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The Age of Productivity

The economies of Latin America and the Caribbean suffer from a chronic low-growth disease. Other developing regions have managed to grow rapidly in recent decades, thereby reducing their per-capita income gaps with developed countries. Latin America and the Caribbean, instead, has actually distanced itself even farther from the developed world.

Contrary to popular belief, the region's lack-luster growth and the resulting income gaps are not due to a lack of investment in physical and human capital or to the slow growth of the labor force; rather, they are due to a chronic productivity growth deficit. Latin American countries simply do not use their productive resources efficiently. No company can be successful without focusing attention on its productivity. Diagnosing the causes of low productivity and finding solutions to the problem are crucial to the management of any firm. The same should apply to countries, but it rarely does.

> Latin America's lackluster growth and the resulting income gaps are due to a chronic productivity growth deficit.

How costly has this low productivity been? Had the countries of the region grown at the global average, they would literally be different countries today. For instance, using 1960 as a starting point, the income per capita of Argentina, Venezuela and Uruguay would today be at the level of France, Israel and Spain, respectively, had they been able to keep pace with the rest of the world. Instead, average income per capita in the region was one quarter that of the Untied States in 1960 and in 2005 was only one sixth.

Chile and Costa Rica are the two economies in the region that best utilize their productive resources but even in these countries productivity levels are barely 75% the level of the United States, meaning that a potential 25% increase in incomes is wasted. If productivity in the region had converged to the U.S. level—that is, if the physical and human resources that Latin American and Caribbean countries currently enjoy were used with the productive efficiency of those in the United States—per capita income would have doubled and the income of the region relative to that of the United States would have been one-third. Of course, with higher productivity, investment and education would certainly have increased as well, narrowing the gap even further and over time converging on the income levels of developed countries.

The good news is that while increasing the stock of physical and human capital may require resources that are unavailable in low-income countries and may even be wasteful if productivity is low, boosting productivity may "simply" require the willingness to transform policies and institutions in light of successful experiences elsewhere. Unfortunately, this is easier said than done, but the productivity challenge cannot wait. Millions of people in Latin America and the Caribbean are suffering from limitations that could be solved if existing resources were better utilized.

The causes of the low productivity that plagues the region are many and varied. High rates of informality screen small, inefficient firms from the competition of better,

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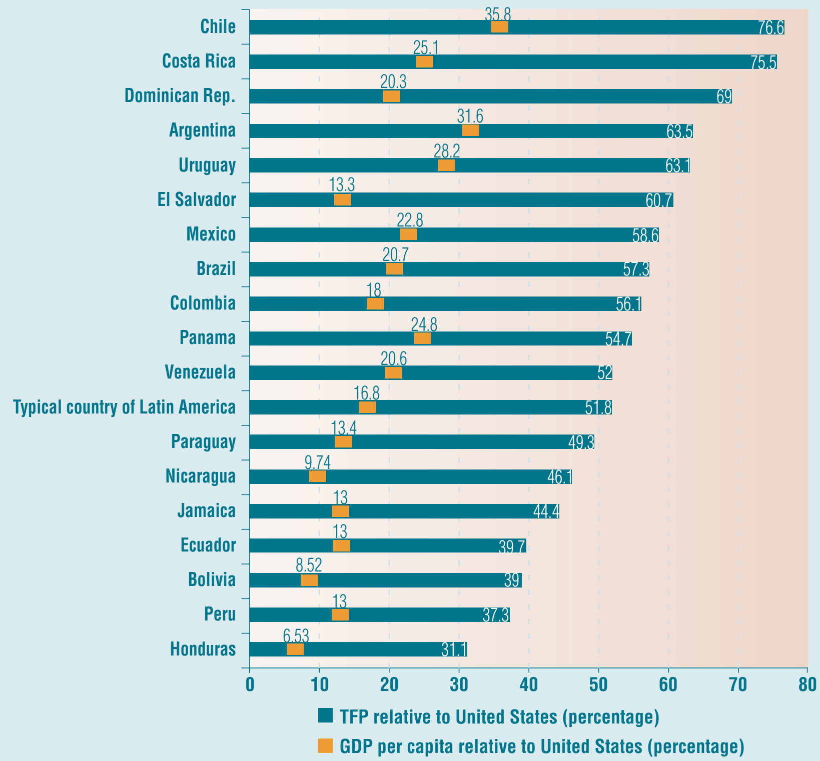
more productive businesses. Poorly designed social policies, which often target informal workers, may actually push more and more people into this low productivity sector. High transport costs, lack of credit, macroeconomic volatility, discriminatory tax regimes, a lack of innovation and a predisposition against productive development policies have all played a role in retarding productivity growth throughout the region.

Identifying the shackles on productivity growth is relatively easy. Designing and implementing a coherent set of policies to unleash a country's productive potential is far more difficult. The Inter-American Development Bank (IDB) took a major step in this direction by dedicating the latest edition of its flagship publication, *Development in the Americas,* to the issue of productivity. This issue of IDEA draws on this study, titled *The Age of Productivity*: *Transforming Economies from the Bottom Up*, as it explores some of the causes—and possible cures—of low productivity in the region.

