in determining the budget, it is not surprising that an ample literature examines the impact of institutions on fiscal outcomes. Two books published by the Inter-American Development Bank, *Latin America after a Decade of Reforms* (1997) and *The State of State Reforms in Latin America* (2006), contributed to this literature, showing that the right set of institutions can make certain undesirable outcomes, such as large budget deficits, less likely. Among the institutions found most helpful were those that set well-defined limits on outcomes—for example, a ceiling on spending or on the public debt—and those that invest greater power in participants who have incentives to keep state finances under control.

Not only does this literature unequivocally confirm that institutions do matter, it also provides many

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This issue of *IDEA* was prepared by Carlos Scartascini, Rita Funaro and Michael Treadway. It is based largely on three books and the background research associated with them: **The State of State Reform**, edited by Eduardo Lora; **Who Decides the Budget? A Political Economy Analysis of the Budget Process in Latin America**, edited by Mark Hallerberg, Carlos Scartascini, and Ernesto Stein; and **Consecuencias imprevistas de la constitución de 1991: La influencia de la política en las políticas económicas**, edited by Eduardo Lora and Carlos Scartascini.

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insights into what makes specific institutions succeed or fail. However, this literature has yet to thoroughly explore how institutions interact with each other and with key players in real-world settings. These interactions may cause a given institution to promote good fiscal stewardship in one country but have the opposite result in another. Why, for example, does essentially the same electoral rule—open-list proportional representation in the legislature—contribute to healthy, sustainable budgets in some countries but increase pork-barrel spending in others?

To fill this gap in the literature, the IDB has sponsored a new book, *Who Decides the Budget?* The book articulates a new approach to the analysis of budget institutions, based on the following premises:

- *The budget process should not be examined in isolation or as a narrowly technical issue*. On the contrary, the budget process is fundamental to the policymaking process. Virtually every law that is passed affects government spending, today or in the future, and thus has budget implications. In turn, the budget process offers an opportunity to cement support for responsible government and to compensate the inevitable losers from reform. In fact, as the country studies in the book illustrate, some reforms in some countries have been achievable *only* during budget negotiations.

- *Budget outcomes cannot be fully explained in terms of just one or two political or institutional dimensions, however important, or the incentives and behavior of just one or a few actors.* Understanding the budget process requires a systemic view, one that takes in multiple institutional dimensions, the entire political cast of characters, and the interactions among them. For example, a legislator's actions are influenced not only by the electoral system, but also by the powers of the presidency, the strength and role of political parties (and their linkages to voters and to interest groups), and the strength and role of the judiciary, which in most countries has the power to undo the legislature's initiatives.

- *It is essential to look beyond formal rules, to examine how the budget is crafted in actual practice*. In most Latin American countries, the written rules—the constitution, laws, and regulations—account for only part of how a budget really gets passed. Informal, unwritten budget practices guide much of the process. Any description that excludes these practices will be incomplete.

- *Fiscal sustainability is not the only measure of good budgeting; there are other important dimensions, which the budget process can also affect.* Most analyses of public budgets to date—and most budget reforms—have focused on variables related to fiscal sustainability, such as the fiscal deficit and the national debt. But it is also important to investigate how countries might use the budget process to increase the efficiency and effectiveness of public expenditure and make both government revenue and the economy as a whole more resilient to shocks. Also vitally important is to assess, after the fact, the political responsiveness of the process, to ensure that the needs, aspirations, and preferences of the people have been fully taken into account.

Understanding the budget process requires a systemic view that takes into account multiple institutions and political actors and the interactions among them.

This issue of *IDEA* looks at these and other critical budget issues, analyzing recent legislation, the political actors involved and the consequences —sometimes unintended—of budget reform. It draws from *Who Decides the Budget*?, *The State of State Reform in Latin America* and other IDB research products that explore the mysteries of the budget process and recognize that a better understanding of that process provides important clues for understanding why some countries are able to develop and others are not.

Fiscal Responsibility Laws: What Is the Secret of Their Success (or Failure)?

Among the causes of Latin America's debt crisis of the 1980s was a breakdown of fiscal management. Government budgets failed to work as they should, as a comprehensive planning tool for fiscally prudent public policy, and fiscal deficits in some cases exceeded 10 percent of GDP. Following the crisis, and with the restoration of democracy in countries formerly under military control, public budgeting took on renewed importance—and became more contentious. Many legislators, other officials, and their parties, responding to their constituents, pressed for increased social services and other expenditures. Others, however, demonstrated a renewed interest in fiscal discipline, and responsible elements of civil society showed a new willingness to rein in their representatives. The Brady Plan's restoration of access to international capital markets in 1989 generated additional incentives for good budgeting: global investors proved willing to resume lending to countries with sound finances.

In response to the crisis, many countries—including all the larger countries of South America—enacted several reforms of the budget process at once, in comprehensive pieces of legislation known as *fiscal responsibility laws*. These laws generally did not aim at rebuilding the budget process from scratch but rather were imposed on top of the existing process, with varying degrees of success. Here we focus on the experience of two countries: Argentina and Brazil.

Argentina's Fiscal Solvency Law

The main objectives of Argentina's 1999 fiscal solvency law were to contain public spending, reduce deficits, and increase transparency. Its main components were a countercyclical reserve fund, new procedural rules, transparency measures, and fixed numerical limits on deficits and expenditure. The law established a deficit ceiling of 2% of GDP for 1999 and called for successively smaller deficits thereafter.

Despite good intentions, the new limits were violated from the start. After the deficit exceeded 2% in both 1999 and 2000, the ceiling for 2001 was relaxed to 2.5%, but the deficit that year came in at nearly 3.5%, more than six times the level envisioned in the original law. Similar outcomes prevailed in 2002 and 2003.

