IDEA
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How Democracy Works in Latin America

> Political institutions work best when they induce various political actors to cooperate and reach agreements that hold over time.

Almost 30 years have passed since a wave of democratization in Latin America swept new, elected governments into power in many countries, some of which had languished for decades under authoritarian rule. In that time democracy's roots have penetrated deeply, and the policy debate has long since moved on from its early focus on how to manage the democratic transition.

Despite its imperfections, most Latin Americans are sold on democracy as the preferred political system and unwilling to give up the inclusiveness it affords.

But if anyone imagined that the turbulent struggle for free democratic institutions would be followed by a period of political tranquility and an upward economic spiral, they were sadly mistaken. The pro-market economic reforms enacted by the new governments after the debt crises of the 1980s had distinctly mixed results, and new crises, every bit as disruptive as the earlier ones, occurred in several countries, including some of the largest. These disappointing outcomes raised questions about whether the region's democratic regimes could, quite literally, deliver the goods, especially in the face of rising societal expectations. By the late 2000s, polls in various countries revealed that support for democracy—at least of the kind practiced thus far—had waned, as the reality dawned that democracy alone does not guarantee prosperity and equality. In some countries where reform chafed more than elsewhere, leaders emerged who, although duly elected, showed a disdain for democratic process exceeded only by their contempt for mainstream economics.

Perhaps the close mutual resemblance of the basic democratic structures established across the region since the 1970s had led policymakers to think that sound economic policies, too, came in a one-size-fits-all pattern. It must have seemed—and the policy literature of the day all but explicitly assumed—that any technically competent economist could prescribe the needed reforms; once the nagging question of proper sequence was resolved, only a few complications, arising from certain well-theorized collective action problems, remained to be overcome.

Gradually, however, the realization spread that there is no universal set of "right" economic policies, no standard cookbook whose recipes work equally well in all countries. Policies, rather, are contingent responses to underlying local conditions, and the value of representative democracy lies precisely in the fact that it gathers together, from across society, a set of actors in close touch with those conditions, in public arenas where the appropriate responses can be debated and negotiated, and solutions (usually in the form of compromises)

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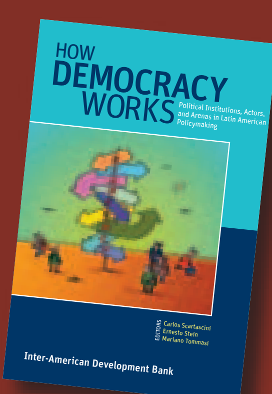

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eventually reached. Those compromises, however, usually move policy away from its original design. Sometimes these policies become more responsive to the needs of the people; other times they are manipulated so much by special interests that they hardly resemble the ideas originally advanced by the policy experts.

This awareness has brought with it a new appreciation of—and more intense scholarly interest in—the workings of real-life democratic institutions in Latin America and how they shape economic and other policies. The Inter-American Development Bank (IDB) has contributed to that literature with a series of edited volumes examining political processes in the region. Beginning with what might be called a general equilibrium approach, looking at how different configurations of institutions within each of several countries interact to produce policy, the IDB has now undertaken a comparative analysis, focusing on each of several main policy actors and institutions one by one, both within government and outside it, and exploring how they differ across countries. Each of these key players—the legislature or the judiciary, for example, or business or the media—is influenced by the incentives its members face from its own institutional setup and from its interaction with the other players. Of particular interest is how these institutional configurations affect not only specific policies but the broader policy framework: the stability of the policy regime, its ability to adapt to changing circumstances, and policies' so-called "public regardedness"—the degree to which policy transforms and transcends the demands of various interest groups to promote the broader national welfare.

The overarching message in the research is that institutions are most likely to give rise to these positive features when they induce the various actors to cooperate and to reach and enforce agreements that hold over time. In turn, the mutual trust that develops from this ongoing cooperation creates a less contentious and more open political environment in which those institutions can evolve and strengthen.

This issue of IDEA is based on the latest book in the policymaking series, *How Democracy Works: Political Institutions, Actors and Arenas in Latin American Policymaking.* It draws on four chapters in the book: those on the legislature, business, organized labor, and the media. The sample is necessarily a small one, but provides a taste of the multiple, complex actors at work on the region's policymaking stage.