Figure 1. Relative Productivity in Latin America, 2005



Source: Authors' calculations based on A. Heston, R. Summers, and B. Aten (2006), Penn World Table Version 6.2, Center for International Comparisons of Production, Income and Prices at the University of Pennsylvania; World Bank (2008), World Development Indicators Online; R. J. Barro and Lee (2000), International Data on Educational Attainment: Updates and Implications, CID Working Paper No. 42, Center for International Development at Harvard University.
Note: TFP = total factor productivity.

This issue of *IDEA* was prepared by Rita Funaro and Eduardo Lora and was based on this year's edition of Development in the Americas (DIA) The Age of Productivity: Transforming Economies from the Bottom Up, edited by Carmen Pagés.

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

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Beyond Manufacturing

The diagnoses and policy proposals on the productivity problems of Latin American and Caribbean economies concentrate almost exclusively on the industrial sectors, and sometimes on manufacturing alone. However, in order to boost growth and per capita income, the region must boost productivity of the nontradable sector.

Industrialization and prosperity are usually considered synonymous, and with good reason: developed countries became rich when, thanks to the industrial revolution, the labor force that was concentrated in the agricultural and traditional craft sectors shifted to industrial manufacturing, which has much higher productivity.

Latin American countries tried to follow this route to prosperity during the second half of the 20th century, but their attempts at industrialization were only partially successful. Quite remarkably, the share of industrial employment is now lower in Latin America than in both East Asia and the developed world. Combined with the declining share of employment in agriculture, this situation has swelled the ranks of the service sector and contributed to its meager productivity growth compared to either developed or fast growing East Asian economies. Unlike developed countries, which first prospered with industry and then transformed themselves into service economies, the region's economies became tertiary (or service-based) halfway along the road from poverty to prosperity.

Since industrial sectors in Latin America and the Caribbean account for barely 20 percent of the labor force, solving the problems of competitiveness or technological backwardness in this sector will do little to overcome underdevelopment. It is estimated that raising the growth of productivity of the manufacturing sector to the rate in East Asia would hardly change total labor productivity. In contrast, per-worker productivity could double if productive growth in the very laggard service sectors rose to match the productivity growth of these sectors in East Asia. Moreover, it should be easier to boost productivity in services than in industry for the simple reason that they are so much farther behind: compared to the United States, the productivity gap in services is 85% while the productivity gap in the industrial sectors is on average 61%.

A look at productivity performance by sector in Latin America from 1951 to 2005 illustrates just how far behind services are compared not only to the rest of the world but to the rest of the economy in Latin America. Throughout the period, productivity has grown more in sectors where the region has a comparative advantage, such as agriculture and other primary activities as well as mining—all intensive in the use of natural resources, which Latin America has in abundance. Productivity in these sectors has expanded at around 3.5% per year in the most recent period (see Figure 2). Yet, the picture is grim in most categories of services, with retail and wholesale trade and financial services posting the worst results. Productivity

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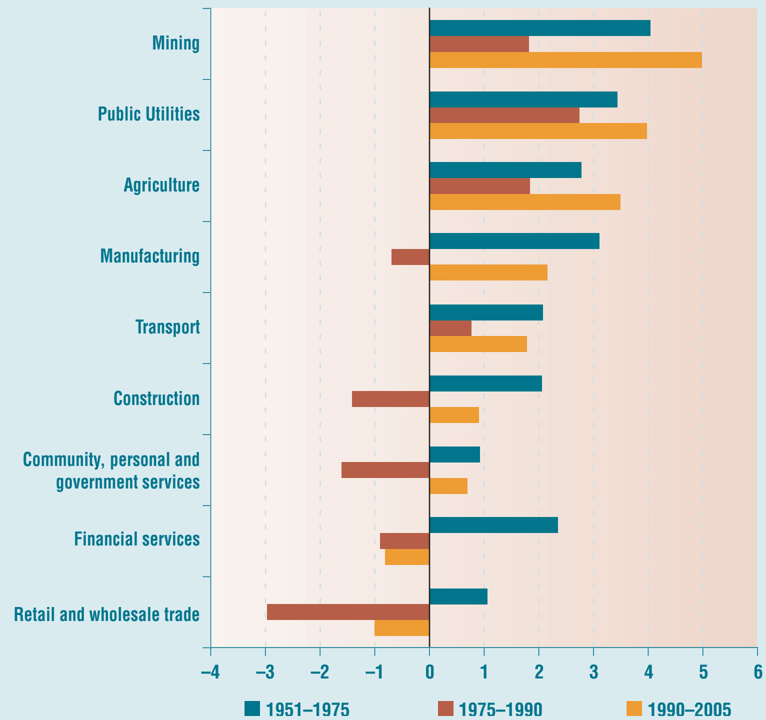
Figure 2. Average Labor Productivity Growth by Sector, Latin America, 1950–2005 (percent)



Source: Authors' calculations based on Timmer and de Vries (2007).

High Business Inequality, Low Productivity

It is common knowledge that Latin America suffers from some of the worst income inequality in the world. But extreme inequality is not limited to individuals: it also applies to firms and has serious implications for productivity.

If Mexican manufacturing firms are arranged in order of productivity, firms in the least productive decile require four times more capital and labor per unit of production than the most productive 10%. These gaps are double those found between firms in the United States or China. Mexico is not an isolated case. In countries as different as El Salvador and Uruguay, productivity gaps between firms are high by world standards. Excluding firms with less than 10 workers, the productivity gaps of firms in Colombia and Venezuela are six to one. And far from narrowing, the gaps between firms have widened in recent years.