Why did Argentina's reform fail to control the deficit? One reason was a mismatch between the new limits and the nature of the problem that actually emerged. Permanent fiscal rules like the ones Argentina adopted can help improve medium- and long-term performance but are of little use in forcing a short-term adjustment to a crisis. Yet in late 2001, a crisis—a devastating one—was exactly what Argentina got.

Another reason was that even well before the crisis, the Argentine public and foreign investors had doubts about the sustainability of the convertibility regime and the country's fiscal solvency. No reform can succeed without public confidence.

But there is also an important political story to tell. In Argentina, federal legislators are elected in province-wide districts and follow their governor's lead. Thus, although the new law covered only the central government—itself a critical design flaw in a federal regime—the governors had to sign off on any budget cuts. To win the governors' support, the national government agreed to increase its contribution to the financing of the provincial pension system.

Once the law was in place, however, the national government itself chose not to comply. Instead, the executive violated its terms in every year from 1999 to 2004. Since no other important political actors had a stake in the law's success, it became a dead letter.

Brazil's Fiscal Responsibility Law

Unlike the 1999 Argentine law, Brazil's fiscal responsibility law, passed in 2000, targeted all levels of government. Although necessary to avoid the problems that its southern neighbor encountered, this was an ambitious undertaking. Remarkably, it succeeded: the consolidated public sector balance shifted from a deficit of 3% of GDP in 1997 to a 4.3% surplus in 2004; state budgets in the aggregate also moved into surplus. One result has been a return to low inflation in a country long known for the opposite.

Why did the Brazilian law succeed where Argentina's failed? One reason is that it brought additional participants into the budget process and gave them incentives to make the law succeed. Among the new participants were the Tribunais de Contas at the State level who saw enforcement of the law as a mechanism to regain leverage in the policymaking process. Also, under the new fiscal rules, reformed electoral laws allowing for reelection, and certain incentives introduced by the federal government, state

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The Legislature's Role in the Budget Process

It is often said that the legislature, directly elected at the district level, is the closest of the three branches of government to the people. If one cares about the representativeness of public budgeting—about the match between budget allocations and popular preferences—then legislative input is clearly vital.

In practice in Latin America, however, the legislature's role in the budget process differs greatly from country to country. In some, legislators have complete freedom to amend the executive's proposals. In others, their role is essentially limited to voting the proposed budget up or down. In still others, additions to spending are possible but must be offset by revenue increases or by cuts in other expenditures.

TABLE 1: Expected Role of President and Congress in the Budget Process

Stage of Budget Process	President	Congress
Draft	Main actor	Does not participate
Approval/Passage	Secondary actor	Main actor
Execution	Main actor	Secondary actor
Review	Main actor	Main actor

The strength of these restrictions largely determines legislators' incentives. In countries where the legislature has a freer hand, individual legislators have greater leverage to bring "pork" home to their district; this encourages them to bargain harder in budget negotiations. Legislators in countries where the rules give them little authority are likely to direct their energies elsewhere.

Broadly speaking, the budget process in every country passes through four stages: preparation, approval, execution, and review. The literature on developed countries focuses on the first two because the later stages are largely automatic: once the budget is approved, various review mechanisms generally ensure its implementation without major deviations. Table 1

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Fiscal Responsibility Laws: What Is the Secret of Their Success (or Failure)?

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governors found that they were better off (i.e they enjoyed more resources and higher chances of reelection) if they cooperated than if they defected. Moreover, only in Brazil were enforcement mechanisms included that the governors could use to address the common pool resource problem at the state level. Now governors could more easily discipline their legislators and show them the consequences of failing to comply with the law. And unlike in Argentina, Brazil's national executive wanted to see the reform succeed because it meant ending routine bailouts of the states. The greater comprehensiveness of Brazil's law also meant greater incentives for the executive to see the process through.

The lesson from Latin America's experience with fiscal responsibility laws is that better rules are not a sufficient condition for better results. The new rules may come into conflict with the existing rules of the political game. But changes in rules *can* have an impact when they transform the game itself. Brazil's new law worked not so much by virtue of the quantitative limits it set, but because it changed the political power relationships, especially between the federal and subfederal governments.

In the end, fiscal responsibility laws, like all budget rules, are only as powerful as the actors who are interested in enforcing them. Rules that lack strong political backing are likely to be only partly enforced—and may be ignored altogether.

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summarizes the roles of executive and legislature in such an "ideal" system. The executive prepares and proposes the draft budget, along with unbiased estimates of total revenue and expenditure as benchmarks for planning. The legislature then passes the budget, with or without revisions. The executive has primary responsibility for implementing the budget once passed, but the legislature monitors the executive to ensure that it acts as the budget prescribes.

So much for the ideal. In practice, executives in Latin America have often used their prerogatives to deviate from the budget once approved. This turns the budget process into a strategic game, where the players must consider not only the letter of the budget documents, but also what the other players might do at the next round. The result is that all behave very differently from what one would expect if the budget were simply implemented as enacted.

Preparing and Approving the Budget

In all countries, the executive takes the lead in proposing the budget. What happens next depends on the balance of power that the rules establish between executive and legislature.

In Chile, the president controls the agenda through the use of "urgencies", a presidential prerogative that sets deadlines for the legislature to vote on a given bill. By removing the option of delay, this weakens the legislature's bargaining power. The president can also call the legislature into special session. The legislature, for its part, has power only to approve or reject the budget and may not change its content.

Paraguay's rules are very different. There is a general time limit for budget approval, but the president has no power to shorten it, and the legislature can amend the president's proposal as it wishes. There are some formal rules intended to shift power toward the president, but these are generally ignored. As a consequence, whereas in Chile the legislature effectively cannot add to proposed spending, this is common practice in Paraguay.

The expectation of further changes after budget approval affects executives' proposals in two ways. First, the executive may draft the proposal more with an eye to what will pass than to what the executive really wants. Second, the executive will also consider the deadlines and other constraints on both sides and the incentives each side has to abide by them. Does the executive have a veto? Can it legislate by decree if the legislature misses its deadline? Both these features strengthen the executive's hand.