This issue of *IDEA* was prepared by Rita Funaro, Carlos Scartascini and Michael Treadway and was based on the book, **How Democracy Works: Political Institutions, Actors and Arenas in Latin American Policymaking**, edited by Carlos Scartascini, Ernesto Stein and Mariano Tommasi. It draws on research conducted for the book by Sallie Hughes, M. Victoria Murillo, Sebastian Saiegh, Ben Ross Schneider, and Andrew Schrank.

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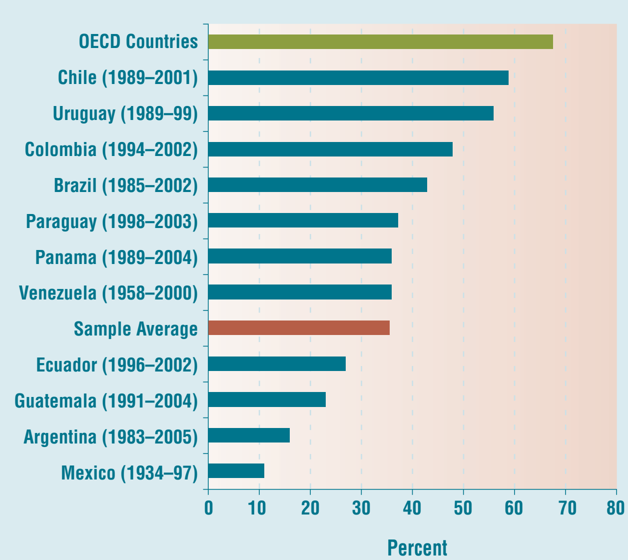
The Legislature: Full Partner, Obstacle, or Rubber Stamp?

Latin America has a decades-long reputation for strong national executives and weak legislatures. To the extent this reputation is deserved (it is, but only partly), countries are missing out on an opportunity for better governance and better policies.

A country where most power lies with the presidency—and all Latin American countries do have presidential, not parliamentary, systems—might at a hasty glance seem fortunate: an energetic president with a sound policy agenda is largely free to implement it without compromise or delay. But representatively elected legislators are, by the nature of the electoral process, closer to their constituents than any president can be. By establishing and nurturing strong channels of mutual communication with the voters back home, legislators can help ensure that the executive's proposed initiatives meet real public needs and demands and that the process of enacting them has broad support and legitimacy. Depending on their constitutional authority, strong legislatures can also initiate policy proposals of their own, thus becoming a proactive rather than reactive force in policymaking. Policies based on a broader social and political consensus through constructive legislative input are more likely to achieve the common good, more likely to be implemented fairly, and more likely to be sustained.

Figure 1. Rates of Reelection to Lower House, Selected Countries



Source: Chapter 3, **How Democracy Works**.

What determines whether a country's legislature functions as a full, proactive partner with the executive? The most important factor is the legislature's institutional capacity: legislatures that have more experienced members and well-developed, professionally staffed committee systems can and generally do play a more constructive role. Legislatures that lack such capacity may still wield considerable power, but only through obstruction. Or they may simply abdicate their constitutional prerogatives and become a rubber stamp, yielding to the executive's whim. Other key institutional variables that influence a legislature's strength are its explicit powers vis-à-vis the executive as laid out in the national constitution, the number and nature of political parties represented, and the degree of support the legislature enjoys in public opinion.

A survey of legislatures in Latin America finds that despite their basic structural similarity, they do indeed differ in institutional capacity and in other important ways. These differences, moreover, are reflected in their relationship with the executive and ultimately in their effectiveness.

As already noted, legislators' experience matters greatly for the body's institutional capacity, and thus for its impact on policy. It is thus noteworthy that the proportion of legislators who are reelected at the end of their term has varied greatly across Latin America in recent decades from a mere 10% on average in Mexico to around 60% in Chile (See Figure 1). However, numbers may tell only part of the story: Mexico's high turnover does not necessarily reflect voter disgust but rather the fact that Mexican legislators may not seek immediate reelection; some other countries with similarly low reelection rates also have rules that encourage turnover. But whatever the reason, a low probability of being reelected gives politicians little incentive to seek a legislative career; those who do serve tend to use their service as a steppingstone to other positions. The result is that few legislators build the expertise needed to be effective in the job.