In the diverse Latin American business universe, the least productive companies tend to be the smallest ones and, throughout the region, size and productivity are related. The capital and human resources invested in firms with over 100 employees typically produce double the output of the same investment spread over a dozen firms with 10 employees each. In some countries the differences are substantially greater. In Brazil, El Salvador and Venezuela large firms are at least three times more productive than small ones.

What aggravates the problem is that—apart from their very low productivity—small firms are extremely numerous in Latin America, and thus absorb a very large proportion of productive resources, especially labor. Although this is true in any economy (in the United States 54% of firms have 10 or fewer workers), in Latin American countries the excess of small firms is overwhelming: in Argentina 84% of firms have 10 or fewer workers, while in Mexico and Bolivia over 90% do not even have 10. If self-employed workers, often selling their products in the streets of the region's cities, are considered one-person enterprises, as in fact they are, the phenomenon of pulverization of economic activity into millions of tiny enterprises with low productivity is even more significant.

Latin America would make a huge gain in productivity if the resources of these less productive firms were reallocated to more productive ones. By making a simple reallocation of resources among manufacturing companies, Mexico could double its industrial production and El Salvador could boost its industrial output by almost 60%.

Outside the manufacturing sectors there is likely to be even more room for improving productivity by reallocating resources. Retail trade, where millions of Latin American workers have fled due to the scarcity of better jobs, is a potential reserve of enormous gains: in Mexico and Brazil the productivity of this sector could be catapulted around 260% and similar gains could be achieved in other services.

The writing on the wall is clear: instead of helping unproductive firms, it would be better to help large firms with high productivity to grow more and absorb the badly used resources of small firms. Obviously, this raises the question, what is preventing this process from taking place or, to put it another way, how can so many firms—especially small firms—survive with such low productivity? The answer lies in the lack of fair competition for resources as policies, market failures, or location advantages favor some firms over others for reasons other than their relative efficiency.

Beyond Manufacturing

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has declined even in the latter period of generally positive productivity growth in the rest of the economy. This implies that labor productivity in these sectors has deteriorated during the 1980s and in the most recent years, illustrating how poorly services have performed.

Raising the productivity of services is a must to improve the standard of living of the region's citizens: most workers are employed in the service sector, and the competitiveness of the primary and industrial sectors depends on having good transport and communications, efficient storage and distribution systems, and many other services. Aside from the first industrial revolution, all the other periods of rapid productivity growth in developed countries have been thanks to revolutions in services: railroads, electricity, telecommunications and informatics. There is no reason to believe that the leaps in productivity that Latin America needs to propel its growth will come from either the primary sectors or manufacturing. Services hold the greatest potential to enhance productivity and drive growth.

Taxes and Productivity

Tax systems in Latin America and the Caribbean are extremely complex, segmented and ineffective, despite correction of many of the worst aberrations in the 1990s. Latin American companies must still dedicate an average of 320 hours annually to preparing their tax returns compared to an average of 177 hours in developed countries. In some countries tax-related transactions can take as many as 2,000 hours a year. Evasion is endemic in the region and is not only a problem of collection but also of productivity. Tax systems distort the allocation of productive resources: the sectors and firms that expand are not necessarily the most productive but rather those that enjoy higher tax breaks or can evade their tax obligations more easily.

Since tax systems are so complex and smaller companies contribute a minimal amount to tax collection, tax administrations in 13 of 17 Latin American countries analyzed by the IDB have established simplified regimes for them. In two other countries, the tax offices have simply decided to exempt small companies from their tax obligations. At first glance, simplified tax regimes seem to be good for productivity because they save small companies costly hours of bureaucratic work. The problem is that since these regimes benefit firms that are below a certain sales or payroll threshold, small companies avoid expanding beyond these limits because their profitability would plunge. The profits of a small Peruvian company would fall 50% if it crossed the line, and the profits of an Argentine company would slide 25%. This helps explain why there are so few medium-sized firms in Latin America. More crucially, it is an important reason why many small, low-productivity companies survive, absorbing resources that would be more productively used in larger companies.

Given the complexity of tax regimes and the meager tax receipts that small- and medium-sized firms generate, tax administrations naturally concentrate their collection efforts on large companies—hence the large taxpayer units that exist in many countries. However, the effect is that many large companies with growth potential are reluctant to make investments that could increase their productivity because it might attract the tax administration's attention. The larger the company, the more their investment decisions are susceptible to these tax risks. And the more investment is concentrated in a few large companies, the greater the temptation of the political system and the tax administration to impose heavy taxes on their income.

Latin American tax regimes encourage the survival of unproductive firms, obstruct the growth of small and large enterprises alike, and foster a deeply unequal and segmented business universe.

Latin American tax regimes bear much of the responsibility for the tragedy of productivity in the region's economies because they encourage the survival of unproductive firms, obstruct the growth of small and large enterprises alike, and foster a deeply unequal and segmented business universe.

Simplifying, unifying and enforcing the tax provisions that apply to enterprises could contribute greatly to productivity. Regimes differentiated by sector, company size or for other reasons distort the allocation of resources, divert the scarce managerial resources of companies, and are an extra burden for the public administration.