In some countries the aggregate estimates that accompany budget proposals become pawns in the legislative game, as different rules give rise to incentives either to understate or to inflate these estimates. In Brazil, the president has discretion to cut projects during execution if actual revenue is below the estimate. Knowing this, presidents consistently overestimate revenue so that actual revenue will likely fall short. In Venezuela, when the price of oil turns out higher than officially projected, the president can spend the "unanticipated" revenue without legislative approval. Not surprisingly, the executive agencies' oil price projections tend to be conservative.

Legislatures, too, can manipulate their own revenue and spending estimates so as to circumvent the rules. Bolivia's legislature has used overoptimistic projections of future gains in tax collection efficiency as a way of overstating revenue. Alternatively, they can reallocate expenditures from one item to another and increase surreptitiously the total budget. In Ecuador and Colombia, expenditure has at times been shifted from debt service to other spending; since the debt has to be serviced, this effectively increases the total budget.

Execution and Review

During budget execution, the initiative shifts back to the executive. Legislatures in most Latin American countries place formal limits on the executive's ability to make unilateral changes, but in reality they often shirk their role. In Argentina, for example, the rules require legislative approval of any expenditure increase, and of any shift of investment expenditure to current expenditure, once the budget has passed. In practice, the executive frequently makes such changes unilaterally, by decree. The legislature has either decided not to oversee them –it took many years to constitute the commission tasked with overseeing such decrees—or granted transitory special powers to the executive.

Most Latin American legislatures play a less important role in budget review in practice than the formal rules call for. Argentine law requires that the legislature approve the investment account each year and review what was spent in the preceding year. In fact, this has never happened on

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How Policymaking Influences Budget Making—and Vice Versa

Far from being a merely technocratic endeavor, the budget process is profoundly political in nature. A country's political and policymaking processes influence both the dynamic of the budget process and the final outcome. They may even determine whether formal budget rules are followed at all. But the budget process in turn affects the political process. Indeed, the budget is often the arena where political transactions are settled, as opposing factions swap their support for each other's favored policies and projects within the narrow confines of budgeted resources.

Good Policymaking Can Make for Good Budgeting…

When one surveys the recent history of Latin America, a striking correlation emerges: the better a country's overall policymaking process, the more likely it is to have a well-functioning budget process—and vice versa. This pattern is especially evident at the extremes: in those countries that perform best at enacting sound budgets, and in those that perform worst.

Chile is one country where both processes are especially robust. Chile has adopted two noteworthy fiscal innovations: a structural surplus rule and a copper stabilization fund. The first targets an annual structural surplus in the central government budget, and the second insulates the budget and the economy from severe macroeconomic fluctuations stemming from the copper market. These mechanisms have contributed to Chile's superb fiscal performance: Chile ran a surplus equal to 8% of GDP in 2007—an impressive achievement for any country. Even as powerful a shock as the recent global financial crisis failed to derail Chile's budget discipline.

At the other end of the spectrum, the case of Paraguay shows that well-intentioned fiscal rules can produce poor outcomes when the policymaking process fails to engender political cooperation. Institutional weakness has rendered Paraguay's executive unable to consistently provide certain public goods favored by legislators. The latter have responded to the problem at the top by swelling the lower ranks, expanding the size of the bureaucracy and increasing its perks. The results have been predictable: employment in the central administration grew by more than 25% over a decade, and the budget balance deteriorated. Although the balance has improved recently, it has typically been volatile, burdened by inefficient spending programs and earmarks for favored groups. Reining in spending to manageable levels has required that the executive cut wherever it can after the budget has been passed. Consequently, actual spending is unrepresentative of the population's needs and wants.

In a few countries, fiscal reforms have enjoyed some success despite serious weaknesses in the broader policy process. Peru's new constitution, adopted in 1993, barred the central bank from financing the government's budget and strengthened the executive's hand in the budget process. A fiscal responsibility law passed in 1999 formally established the goal of a budget surplus over the economic cycle and introduced ceilings on deficits and expenditure. More recent legislation has made the process more transparent and has created new regional governments with some autonomous fiscal authority. These reforms have contributed to a fiscal turnaround and appear to have eliminated Peru's political business cycle, where spending tended to rise sharply in years preceding elections.

Despite some clear successes, then, the Latin American experience illustrates the limits that the policymaking process can impose on budgeting and budget reform. Other examples can be cited. In Ecuador, the legislature and the president routinely agreed to weaken the fiscal responsibility law in the years just before elections, and a rapid turnover of finance ministers (average tenure about seven months) dissipated any power inherent in that office. In Peru, political parties are still highly fragmented, and the logrolling required to win political support for needed spending initiatives tends to increase total spending. Unfortunately, even when political reform achieves measurable improvements in governance and popular participation, the result can be to make budgeting even harder, at least in the short run, as the case of Colombia illustrates (Box 1).

In addition, the achievement of fiscal sustainability, where it has happened, often masks other, less favorable developments. In many countries the budget has become

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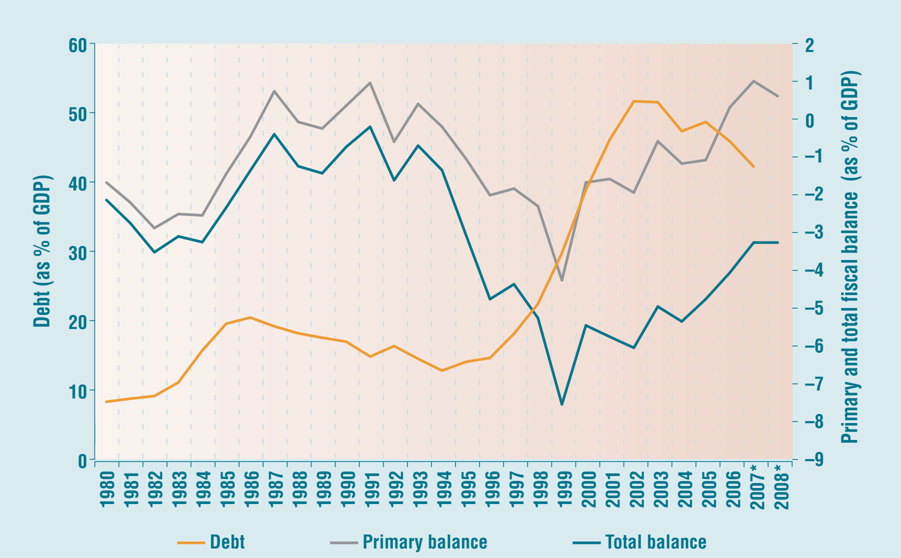
BOX 1