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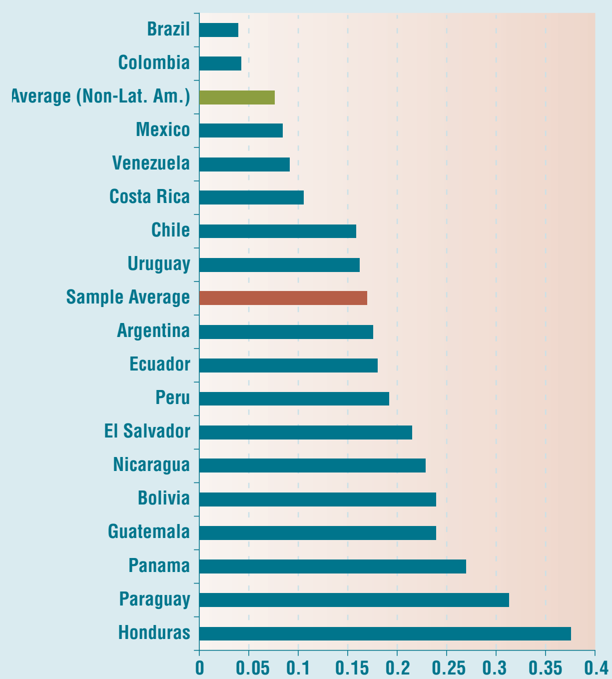
No legislature can conduct its business in full-time plenary session; all depend on a well-functioning committee system to get anything done. Legislators who serve multiple terms on a committee can develop substantial expertise in the committee's area of work and thus contribute to the body's overall effectiveness. Unfortunately, some Latin American legislatures are burdened with an absurd number of committees relative to the number of legislators (see Figure 2). As a consequence, the average Argentine deputy, for example, serves on 4.5 committees. Some legislatures also rotate their committee assignments. These practices are not conducive to productive specialization. Committees are also typically understaffed (although less so in most larger countries), further undermining their potential.

Figure 2. Ratio of Number of Committees to Size of Legislature



Source: Chapter 3, **How Democracy Works**.

The legislature's powers vis-à-vis the president likewise differ across countries. In many, the constitution gives the president a relatively strong hand. In Argentina, Brazil, and Colombia, presidents can bypass the legislature entirely and enact new legislation by decree, although usually within limits. Presidents in Brazil, Colombia, and Uruguay can declare a legislative proposal "urgent" and require that the congress pass or reject it by a certain date. Presidents in Brazil and Chile can convene special legislative sessions where only certain initiatives specified by the president may be debated. In Brazil, Chile, and Colombia, only the president may initiate legislation in certain policy areas. Many Latin American presidents have the line-item budget veto—a power that U.S. presidents have sought in vain for decades. All these arrangements weaken the legislature's clout relative to the executive branch.

The role of political parties is more complex but also varies. In countries with multiple parties, like Brazil and Colombia, legislative coalitions are the norm. Because Latin American governments are presidential, the legislature and the executive may be of different parties. This may result in gridlock, but it can also increase the chances for independent legislative policymaking, as happened in Mexico when the PRI lost its long-standing monopoly on the presidency.

Parties in Latin America may be more or less centralized, with individual legislators or caucuses enjoying more or less autonomy within the party. Greater centralization helps presidents secure legislative support, facilitates negotiation, and limits the influence of regional and sectoral special interests, but it also reduces individual legislators' incentives to respond to their constituents. The rules governing legislative elections also matter: in countries like Colombia, where each district elects multiple representatives, these incentives are weaker.

How does a country with a historically weak legislature build that body's capacity so that it can realize the potential latent in its constitutional authority? It is a classic collective action problem: individual legislators today may have their eyes on their post-legislative careers; lobbyists may be only too content with a legislature that it can easily sway; the executive may be less than eager to build the legislature into an equal and formidable partner. Perhaps the best approach is to restructure the incentives facing individual members, so that the success of each depends on their working together to craft a stronger and more cohesive body. If the members or their leaders can succeed in reengineering their own incentives, they may be able to bootstrap their way to a more effective and popularly responsive national legislature.