A well-designed tax system should create incentives to pay taxes and prevent evasion. This is the great virtue of the value added tax because each company has an interest in seeing that its suppliers pay their VAT to obtain credit for its own payments. In contrast, taxes on financial transactions encourage companies to conspire with each other to keep operations outside the financial system, thereby destroying the payment system and the channels of information needed for overseeing compliance with tax obligations.

Simplified tax regimes for small companies are a collection of all the defects of a bad tax system: they discriminate by size, facilitate evasion, inhibit cross-control between firms and rarely generate useful information for tax control.

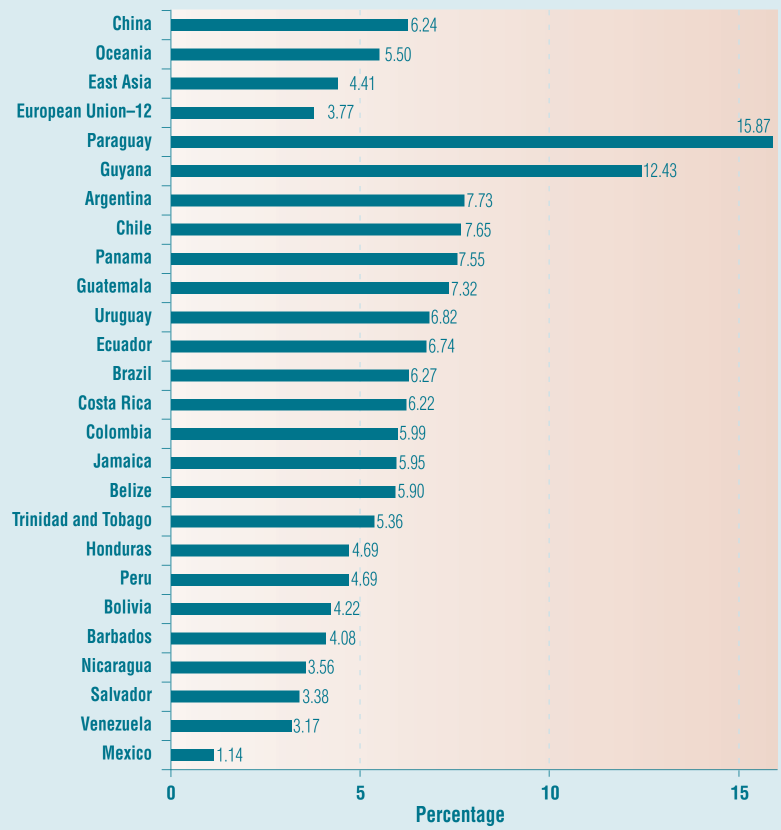
Transport Costs: A High Toll on Productivity

Free trade has often been touted a boon to productivity. Opening the door to imports should expose producers to greater competition, forcing them to cut costs and increase their efficiency while providing greater access to more and better inputs, particularly capital goods. But there are other very important channels through which international trade affects productivity that have been less studied. Even without changing the productivity levels of firms, international trade can boost aggregate productivity by helping to reallocate resources in favor of more productive uses.

Unfortunately, transport costs have in large part prevented the region from capitalizing on the productivity potential of international trade. For most countries, transport costs represent the highest percentage of the cost of trade, especially exports, and distance or geography are not the only reasons why. Figure 3 highlights that cargo transport costs of Central American countries as a proportion of the value of their exports to the United States are higher than China's, despite their proximity. Why? Their ports and airports are grossly inefficient. And the situation in Latin America is not much different. Inadequate physical infrastructure is to blame in some countries, but more important are the support activities for the movement of cargo and the inefficiencies caused by inadequate regulation, lack of competition in services, and deficient operating procedures and information systems.

Traditionally, tariffs have been one of the biggest impediments to higher productivity but its relative share of total trade costs has decreased over the past decade thanks to the opening up of the region's economies to more trade. Currently, transport costs are more than four times larger than tariff costs in Latin America and the Caribbean, representing a bigger trade barrier than tariffs.

Figure 3. Freight Expenditures as a Share of Exports to the United States, 2006



Source: Authors' calculations based on U.S. Census Bureau dataset on U.S. Imports of Merchandise (various years).
Note: European Union-12 countries are: Austria, Belgium, Denmark, Finland, France, Germany, Ireland, Italy, Luxembourg, Netherlands, Sweden and United Kingdom.

High transport costs protect inefficient producers, lowering their likelihood to exit, and limit the expansion of efficient plants, impinging on their possibility to export. Statistical analysis for Brazil and Chile show that transportation costs reduce plant efficiency and distort the allocation of resources in the economy, which affects the overall level of productivity. A 10% cut in freight costs would raise plant productivity by 0.5% and 0.7% in Brazil and Chile respectively. Lower freight costs would also raise aggregate productivity by making the inefficient firms more likely to close shop and the efficient firms more likely to export. For example, a 10 percentage point cut in freight costs increases the probability that an inefficient firm will exit in Chile by 1.5% and the probability of exporting by 4%.