Unforeseen Consequences: Colombia's Constitutional Reform

Colombia's 1991 constitutional reform has succeeded in increasing political participation and making government more representative while decentralizing power both geographically and functionally. The new constitution made all political parties with membership exceeding a modest threshold eligible for direct public financing and subsidized media access, whatever their ideology. Today, numerous parties and movements compete for votes, and start-up parties have defeated the two traditional parties, which had long monopolized power, in elections at all levels, including the presidency. In addition, state governors are no longer appointed by the president, or mayors by the governors; instead all are chosen in popular elections, which function more or less normally despite harassment by guerrillas and paramilitary groups. Indigenous peoples and afro-descendant communities now have guaranteed representation in the senate. Women occupy one out of every eight seats in the senate, and over a fifth of cabinet posts have been held by women at one time or another since 1991.

Figure 1. National Government: Debt and Total and Primary Fiscal Balance (*percent of GDP*)



Source: Authors' calculations based on DNP and CONFIS data.
Note: Asterisks indicate that statistics for 2007 and 2008 are estimates.

However, as revealed in a new book, *Consecuencias imprevistas de la Constitucion de 1991: La influencia de la política en las políticas económicas (Unforeseen Consequences of the 1991 Constitution: The Influence of Politics on Economic Policy)*, the reform also fragmented political power by multiplying the number of actors. As the number of parties grew, party discipline in the legislature weakened. A reduction in its powers vis-à-vis the legislature cost the executive its ability to press its agenda effectively. Meanwhile, the constitutional court has become an important political actor, sometimes overturning the other branches' laboriously crafted agreements.

Fragmentation has increased the cost and difficulty of passing legislation, and the laws that do get passed tend to be less coherent and more difficult to implement. Budgetary measures are among those affected, undermining fiscal discipline. The greater rigidities introduced into budget allocations, together with the elimination of certain mechanisms available for building coalitions (such as the *auxilios parlamentarios*), have weakened the executive's capacity to build the legislative alliances it needs to pass its budget proposals. The same fragmentation makes it harder to respond to the problem by reforming budgetary institutions. Consequently, authorities have had to adapt their practices to this new environment by de facto elimination of budget additions—

so they do not provide the legislature with an additional stage for budget negotiations during the year—thereby increasing certain allocations and policies targeted at sectors of interest to important actors.

The incentive system facing policymakers and the legal restrictions in force have also affected, in many ways and with varying intensity, the capacity for reform in all areas of fiscal policy. Although the executive branch can still put through significant reforms in the area of decentralization, it has been able to make only minor and contingent tax reforms and has preferred to forgo budget reform altogether, to prevent the legislature from seizing an even bigger role in the budget process.

Together these unforeseen consequences of constitutional reform go far to explain Colombia's worsening fiscal outcomes, such as higher deficit and debt. Even though Colombia's fiscal situation has been improving since 2000, the national government's deficit still exceeded 3.3% of GDP in 2007 (see Figure 1). Few question that the 1991 constitution was a great achievement, fostering unprecedented political and social inclusion. But these successes now must be reconciled with the objective of improving the design and execution of fiscal and other policies. The political reform of 2003 could be the first step in that direction.

How Policymaking Influences Budget Making—and Vice Versa

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more rigid over time, and cuts in public spending have done little to make that spending more efficient.

...and Good Budgeting Can Improve Policymaking

Few if any countries in Latin America have achieved significant budget reform without some adjustment of the broader policymaking process. It appears that a supportive policymaking environment, if not a necessary condition for fiscal reform, does help. Yet an intriguing finding from a subset of countries is that parts of the budget process seem expressly designed to address persistent weaknesses in the policymaking process. This indicates that there is some scope for fiscal reform even where the policymaking machinery badly needs overhauling.

Consider Uruguay, which has one of the few well-established party systems in Latin America. The powers of the president and the legislature are clearly defined, and each provides an effective check on the other. Yet the country also has a pronounced electoral cycle, which undercuts the fiscal rules and influences the participants' incentives and interactions for the worse. At the start of each five-year term, political cooperation tends to be high. But as elections near, parties and presidents become more concerned with boosting their own popularity, and coalitions tend to break down. Fortunately, in the first year of each term, cooperation is usually sufficient to pass a five-year budget plan, which under existing rules becomes the default budget if annual budgets cannot be worked out in subsequent years. This ensures some fiscal discipline even in the politically overheated years preceding elections.

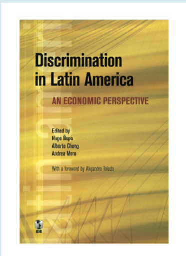
A similar story can be told for Brazil. There, the budget process lies at the core of the policymaking game, because it provides the president with the bargaining chips to survive in a highly contested political arena. The president's powers include, most critically, the power of impoundment: the president may simply choose not to spend money that the legislature has budgeted for a particular agency or program. This power partly compensates for the tendency of individual legislators to push aggressively for more spending in their own districts. Not surprisingly, Brazilian presidents have used this power frequently.