Investing in Influence: The Role of the Business Sector

Businesses every where have a keen interest in policy and ample resources with which to influence it. They exert that influence through various channels, which, as Ben Ross Schneider notes, can conveniently be thought of as assets in a portfolio. Businesses are constantly "rebalancing" these assets, shifting resources in search of the highest "return" in the form of policies that favor their interests.

The most straightforward channel is lobbying by individual businesses, usually on matters of specific interest to the business, for example when a telecommunications company seeks a license for a new service. When many businesses share an interest in a policy outcome, such as lower business tax rates, they are likely to band together as an association—the second channel—in order to speak with one voice. All Latin American countries have well-established business associations at the sectoral or regional level at least, and most have national associations representing the entire business community.

A third channel is the so-called revolving door: top business leaders are appointed to government positions, and in turn, former government officials are invited into the corporate boardroom. A dense network of relationships can develop in which information and favors are passed in both directions. In Latin America, and especially in countries where a small elite is concentrated in the national capital (think Buenos Aires or Lima), the revolving door is often lubricated by long-standing personal acquaintances between business and government leaders.

Yet another channel, and one in which deep-pocketed businesses have a natural advantage, is campaign finance. Most of the large countries in the region, as well as some of the smaller ones, have reformed the legal framework for campaign finance in recent years, but, as in other parts of the world, the rules are often circumvented. Lavish campaign contributions are sure to attract policymakers' attention, but without an explicit quid pro quo, the contributor cannot be certain that this investment will pay the expected return. When the money does come with strings attached, it crosses the line into a fifth channel of influence, namely, corruption.

Capital flight, or the threat of flight, can be considered a sixth channel: wealthy business owners that dislike a government's policies can simply send their capital elsewhere, or keep it in the country but spend it on yachts and villas instead of productive investment. Although flight might seem a response of last resort, in Latin America it can also be a safety valve: politics may be less contentious when capital is not forced into a cage match with labor and other interests but can exit freely. Less capital investment, however, almost always presages slower economic growth.

All these channels are important, but business associations are particularly important in Latin America for multiple reasons. For one, not only are they a natural vehicle for addressing the broadest policy issues, but the resulting dialogue tends to be more open—and less demanding on policymakers' scarce time—than when businesses lobby individually. For another, a strong business association working closely with government contributes to the predictability of policy, which businesses value almost as much as its content. Yet another reason is that governments are often well-positioned to mold business groups into a valuable source of economic information that serves the public as well as the private good. Finally, the nature and strength of business associations vary greatly across Latin America, providing a rich source of data on what best serves the interests of businesses themselves and society at large.

Influence flows both ways: policymakers must be wary of business groups bearing advice and campaign contributions but can help shape the behavior of self-interested businesses toward worthwhile national goals.

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Investing in Influence: The Role of the Business Sector

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Almost all of the smaller Latin American countries—Uruguay is a notable exception—have important economy-wide ("encompassing") business associations. The larger countries have them as well, but their strength varies: those in Chile, Colombia, and Mexico are strong, organized much like those in Europe and Japan; their counterparts in Argentina and Brazil are relatively weak, as in the United States; the associations in Peru and Venezuela fall in between.

In countries where encompassing associations are strong, it is often because government has deliberately encouraged them. (In Chile, it is also because the other channels of influence are relatively unattractive: most policy is made by the executive, which is largely insulated from individual lobbying; corruption is low; and the highly stable balance of legislative power provides little incentive to invest in campaign finance.) Such encouragement takes various forms, but usually it involves some benefit extended only to participating businesses. These benefits can range from luncheons with ministers to the sharing of public authority and funding. In Colombia, for example, the national coffee confederation controls coffee export tax revenue and is tasked with promoting and marketing Colombian coffee worldwide.

Governments can also institutionalize relations with business and its associations through the creation of policy councils on which both government and business, and possibly labor and other interests, are represented. These, too, may be granted functional authority, which may be as broad as determining monetary policy or as narrow as setting animal husbandry standards. They are usually structured so that business lacks a majority or even an effective veto, but they are nonetheless worth business leaders' while for the opportunity to be heard at the highest governmental levels, and to shape or even delay the passage of policies they disapprove of.