Both tariffs and freight costs matter, but the scope for paring down transport costs today is much larger than for tariffs. For instance, Chile would need

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The Politics of Productivity

Since productivity is the art of achieving more with the same, policies aimed at increasing productivity should be the sweethearts of any political system. Unfortunately, raising productivity is a complex task that requires identifying appropriate policies, understanding the conflicts between different objectives, securing the resources to implement the policies, dealing with those who would prefer the status quo or other policies, and maintaining sustained efforts in complementary areas until they bear fruit. It is such an uncertain task, which requires so much coordination, effort and patience, that it is rarely the priority of political systems. Distributing subsidies to unproductive enterprises or increasing social programs for the unemployed, low-income families, small firms, or informal workers is easier and reaps greater and more immediate political returns.

To have even a possibility of success, policy recommendations for raising productivity must take into account the way private interests are organized and the capacity of the State and the political system to articulate and implement policies. Although these circumstances are difficult to change radically, the possibilities of success can improve by concentrating on just a few points:

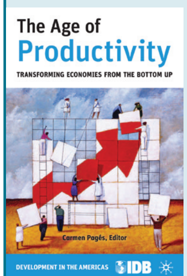
- *Make productivity a central theme of the public discourse*, as growth, inflation or unemployment currently are, and as on occasion even something as diffuse as "competitiveness" can be. Raising productivity depends on citizens and opinion leaders demanding adequate policies from the political system. In some cases, setting up national councils can be a valuable tool, provided they are institutionalized by law and endure over time. This requires an institutional framework that separates strategy from policy design and evaluation, has great credibility, and is protected from particular rent-seeking conducts.
- *Disseminate the effects of policies on long-term productivity.* This applies to both direct policies to improve productivity and others with indirect effects such as social or tax policies. Explain how these policies affect the productivity of the benefited sectors—such as microenterprises or informal workers—as well as the aggregate productivity of all productive sectors. This implies creating independent and transparent institutions to monitor and evaluate the impact.
- *Incorporate business and labor into the policy debate* through organizations at the highest level that represent national interests, rather than through more specific sectoral or interest groups. It is also useful to promote the formation of groupings with the broadest possible coverage and strengthen their capacities.
- *Invest in developing the capacity of the State to adopt long-term policies*. When they have longer-term career prospects, lawmakers, public officials and judges can invest more in their capacities and in developing effective forms of cooperation with other actors. A judicial branch with stability and political independence are crucial for credible policies.
- *Involve entities that guarantee credibility* thanks to their political independence, technical seriousness and permanence on the national scene. Certain academic bodies, nongovernmental organizations or multilateral organizations that can facilitate political transactions and oversee compliance with commitments could all fit this bill.
- *Anticipate the indirect consequences of reforms on political actions*. Decentralization of the State and the emergence of new political parties can be desirable for increasing citizen participation and opening channels of representation to excluded social groups, but they can also have negative effects on the capacity of the political system to adopt policies to raise productivity. The instruments of economic and social policy that most affect productivity must be isolated from these trends toward fragmentation.

Managing the politics of productivity may be just as challenging as devising the actual policies, but the need to boost productivity in the region is clear. A country's standard of living can be raised by exploiting the fact that—for reasons of nature—some crop or mineral or energy source can be produced or extracted at very low cost in relation to the international price; it can also be raised for a time by borrowing. But the lag that Latin America and the Caribbean have suffered for decades in relation to the rest of the world shows prima facie that in the medium term these strategies are not viable. In the end, there is no substitute for producing more effectively, innovating, training, adapting, changing, experimenting, reallocating and using work, capital and land with greater efficiency; in short, there is no substitute for higher productivity.

New Publications

Available in English only unless otherwise stated.

BOOKS



The Age of Productivity: Transforming Economies from the Bottom Up

Carmen Pagés, Editor

Washington, DC: IDB and Palgrave. 2010

Productivity, the main driver of economic prosperity, is languishing in Latin America and the Caribbean and is preventing the region from catching up with the developed world. Asking why the region is falling farther and farther behind, this book looks beyond the traditional macro explanations and digs all the way down to the industry and firm level to uncover the causes of this low productivity. It provides tools to ponder productivity growth beyond conventional aggregate analysis, focusing on the extreme heterogeneity of sectors and firms while emphasizing the importance of policies that allow high productivity firms to thrive and expand. While it certainly considers the plight of manufacturing, the book zeros in on the critical services sectors, particularly those, such as transportation and retail, with important repercussions on the rest of the economy. It challenges the argument that the region is condemned to stagnation and examines a number of policy levers that can transform the economies of the region.

MICRODATA

Politics, Policies, and Productivity: An International Dataset (DBA-013)

Ariel Mecikovsky, Carlos Scartascini, Mariano Tommasi

This dataset compiles publicly available data that proxies for the quality of the public policies that affect productivity at the national level, along with proxies for the articulation and characteristics of interest groups. It complements another dataset by the authors and Berkman et al. (2008) on the features of public policies.

Medium-Term Frameworks and the Budgetary Process in Latin America. A Database (DBA-014)

Carlos Scartascini, Gabriel Filc

Medium-Term Frameworks (MTF) in every one of their varieties (fiscal, budgetary, and expenditure) have become one of the most popular reforms to the budgetary process in Latin America during the last decade. Filc and Scartascini (2010) discuss the normative merits of using MTFs, provide a characterization of the different types of MTF, and describe their development in the Latin American region based on extensive field work. This database provides a unique set of information about the current state of development of MTFs based on that field work.