The overall message is clear. Even well-crafted and well-intentioned fiscal reforms can fail because of more fundamental shortcomings in the overall policymaking process. But the budget process can sometimes provide a forum for brokering competing agendas and solving political disagreements that are not resolvable in the broader arena. Influences thus run in both directions: from policymaking in general to the budget process and back again. When designing reforms, policymakers should be careful to take account of these feedback effects and use them to the best advantage.

New Publications

Available in English only unless otherwise stated.

BOOKS



Discrimination in Latin America: An Economic Perspective

Alberto Chong, Andrea Moro and Hugo Ñopo

Washington, DC: IDB and The World Bank. 2010.

This book presents a set of studies on contemporary discrimination in Latin America that takes advantage of a series of new analytical tools. The findings confirm some of the common perceptions regarding discrimination but challenge the conventional wisdom in other regards. It finds that Latin Americans do not discriminate more or less than inhabitants of other regions, and that when discrimination does occur, it appears largely to stem from lack of information on individuals.

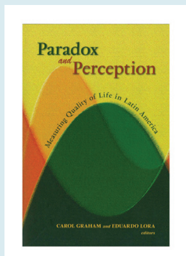
Unintended Consequences of the 1991 Constitution. The Influence of Politics on Economic Policies

(Available in Spanish only)

Edited by Eduardo Lora and Carlos Scartascini

Bogota, Colombia: Alfaomega and Fedesarrollo.2010.

This book highlights how public policy can be plagued by unforeseen consequences. Initiatives that in principle seem indisputably worthwhile can end up having adverse implications, sometimes even calling into question the value of the initiatives themselves. In the case of Colombia, under the new Political Constitution of 1991, the resulting fragmentation in the party system and increasing judicial interference in economic and social fields have produced unfavorable consequences for the quality and sustainability of various economic policies, especially in regard to fiscal management, pensions and finance.



Paradox and Perception: Measuring Quality of Life in Latin America

Carol Graham and Eduardo Lora

Washington, DC: IDB and Brookings Institution Press. 2009.

This book takes the study of happiness as a point of departure and uses a broader "quality of life" approach to study well-being in the region. The approach incorporates basic needs but extends beyond them to include capabilities, the livability of the environment, and life appreciation and happiness.

IDB WORKING PAPERS

Monetary and Exchange Rate Policies for the Perfect Storm (WP-678)

Andre Minella, Andrew Powell, Alessandro Rebucci and Nelson Souza-Sobrinho

This study provides a set of tools to analyze the monetary and exchange rate policy issues in the seven countries of the IDB's Caribbean region: The Bahamas, Barbados, Jamaica, Haiti, Guyana, Suriname, and Trinidad and Tobago. It then applies some of them to analyze the impact of the global turmoil on these economies in the last quarter of 2008. The paper also discusses, in light of both recent theoretical developments and key aspects of these economies, the monetary and exchange policy responses to the initial phase of the global turmoil.

Job Quality and Labor Productivity in Peru (WP-691)

Juan Chacaltana and Gustavo Yamada

The Peruvian economy presently has a limited ability to create high-quality jobs due to low levels of labor productivity. The first part of the document analyzes data from the period 2000–2006 and finds little growth in labor productivity and levels of high-quality jobs. The second part of the study examines firms in two sectors that stand out for their ability to create jobs: asparagus production and hotels. The three factors with the most positive impact on productivity were identified in each sector. For asparagus production, these factors were access to financing, worker training and relations with suppliers and middlemen. For hotels, they were worker training, room prices, and the training of managers.

Politics, Policies and the Dynamics of Aggregate Productivity in Colombia (IDB-WP-101)

Marcela Eslava and Marcela Melendez

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New Publications

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This paper describes private actors' involvement in Colombia's policy-making process. While more transparent and formal channels are used to discuss horizontal policies, they are less effective. The adoption of targeted policies, however, follows a faster track and depends more on political power than on those policies' potential as engines for productivity growth. Electoral weight and being represented by business groups and associations are found to be important determinants of the policy benefits received by a sector in a region, especially when activities are located in regions affected by armed conflict. The resulting imbalance of policies is found to damage aggregate productivity.

The Political Economy of Productivity in Argentina: Interpretation and Illustration (IDB-WP-102)
Marcela Cristini, Cynthia Moskovitz, Sebastián Saiegh and Santiago Urbiztondo

This paper examines how the main characteristics of Argentina's policymaking process (PMP) affect the productivity of its economy. First, the paper complements existing descriptions of the PMP by considering private agents and elaborating on structural characteristics possibly conducive to policymaking instability. Second, the paper illustrates the (negative) impact of Argentina's low-quality and myopic PMP equilibrium on productivity by examining two key areas: provision of infrastructure services and agricultural policy. Finally, the paper explores the PMP at the local level of government (municipalities and local communities), finding that it mimics the flaws at the federal level.

The Making of Policy: Institutionalized or Not? (IDB-WP-108)
Carlos Scartascini and Mariano Tommasi

This paper develops a framework for analyzing different policymaking styles, their causes and their consequences in Latin America. It finds that lower institutionalization and greater use of alternative political technologies (APTs) are more likely the lower the cost of using these technologies, the higher the potential damage they can cause, the lower the wealth of the economy, and the more asymmetric the distribution of de jure political power. Moreover, strategic complementarity exists in the use of alternative political technologies; for instance "bribes by the rich" and "protests by the poor" are likely to be countervailing forces, and will both occur in polities with weaker political institutions.

New Century, Old Disparities: Gender and Ethnic Wage Gaps in Latin America (IDB-WP-109)
Juan Pablo Atal, Hugo Ñopo and Natalia Winder

This paper surveys gender and ethnic wage gaps in 18 Latin American countries. It finds that men earn 9–27 percent more than women, with high cross-country heterogeneity. The unexplained pay gap is higher among older, informal and self-employed workers and those in small firms. Ethnic wage differences are greater than gender differences, and educational attainment differentials play an important role in explaining the gap. Higher ethnic wage gaps are found among males, single-income generators of households and full-time workers, and in rural areas. Much of the ethnic wage gap is due to the scarcity of minorities in high paid positions.