Examples of successful cooperation between governments and encompassing business associations are many. Perhaps the most celebrated is Mexico's series of stabilization pacts in the late 1980s, when government, business groups, and labor collaborated to bring annual inflation down from 100% to less than 20%. Similar efforts in Argentina and Brazil failed, in part because of their lack of strong business associations. Both Chile and Mexico involved business associations closely in negotiations over MERCOSUR and NAFTA, respectively; Argentina and Brazil, Chile's MERCOSUR partners, did not.

Adam Smith famously remarked that gatherings of businesspeople, whatever their original purpose, typically end "in a conspiracy against the public." His warning remains worth heeding: policymakers must always be wary of business groups bearing advice and campaign contributions. But government can shape the behavior of naturally self-interested businesses toward the achievement of worthwhile national goals—influence flows both ways. The trick for policymakers to avoid capture is to match business one for one in knowledge and negotiating skill, and to stay as focused on the public interest as the participating businesses are focused on their own.

Welcome to RES

Sebastian Miller, a US national, joins the research department as a Research Economist. Mr. Miller holds a PhD in Economics from the University of Maryland, College Park, and an Engineering degree and an MA in Economics from the University of Chile. He previously served as Country Economist in the Southern Cone Countries Department at the IDB. He has published several journal papers and book chapters mainly on environmental/sustainability issues. His current areas of interest include Environmental Economics, Economics of Climate Change and Political Economy.

We also welcome back Andrew Powell who returns to RES as Principal Advisor after his two-year stint as Regional Economic Advisor for the Caribbean Region.

A Comeback for Labor in the Post-Reform Era

Organized labor fared worse than most groups under the market reforms of the 1980s and 1990s. Market liberalization, together with widespread privatization and fiscal austerity, jeopardized the jobs of millions of unionized workers in formerly protected firms. Efforts to deregulate labor markets further eroded union hegemony, and the rollback of the social safety net raised the cost of job loss, weakening labor's bargaining power. Unions seemed to be in permanent retreat across the region, as evidenced by the decline in the unionized share of the aggregate regional workforce from 25% in the early 1980s to 16% by the mid-1990s.

The last decade, however, has seen a political backlash against reform in many countries. Left-leaning presidents were elected in Argentina, Brazil, Chile, Ecuador, Peru, and Uruguay, and leaders openly hostile to "savage capitalism" took power in Bolivia and Venezuela. Many more ideologically moderate politicians began calling for heterodox alternatives, or at least modifications, to Washington Consensus-inspired policies.

Remarkably, the very unions widely thought comatose, or worse, a decade before have been at the vanguard of this re-revolution. They not only formed the backbone of movements that brought Brazil's Lula and Bolivia's Evo Morales to power, for example, but helped force the removal of several presidents less friendly to labor. Is this resurgence simply a return to equilibrium in a region where labor enjoys natural advantages, or did unions and their allies show exceptional skill in playing a weak political hand? The answer is probably a mixture of both and, as always, varies from country to country.

One constant in Latin America is that its unions have tended, relative to their counterparts abroad, to give greater weight to political engagement than to industrial action, to which employers have traditionally been hostile and unyielding. Another is that within the political realm, labor-backed parties have sought to leverage organized labor's modest numbers by making common cause with nonunionized workers. A third is that unions have historically been stronger in the larger, more industrialized countries, Bolivia and Nicaragua being notable exceptions.

Within a given country, two strategic factors have largely determined labor's ability to influence policymaking: the degree of union centralization, and the presence or absence of party competition for labor's support. A centralized, all-encompassing labor organization is much more likely to have the clout to negotiate and enforce comprehensive agreements with governments, without free riding or challenges from rival unions. Similarly, when a leading labor-backed party faces competition for workers' support from an insurgent party, the necessary compromises with business become much more difficult: the insurgent can always siphon off support by outflanking the lead party on the left—taking a more militant stance and accusing the lead party of "selling out." Argentina's Austral Plan and Brazil's Cruzado Plan both failed in their attempts to achieve price stability in part because a divided labor movement could not restrain workers' wage demands. In Mexico, by contrast, because the peak labor organization encompassed some 90% of all unions, it was able to join with a similarly strong peak business association in adopting—and policing—a comprehensive and largely successful economic pact.