MONOGRAPH

The Aftermath of the Crisis: Policy Lessons and Challenges Ahead for Latin America and the Caribbean (B-642)

Alejandro Izquierdo, Ernesto Talvi

In the aftermath of the direst global crisis in recent times, Latin America and the Caribbean has shown remarkable resilience. The aim of this report is threefold: first, to understand the sources of this resilience, identifying the role played by unprecedented international financial support on the one hand, and the strength of domestic macroeconomic fundamentals on the other; second, to highlight the policy lessons that emerge from this analysis both for the region and the international financial community; and finally, to identify critical macroeconomic policy challenges for the region.

POLICY BRIEF

Debt Management in Latin America How Safe Is the New Debt Composition? (IDB-PB-109)

Eduardo A. Cavallo

While public debt ratios in Latin America increased in 2009 amid the global financial crisis, they remain below levels following the Asian and Russian crises of the late 1990s. Moreover, debt composition has shifted towards ‘safer’ debt (domestic debt with a higher prevalence of domestic currency liabilities). However, the current debt structure poses risks and policy challenges that should not be overlooked. This brief concludes that debt managers should avoid complacency in thinking that the region is completely redeemed from old sins. Particularly overlooked is that the region still lacks a large investor base for debt denominated in domestic currency at fixed nominal rates and reasonably long maturities.

IDB WORKING PAPERS

The Political Economy of Productivity in Brazil (IDB-WP-104)

Bernardo Mueller, Carlos Pereira, Lee J. Alston, Marcus André Melo

This paper explores the link between Brazil’s political institutions and its disappointing productivity and growth in recent decades. Although political institutions provide the president with incentives and instruments to pursue monetary stability and fiscal discipline they

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also raise the costs of achieving those objectives. Insulating certain expenditures from presidential discretion leads to other policy options, such as high taxes and expenditure cuts, which put a drag on productivity and growth. Given robust checks and balances and interest group fragmentation, a state overburdened by constitutional entitlements has resorted to massive tax hikes. The result is a mix of both essential elements for sustainable economic growth and distortions that conspire against it. While productivity and growth have improved in the past decade, the pace has been slow and incremental.

Productive Development Policies in Trinidad and Tobago: A Critical Review (IDP-WP-115)

Anne-Marie Mohammed, Ramiro Moya, Sandra Sookram

Even as Trinidad and Tobago diversifies away from the energy sector, the process underlying the country's productive development policies (PDP) is evolving from state-directed industrial policy to a newer approach with extensive private-public participation. This study explores the main characteristics of four PDPs and reviews them following the related literature. The four PDPs are: a) The process towards the promotion of clusters; b) the PDPs for the Tourism industry; c) the classical PDPs for Micro, Small and Medium Enterprises and; d) the Free Trade Zone as a policy designed to compensate for the failure of the State.

The Political Economy of Fiscal Reform in Brazil: The Rationale for the Suboptimal Equilibrum (IDP-WP-117)

Carlos Pereira, Marcus André Melo, Saulo Souza

This project examines fiscal reforms in Brazil since the 1990s, particularly in taxation, budgeting, and fiscal federalism. In budgeting, the economic crises of the mid-1990s prompted the government to rein in subnational fiscal imbalances but discouraged policymakers from changing the tax system. As fiscal stability and inflation control provide the executive with electoral incentives and international credibility, reform initiatives can generate political benefits for incumbent politicians. The paper argues that the Achilles' heel of the Fiscal Responsibility Law is its enforcement technology: the Tribunais de Contas.

Misallocation and Productivity in Colombia's Manufacturing Industries (IDP-WP-123)

Adriana Camacho, Emily Conover

This paper studies productivity dispersions in Colombian industrial establishments using the Colombian Annual Manufacturing Survey (AMS) from 1982 to 1998. About 3–8% gains are found in manufacturing Total Factor Productivity (TFP) and TFP is positively correlated with exporting status, age, size, and location in the central region of the country. Opening up the economy in 1991 is associated with an increase in plant productivity levels for exporting firms. The 1990 reform that reduced dismissal costs boosted productivity, while the reform that increased labor costs in 1993 decreased plants' productivity.

Productive Development Policies in Jamaica (IDB-WP-128)

Monica Panadeiros, Warren Benfield

Jamaica is a puzzling case for economic growth: despite structural reforms over the last three decades and adequate investment, real GDP per capita is roughly the same as in 1970. The disappointing performance of this economy suggests that PDPs, including first-generation reforms, have not been enough to create a better environment for productivity growth. This paper examines PDPs in Jamaica and concludes that behind the paradox of high investment and low growth are the "public debt trap" and a highly distortive tax incentive structure to attract foreign direct investment (FDI) and promote exports. Although industrial policy is evolving, the old schemes seem politically difficult to dismantle.

Productive Development Policies in Latin American Countries: The Case of Peru, 1990–2007 (IDB-WP-129)

Jose Tavara, Mario D. Tello

This paper assesses the institutional setting and productive impact of selected PDPs, institutions, and programs implemented in Peru from 1990 to 2007. Evidence indicates that PDPs and structural reforms did not significantly alter the productive structure of the Peruvian economy. If the objectives of the PDPs are to transform the productive structure, increase total factor productivity, and enhance innovation, government interventions must focus directly on the source of market failures and create quality productive changes within the private sector.