Gender Wage Gaps in Central American Countries: Evidence from a Non-Parametric Approach (IDB-WP-111)
Ted Enamorado, Ana Carolina Izaguirre and Hugo Ñopo

This paper compares gender wage gaps for Costa Rica, Honduras, Nicaragua and El Salvador from the mid-1990s to the mid-2000s using Ñopo's (2008) non-parametric matching methodology, which permits analysis of not only average gaps but also distributions. While a simple comparison of average wages would suggest small or even negative gaps, the wage gap is substantial when workers with comparable human capital characteristics are considered. Although the gender wage gap declined from the mid-1990s to 2000, the gap appears to increase thereafter. Among females, access barriers to certain human capital profiles contribute to wage gaps. Unexplained gender wage gaps are more pronounced among poorer individuals.

Happiness, Ideology and Crime in Argentine Cities (IDB-WP-112)
Rafael Di Tella and Ernesto Schargrodsky

This paper uses self-reported data on victimization, subjective well being and ideology for a panel of individuals living in six Argentine cities. While no relationship is found between happiness and victimization experiences, a correlation is documented between victimization experience and changes in ideological positions. Specifically, victims of crime are more likely than non-victims to state that inequality is high in Argentina and that the appro-

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priate measure to reduce crime is to become less punitive (demanding lower penalties for the same crime).

Financial Integration and Foreign Banks in Latin America: How Do They Impact the Transmission of External Financial Shocks? (IDB-WP-116)
Arturo J. Galindo, Alejandro Izquierdo and Liliana Rojas-Suárez

This paper explores the impact of international financial integration on credit markets in Latin America. It finds that financial integration amplifies the impact of international financial shocks on aggregate credit and interest rate fluctuations. Nonetheless, the net impact of integration on deepening credit markets dominates for most conditions. The paper also explores the role of financial integration—captured through the participation of foreign banks—in propagating external shocks. It finds that interest rates charged and loans supplied by foreign-owned banks respond more to external financial shocks than those supplied by domestically owned banks. This does not hold for all foreign banks, notably Spanish banks, which behave more like domestic banks.

Financial Dependence, Formal Credit and Informal Jobs (IDB-WP-118)
Luis Catão, Carmen Pagés-Serra and María Fernanda Rosales

This paper examines a much overlooked link between credit markets and formalization: since access to bank credit typically requires compliance with tax and employment legislation, firms are more likely to incur such formalization costs once bank credit is more widely available at lower cost. It is found that formalization rates increase with financial deepening, especially in sectors where firms are more dependent on external finance. Also, decomposing shifts in formalization rates into those within each firm size category and those between firm sizes shows that financial deepening significantly explains the former but not the latter. Some key policy implications are derived.

The Training of Economists in Latin America (IDB-WP-119)
Eduardo Lora and Hugo Ñopo

This paper presents a comparative view of the training of economists in five countries of Latin America, analyzing curricula, commonly used textbooks, the full or part-time employment of professors, teaching methods, and the use of computer technology. In addition, a survey of students majoring in economics is conducted in order to obtain a socioeconomic profile of them and to outline their attitudes and opinions. Among the patterns found in the five countries, particularly notable is the disconnect between students' expectations of the job market and the actual demand for economists in various sectors of the economy.

Institutional Quality and Fiscal Transparency (IDB-WP-125)
Nicoló Andreula, Alberto Chong and Jorge Guillén

This paper uses new data on fiscal transparency for a cross-section of countries; these data have several advantages. First, the data are based on in-depth reports using a standardized methodology and protocol. Second, this study covers 82 countries, more than previous comparable studies. Third, the fiscal measures used have been obtained with the collaboration of government authorities, which makes them particularly reliable. Finally, the data collection has been undertaken at a high level. These new data permit examination of a relevant but little-studied issue: the role of institutional quality in a country's fiscal transparency. It is shown that there is a causal relationship between institutions and transparency.

OUTSIDE PUBLICATIONS

Firm Heterogeneity and Wages in Unionised Labour Markets: Theory and Evidence.
Labour Economics 16(4): 440–450.
Paulo Bastos, Natalia P. Monteiro and Odd Rune Straume

In many countries wages are set in two stages: industry-level collective bargaining is followed by firm-specific arrangements determining actual paid wages as a mark-up on the industry wage floor. What explains the wage set in each of these stages? This paper shows that both the industry wage floor and the average wage cushion are systematically associated with the degree of firm heterogeneity in the industry. The former (latter) is negatively (positively) associated with the productivity spread. Furthermore, since the response of the wage floor dominates that of the wage cushion, workers in more heterogeneous industries tend to receive lower actual paid wages.

Oligopoly, Open Shop Unions and Trade Liberalisation
International Journal of Industrial Organization 27(6): 679–686.
Paulo Bastos, Udo Kreickemeier and Peter Wright

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This paper investigates how, in an international duopoly model, trade liberalization impacts collective bargaining outcomes when workers are represented by open shop unions. It is found that, with intermediate levels of union density, trade liberalization may lead to higher negotiated wages even if no trade occurs in equilibrium. In addition, union wages may be higher with free trade than in autarky.

Unions, Competition and International Trade in General Equilibrium
***Journal of International Economics* 79(2): 238–247.**
Paulo Bastos and Udo Kreickemeier

This paper develops a two-country, multi-sector model of oligopoly in which unionized and non-unionized sectors interact in general equilibrium. The model is used to study the impact of trade liberalization, deunionization and firm entry on wages in unionized and non-unionized sectors, and on welfare. It finds that a shift from autarky to free trade increases non-union wages and welfare, whereas the effect on union wages is ambiguous. Partial deunionization leads to higher wages in both unionized and non-unionized sectors, but only increases welfare when the proportion of unionized sectors is sufficiently low. Finally, wages in non-unionized sectors increase with firm entry, while the response of union wages and welfare depends on the trade regime.