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Whatever their strategic advantages or disadvantages, unions in Latin America have always had to pick their battles carefully. Matching their corporate adversaries in financial resources is out of the question, and the much-vaunted solidarity of the labor movement is often less than solid. The goals of most workers are, after all, material, not ideological, making it difficult to rally the mass of workers to challenge encroachments on a relative few in a particular firm or sector. Unions have therefore tended to devote their limited resources to campaigns that are broad in scope, affecting all or most workers in the country, and intense in impact.

Reform of labor law itself is the archetypal example. Because these laws affect all workers, unions and their allied parties have generally been able to mobilize broad opposition to their weak-

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Monitoring the Monitors: The Influence of the Media on Policymaking

Researchers often portray the Latin American media as a passive conduit that chiefly conveys elite opinion to the public. But the region's politicians see the media as an active and important part of the policymaking process that they must seek to influence, through both the well-known tactics of U.S.-style "strategic communications" and more old-fashioned and authoritarian methods.

Former Mexican president Carlos Salinas de Gortari pioneered the use of policy-focused polls and focus groups in Latin America in the late 1980s. Today, even small countries regularly use such techniques to help launch policy initiatives, while larger nations such as Brazil and Mexico have cabinet-level offices devoted to analyzing and shaping public opinion. As secularization and political liberalization and the trend toward candidate-centered elections make leaders rely more and more on molding public opinion to win elections and implement policies, the use of strategic communications will continue to grow.

Latin American leaders also increasingly use "news management" tactics to make media messages about policy and policymakers more consistent, more positive, and more effective in promoting their goals. These techniques aim not only to plant messages in media coverage but to alter the interpretive frame that journalists use to cover and evaluate events. Establishing a frame of coverage that puts events in a context that the public favors has been essential to the success of reform efforts across the region. At the same time, even as democracy's roots deepen across Latin America, many regimes continue to use such older and undemocratic techniques as cronyism, control of broadcast frequencies and government advertising spending, propagandist use of state media outlets, and even repression to manipulate the media.

The media impact policymaking in each of four stages of the process: agenda building, policy formulation, policy adoption, and policy implementation. In the first stage, the media often set the agenda by highlighting issues that policymakers have overlooked or downplayed. Since coverage of policy-related issues is often sporadic and event-driven, both government actors and outside reformers can win attention and gain control of the agenda, the former through calculated leaks of information to sympathetic journalists, and the latter by staging dramatic events such as land occupations or confrontations. The Zapatista movement in Mexico, the landless peasant movement in Brazil, and many other activist groups have skillfully manipulated this process.

In the policy building stage, the media often cover issues in crisis terms, creating a sense of urgency and pressure to act quickly. This dynamic tends to accelerate the policymaking process but can also encourage decision-makers to take short-term, symbolic steps to meet a perceived crisis rather than engage in sound, long-term policymaking. The interpretive frames that journalists use can be particularly powerful at this stage, conferring legitimacy on certain actors, proposals, and worldviews and disqualifying others. In both Brazil and Uruguay, for instance, governments successfully pushed through administrative reforms in large part because they prompted the media to frame the reforms positively, as a way to enhance the efficiency of the state, rather than as an attack on unions or public employees.

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When issues reach the policy adoption stage, the volume of coverage they receive can strongly affect the fate of reform. When coverage is scarce, the drive for reform can easily stall, and opponents have more room to bargain or to promote special interests. When coverage is copious, it tends to push public debate forward and raise the costs of rewarding special interests or self-interested policymakers. At this stage, media leaders often influence,

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ening. Indeed, it is precisely because labor's position in other areas—from trade protection to social security—has become so precarious that unions have fought so tenaciously to maintain and, where possible, expand their basic rights and privileges. This is especially true of the "collective" aspects of labor law—the right to organize, to bargain collectively, and to strike—as opposed to the more individual ones, such as minimum wages, benefits, and working conditions. Without the former, after all, labor has little leverage to win concessions on the latter.

The downside of focusing only on those issues that unite the labor movement is that it leaves labor vulnerable to what might be called "divide-and-compensate" strategies. Here privatization provides the classic example. Many a reforming government has found that it can co-opt the workers of privatizing enterprises by offering them shares in the new company: the cost of doing so for any one company is limited and often can be financed from the sale itself; meanwhile only a very powerful and militant union will go to the wall to protect the jobs of one firm's workers. The Brazilian government, for example, offered shares on attractive terms to the workers of Usiminas and Embraer, thus neutralizing the appeals of union leaders. Yet there have also been notable counterexamples: Uruguayan workers and their allies blocked the privatization of the telecommunications monopoly, and workers at Mexico's PEMEX continue to resist any and all measures perceived as back-door privatization.