Analysis of Several Productive Development Policies in Uruguay (IDB-WP-130)

Gustavo Michelin, Juan Jose Barrios, Nestor Gandelman

This paper reviews and assesses some of the Productive Development Policies currently being implemented in Uruguay. Three horizontal and three vertical policies are considered in light of the market and public failures they attempt to address and minimize. Hor-

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izontal policies comprise Innovation, Industrial Promotion and Directives for Industrial and Technological Development. Vertical policies include the analysis of Forestry Law, Meat Traceability and the Sustainable Production Project in the agricultural sector.

On the Role of Productivity and Factor Accumulation in Economic Development in Latin America and the Caribbean (IDB-WP-155)

Christian Daude, Eduardo Fernández-Arias

This paper estimates the relative importance of total factor productivity and the accumulation of factors of production in the economic development performance of Latin America. It finds that total factor productivity is the predominant factor: low productivity and slow productivity growth, as opposed to impediments to factor accumulation, are the key to understanding Latin America's low income relative to developed economies and its stagnation relative to other developing countries. While policies easing factor accumulation would improve productivity somewhat, closing the productivity gap requires productivity-specific policies.

Productive Development Policies in Costa Rica: Market Failures, Government Failures, and Policy Outcomes (IDB-WP-157)

Julio Rosales-Tijerino, Luis Rivera, Ricardo Monge-Gonzalez

This paper analyzes five PDPs implemented in Costa Rica, finding that they are not optimally addressing market failures. Moreover, government failures rather than market failures represent the main justification for PDPs. Even in the presence of market failures, the policy instruments applied are not necessarily the most economically efficient but rather the most politically feasible options. In addition, the lack of policy evaluation and monitoring prevents adjustments and corrections of such policies. Addressing the arguments for policy intervention and incorporating the results of evaluation into policy design and reform are necessary conditions for success.

Political Institutions, Policymaking, and Economic Policy in Latin America (IDB-WP-158)

Carlos Scartascini, Mariano Tommasi, Martin Ardanaz

This paper surveys selected themes in the political economy of policymaking in Latin America. In particular, it addresses how political rules work for or against intertemporal cooperation among political actors. The extent to which polities obtain the key policy features that determine development depends on: 1) the workings of political institutions, which define how the policymaking game is played, 2) the arenas of interaction, which define where the policymaking game is played, and 3) the characteristics of key socioeconomic groups, which define who interacts with professional politicians to pursue different policy preferences.

Veto Players and Policy Trade-Offs: An Intertemporal Approach to Study the Effects of Political Institutions on Policy (IDP-WP-159)

Carlos Scartascini, Ernesto H. Stein, Mariano Tommasi

The capacity to sustain policies over time and to adjust policies as circumstances change are two desirable properties of policymaking systems. The veto player approach suggests that polities with more veto players will be able to sustain policies at the expense of the ability to change policy when necessary. This paper disputes that assertion from an intertemporal perspective, drawing from transaction cost economics and repeated game theory and showing that some countries might have both more credibility and more adaptability than others. More generally, when studying the effects of political institutions on policy outcomes, a perspective of intertemporal politics might lead to predictions different from those emanating from more atemporal approaches.

Is Latin America on the Right Track? An Analysis of Medium-Term Frameworks and the Budget Process (IDB-WP-160)

Carlos Scartascini, Gabriel Filc

Medium Term Fiscal Frameworks (MTFs) have become one of the most popular reforms to the budgetary process in Latin America, and introducing MTFs seemed to be the magic solution for most fiscal ailments. However, there has been no comprehensive evaluation of their impact. This document discusses the normative merits of using MTFs, characterizes the different types of MTF, and describes their development in Latin America using the cases of Argentina, Colombia and Peru. This paper lays the groundwork for progress toward comprehensive impact evaluations and, eventually, to the consolidation of MTFs in the region.

Estimating the Direct Economic Damage of the Earthquake in Haiti (IDB-WP-163)

Andrew Powell, Eduardo A. Cavallo, Oscar Becerra

This paper uses simple regression techniques to make an initial assessment of the monetary damages caused by the January 12, 2010 earthquake that struck Haiti. Damages are estimated for a disaster with both 200,000 and

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New Publications

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250,000 total dead and missing (i.e., the range of mortality that the earthquake is estimated to have caused) using Haiti's economic and demographic data. The base estimate is US$8.1bn for a death toll of 250,000, but an estimate of US$13.9bn for the same death toll is within statistical error. The implications of such an estimate are significant. Raising such a figure will require many donors—bilateral, multilateral and private. Hence, excellent coordination of funding and execution will be the key to ensuring the efficient use of funds.

OUTSIDE PUBLICATIONS

Bastos, Paulo and Joana Silva Rauch.
Identifying Vertically Differentiated Products. ***Economics Letters, vol. 106 (1), pp. 32–34, January.***
Bastos and Silva (1999) introduced a product classification scheme that has since been widely used to empirically identify differentiated goods. Using firm-level data on export unit values, this paper provides direct evidence that this classification is well suited for capturing quality differentiation.

Catao, Luis, Ana Fostel and Sandeep Kapur.
Persistent Gaps and Default Traps. ***Journal of Development Economics 89, pp.271–84***
This paper shows how vicious circles in countries' credit histories arise in a model where output persistence is coupled with asymmetric information about output shocks. In such an environment, default signals the borrower's vulnerability to adverse shocks and creates a pessimistic growth outlook. This translates into higher interest spreads and debt servicing costs relative to income, raising the cost of future repayments, thereby creating "default traps." A long and broad cross-country dataset shows the existence of a history-dependent "default premium" and of significant effects of output persistence on sovereign creditworthiness.