Debt Sustainability under Catastrophic Risk: The Case for Government Budget Insurance
***Risk Management and Insurance Review* 12(2): 273–294.**
Eduardo Borensztein, Eduardo Cavallo and Patricio Valenzuela

Natural disasters are an important source of vulnerability in the Caribbean region. Despite being one of the more disaster-prone areas of the world, it has the lowest levels of insurance coverage. This article examines the vulnerability of Belize's public finance to the occurrence of hurricanes and the potential impact of insurance instruments in reducing that vulnerability. The article finds that catastrophic risk insurance significantly improves Belize's debt sustainability. In addition, the methodology employed makes it possible to estimate the appropriate level of insurance, which for the case of Belize is a maximum coverage of US$120 million per year. International organizations can play a role in helping countries overcome distortions in insurance markets, as well as to relax internal political resistance to the purchase of insurance policies.

The Determinants of Corporate Risk in Emerging Markets: An Option-Adjusted Spread Analysis
International Journal of Finance & Economics
(early view available at: http://www3.interscience.wiley.com/journal/99017880/issue).

Eduardo Cavallo and Patricio Valenzuela

This study explores the determinants of corporate bond spreads in emerging market economies. The paper finds that corporate bond spreads are determined by firm-specific variables, bond characteristics, macroeconomic conditions, country-specific sovereign risk, and global factors. A variance decomposition analysis shows that firm-level performance indicators account for the larger share of the variance. In addition, corporate spreads respond more acutely to sovereign and global risk increases rather than to decreases. This suggests two asymmetries prevalent in the data. The first is in line with the sovereign ceiling "lite" hypothesis, which states that sovereign risk remains a significant determinant of corporate risk even though credit rating agencies have gradually moved away from a policy of never rating a corporate above the sovereign. The second echoes the popular notion that panics are common in emerging markets where investors are less informed and more prone to herding.

The Fiscal Vulnerability of Social Spending: Is Latin America Different?
***Revista de Análisis Económico [Review of Economic Analysis]* 24 (1): 3–20.**
(Available in Spanish)
Eduardo Lora

An unbalanced panel of 50 countries for the period 1985–2003 is used to compare the vulnerability of public social spending on health and education to current fiscal variables and public debt in Latin America with the rest of the developing world. Social spending is significantly lower (although it absorbs a higher proportion of primary spending) and is more sensitive to higher interest on debt payments, but less sensitive to variations in other public expenditures. As in other regions, social spending in Latin America contracts with increases in public debt, and even more when multilateral bank debt is involved. In contrast with the rest of the world, in Latin America debt defaults lead to a reduction in social spending as a share of total public spending.

Look Who's Talking

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

Development Challenges and Policies in Latin America and the Caribbean: What Are the Issues?

September 9–10, 2009

On the occasion of the Research Department's 15th anniversary, academicians and policymakers gathered at IDB headquarters for a two-day seminar in early September to discuss the principal development challenges facing the region. Presentations ranged from evaluation techniques and the role of experimentation in policymaking to social safety nets, infrastructure and macroeconomic management. The following summaries provide a taste of the breadth of issues discussed at this celebratory event.

Guillermo Calvo and Ricardo Hausmann Discuss the Financial Crisis

The situation of emerging markets prior to the fall of Lehman Brothers was satisfactory because the terms of trade maintained their upward trend and spreads were shrinking. However, this crisis —which Calvo called a bank run, not in the traditional sense of runs on deposits but on financial instruments—at some point reversed the trend of spreads, which increased through the end of the rescue of AIG and then resumed their downward trend. This may be because the region enjoyed more solid fundamentals when this crisis hit or because the region is no stranger to shocks: this crisis is in no way unprecedented or even dramatic when compared with those that have hit the region in the past.

On the last point, in particular, this crisis simply highlights the importance of the lessons learned from previous shocks: the roles of external factors, fiscal solvency—maintaining low levels of well-structured public debt, flexible and competitive exchange rates, bank liquidity, saving by government in boom times, the balance on current account, liability dedollarization, among others. Disciplined countries that learned these lessons are making a quicker recovery, according to Hausmann.

Recovery in today's context, however, has taken on a different meaning. This time the crisis hit everyone and the fall in asset prices required actions by the developed world. Emergency measures have resulted in large fiscal deficits, a cut in interest rates to almost zero, and significant expansion of central bank balance sheets.

The emerging world has very limited room to use fiscal policy as a response to the crisis; few countries have the resources needed to generate anti-cyclical policy. The policy actions of emerging countries have involved devaluation of their currencies, taking into account the low impact that this measure can have on general price levels given the process of world disinflation.

Clearly, financial health—which is the objective—does not per se guarantee stability of output. A sound banking system does not necessarily mean that credit will continue flowing in the same way. The challenge created by the crisis is how to maintain growth patterns.

For Hausmann, the problem starts with identifying each country's restrictions on growth, and the capacity a set of policies could have on moderating the impact of these restrictions on growth.

Institutions, Regulation and Reform

Florencio López-de-Silanes, EDHEC Business School, France

The level of development of capital markets varies enormously between developed and developing countries. Presumably, a higher level of economic development should be associated with a higher degree of financial development. However, there appears to be a significant degree of heterogeneity when it comes to capital markets, even among developed countries.

Increasingly, research has focused on the role of institutions in determining the level of development achieved by different countries. Empirical evidence demonstrates that in an interdependent world, the benefits of trade and integration or the effects of a crisis depend on the type and quality of institutions: the experiences of the European Union, NAFTA, the end of socialism, and the crises in Asia, Russia and the United States all testify to this point.

There are two principal reasons why countries do not develop efficient institutions. The first relates to politics: politicians are imperfect and they tend to be heavy handed in regulating. The other reason is that many coun-

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tries have inherited this inefficiency from colonial times. Notably, there are aspects inherent in particular systems that contribute to their efficiency. The English system (*common law*) tends to promote greater institutional efficiency than the French system (*civil law*). This translates into greater protection of prívate investment, less regulation and more autonomous and formal judicial systems.