Catao, Luis and Allan Timmermann.
"Volatility Regimes and Global Equity Returns," ***in Volatility and Time Series Econometrics. Essays in Honor of Robert Engle, Tim Bollerslev, Jeffrey Russell, and Mark Watson (eds). Oxford University Press, 2009.***

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Transport Costs: A High Toll on Productivity

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to cut its freight rates by more than 50% to match U.S. levels, while tariffs would have to be cut by only 10% to be on a par with the United States.

Port and airport inefficiency explain about 40% of the difference in shipping costs between Latin America and the United States and Europe. Limited competition among shipping companies and inefficient domestic transportation systems, including unbearable traffic congestion in the region's burgeoning metropolitan areas, also contribute to the high costs.

The region's ports fare the poorest in terms of productivity when compared with ports in North America, Western Europe, the Middle East and Asia. Port efficiency is related not only to the quality of their physical facilities but also to support activities such as pilotage, towing and tug assistance, or cargo handling. Port and airport efficiency also depend on aspects such as the clarity of port procedures, the accuracy of their information systems or the existence of legal restrictions, such as requiring special licenses for loading and unloading.

What can be done? Cutting transport costs will require not only better infrastructure but also a regulatory framework that promotes investment and competition. More efficient ports and airports and improved regulation must be assigned a high priority by policymakers in the region. The government must encourage greater competition among shipping companies and decentralize port operations while making important investments, such as dredging a channel to allow for larger vessels with lower operating costs to enter a port.

In terms of air freight, airport efficiency and regulation are at the heart of the region's problems. Latin America must pursue more aggressively open skies agreements because they promote competition and help cut air transportation costs. The region must also ensure adequate airport regulation to deal with service quality while advancing privatization efforts.

The relationship between trade and productivity is intricate and far-reaching. And while it surely cannot provide all the answers to the productivity puzzle, the region has yet to lay all the groundwork to fully extract the productivity benefits that trade can yield.

New Publications

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This paper presents a regime switching framework to jointly address three important questions in international finance: whether global equity returns display well-defined volatility regimes; the extent to which equity market volatility is accounted for by global, country- and sector-specific shocks and; the implications for global risk diversification. Estimates spanning over three decades of international firm-level data reveal well-defined volatility states in stock returns and show that the contribution of country factors dramatically drops when the global factor is high and during major sector-specific shocks with a global reach, such as oil and IT shocks.

Cavallo, Alberto F. and Eduardo A. Cavallo.
Are Crises Good for Long-term Growth? The Role of Political Institutions.
Journal of Macroeconomics. Early view available at: http://dx.doi.org/10.1016/j.jmacro.2010.01.006

This paper provides empirical evidence on the importance of institutions in determining the outcome of crises on long-term growth. It shows that political institutions affect growth through their interaction with crises. In particular, the effect of a crisis on long-run growth is conditioned by the prevailing institutional environment. In countries with democratic institutions, the negative effect of crises is mitigated, while in countries with autocratic institutions, the negative effect is exacerbated.

Network News

Latin American and Caribbean Research Network

The proposals selected to conduct studies for the research project **Protecting Workers Against Unemployment in Latin America and the Caribbean** are:

- **Labor Market Transitions and Active Policies in Bolivia: A Case Study of Bolivian PLANE** – Fundación Aru and CIDES-Universidad Mayor de San Andrés
- **Protecting Workers Against Unemployment in Uruguay —** Instituto de Economía, Universidad de la República
- **Protecting Workers Against Unemployment: Evidence from Argentina** – Universidad Torcuato Di Tella
- **Study of the Unemployment Insurance System in Chile —** Cieplan, Corporación de Estudios para Latinoamerica
- **Unemployment Subsidy Program in Colombia: An Assessment and Future Policies –** Economía Urbana

Research Network Events

- **Improving Early Childhood Development in Latin America and the Caribbean**
  Seminar: May 17–18, 2010. IDB Headquarters, Washington, DC.
- **Housing Finance in Latin America and the Caribbean: What is Holding It Back?**
  Seminar: June 24–25, 2010. IDB Headquarters, Washington, DC.
- **Protecting Workers Against Unemployment in Latin America and the Caribbean.**
  Seminar: July 8–9, 2010. IDB Headquarters, Washington, DC.

Other Events

Policy Seminar:
World Growth in Perspective: The New Normal and Its Risks
April 23, 2010. IDB Headquarters, Washington, DC.

Moderator: Daniel Zelikow, Inter-American Development Bank
Panel:
Peter Garber, Deutsche Bank
Larry Hatheway, UBS Investment Bank
Ricardo Hausmann, Harvard University
John Williamson, Peterson Institute for International Economics

Seminar
The Aftermath of the Crisis
May 3, 2010. Banco de España, Madrid, Spain.

Alejandro Izquierdo and Ernesto Talvi present the Inter-American Development Bank 2010 macroeconomic report: *The Aftermath of the Crisis. Policy Lessons and Challenges Ahead for Latin America and the Caribbean.*

www.iadb.org/res/researchnetwork