Thus, there is a positive relationship between institutions and the level of a country's development. In particular, institutions have a significant impact on the development of financial markets, private capital, interest rates, corruption as well as variables in the real economy such as labor participation and unemployment.

A major challenge facing the countries of Latin America today is to advance in the process of institutional reform, which is a basic tool for promoting greater competitiveness and attracting higher capital flows to the region.

The Legislature's Role in the Budget Process

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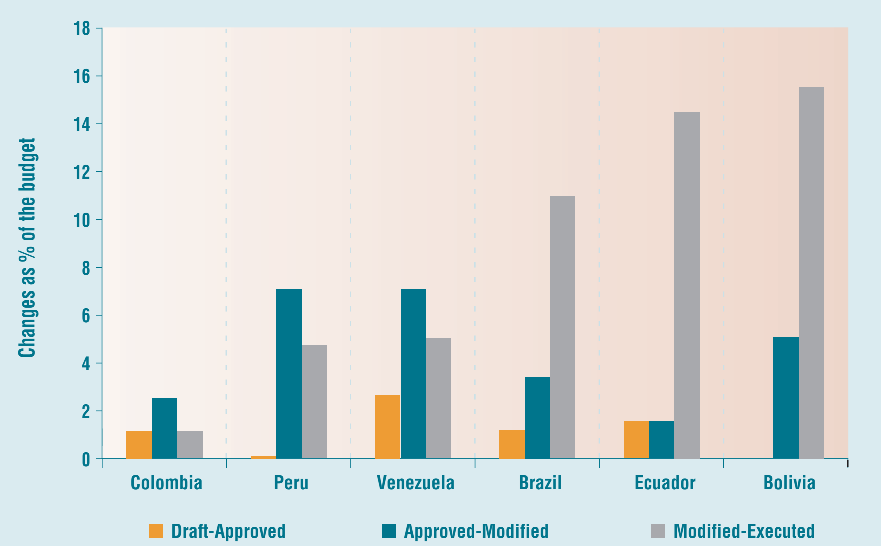
time, with the result that any possible lessons from this year's experience for next year's planning go unlearned. This is not an isolated case. In most countries in the region there is not a relevant process established for reviewing and correcting budget allocations from one year to the next.

Figure 2, based on average changes made to the budget between 1997 and 2005, shows that in most countries in Latin America, Congress plays a minor role in the budget process—changes during approval are few, as the first bar illustrates—and that the changes Congress introduced can generally be reversed by the executive during execution—as the last bar shows.

One reason why legislative review is often weak is the resource disparity inherent in the executive-legislative relationship. National executives usually have abundant technical resources to support budget analysis: most executive-branch budget offices in Latin America have more than 40 employees. In contrast, very few legislatures even have a specialized budget office, and those that exist seldom have more than 10 employees. The legislature's analytical capacity thus depends on the experience of the legislators themselves, on the extent to which individual lawmakers specialize in budgeting and other issues, and on the availability of outside technical advisers.

To sum up: greater legislative involvement in the budget process can both enhance its efficiency and improve its representativeness. But a process that places no checks on legislators' pork-barreling can lead to overspending and an unsupportable public debt. Often the budget process degenerates into a chess match between executive and legislature that causes spending to spiral upward. Better rules—for example, rules that restrict the legislature's ability to increase overall spending during the approval process, and rules that limit the executive's ability to deviate from approved budgets—can avoid such unsustainable results, but only if adequately enforced. Moreover, these rules are only pertinent in the context of the overall policy game.

Figure 2. Changes to the Budget at Each Stage (*average, 1997–2005*)



Network News

Latin American and Caribbean Research Network

Improving Early Childhood Development in Latin America and the Caribbean:
The proposals selected to conduct this research project are:

Brazil	*Early Childhood Development in Brazil: Supply and Quality of Daycare and Preschool Services, and their Impacts on Future Educational Outcomes.*	IETS – Instituto de Estudos do Trabalho e Sociedade	Ricardo Paes de Barros, Miguel Fogel, Daniel Santos, Fernando Veloso, Cristine Pinto, Rosane Mendonça
Chile	*The Impact of Child-Care Centers on Early Childhood Development.*	Centro Microdatos, Universidad de Chile	Sergio Urzua, David Bravo, Gregory Veramendi
Guatemala	*The Inter-Generational Transmission of Cognitive Abilities and Early Childhood Development Outcomes in Guatemala.*	IFPRI: International Food Policy Research Institute	John Hoddinot, Maria Cecilia Calderón
Honduras, Nicaragua, Mexico	*The Coffee Crisis, Early Childhood Development, and Conditional Cash Transfers*	Towson University	Seth Gitter, Brad Barhamn, James Manley
Mexico	*The Effects of Adult Migration on the Cognitive Development of Children: Evidence from the Mexican Family Life Survey.*	University of Illinois at Urbana-Champaign	Elizabeth Powers
Peru	*Early Childhood Development in Peru: Evidence from Young Lives children and their siblings.*	University of Oxford, GRADE: Grupo de Análisis para el Desarrollo (Peru)	Catherine Porter, Stefan Dercon, Javier Escobal Escobal D'Angelo, Outes Leon, Alan N. Sanchez
Uruguay	*CCTs and Birth Outcomes. Evidence from the Uruguayan PANES.*	London School of Economics, UCA-Berkeley, Instituto de Economía-Universidad de la República	Marco Mancorda, Edward Miguel, Veronica Amarante, Andrea Vigoritto

2010 IDB-IIC Annual Meeting

Seminar:
The Financial Crisis: Is It Over Yet? Is It Time to Celebrate the Recovery?
Saturday, March 20, 2009.
3:00–6:00 pm
Convention Center Cancun
Gran Cancun Room

www.iadb.org/res/researchnetwork