Do labor's recent victories presage a return to the "bad old days" of rigid labor markets, stop-go macroeconomic policymaking, and recurrent crisis? Or do they mark the emergence of a new, more stable, perhaps European-style social democracy? It is far too soon to tell. One thing is certain, however: whatever its recent challenges, labor in Latin America has survived much worse—only thirty years ago, in a number of countries, labor leaders were routinely imprisoned, tortured, and systematically murdered. Their successors are determined that organized labor will survive and remain a vital force throughout the region.

Monitoring the Monitors: The Influence of the Media on Policymaking

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and sometimes distort, the debate by intervening as an interest group of their own, either by openly supporting certain coalitions or by pushing for policies that favor the private interests of certain media outlets or the professional interests of journalists as a group.

At the policy implementation stage, coverage again tends to be scant and to focus on isolated events or scandals that involve villains and victims, moral transgressions, and acts of public corruption. Although this kind of coverage fulfills the classic monitoring function that democratic theory prescribes for the press, it can also distort events by suggesting that a policy is failing when it is essentially working well.

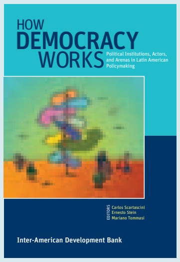
What, then, can be said about the impact of the region's media on the possibilities for the kind of stable, flexible, long-term, public-spirited cooperation conducive to promoting optimal public policy? The record appears mixed. Not surprisingly, negative coverage of policy debates raises the cost of long-term cooperation whereas positive coverage encourages it. Media coverage can also influence the number of actors engaged in cooperation by conferring or denying legitimacy to public and private actors and exposing secret actors. Media monitoring also seems to promote public-spirited cooperation by increasing the visibility of policy moves, although it can hide the role of the media themselves as a policy player. Strong press oversight can promote sound policy by encouraging proper policy enforcement but can also create demands for quick responses to perceived crises that lead to poorly designed policies.

The role of the media in policymaking varies from country to country and from moment to moment within each country. The constant is the importance of the media to the public and policymakers alike. The media wields power and influence that can earn it respect, disdain, anger and even censure—to wit the Venezuelan government's closure of Radio Caracas Televisión. Using that power to help shape better public policy is the challenge.

New Publications

Available in English only unless otherwise stated.

BOOKS

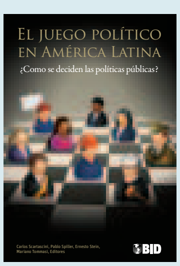


How Democracy Works: Political Institutions, Actors, and Arenas in Latin American Policymaking

Carlos Scartascini, Ernesto Stein and Mariano Tommasi

Over the past 30 years, democratic freedoms and competitive electoral processes have taken hold as never before in Latin America. *How Democracy Works* takes a detailed look, from an institutional perspective, at each of the main actors on the policymaking stage in Latin America, emphasizing the extent to which institutions facilitate or hinder intertemporal political cooperation and compromise. It analyzes official political actors and arenas, as well as a number of societal actors, and explores the (formal) roles of these players, their incentives, capabilities, and the way in which they actually engage in the policymaking game. The conclusion: these political institutions and actors matter for policymaking in Latin America and leave an indelible imprint on the policy process and the resulting policies.

Carlos Scartascini, Pablo Spiller, Ernesto Stein and Mariano Tommasi



El juego político en América Latina: ¿Cómo se deciden las políticas públicas? (The Political Game in Latin America: How are Public Policies Determined?)

Available in Spanish.

What determines the capacity of countries to design, approve and implement effective public policies? This book is based on the premise that good policies must begin with good institutions. It analyzes the political institutions, policymaking process and policy outcomes in eight Latin American countries. The book provides not only micro data on each individual country but a cross-country, interdisciplinary analysis of the policymaking process.

WORKING PAPERS

Alvarez, Roberto and Claudio Bravo-Ortega

Innovation, R&D Investment and Productivity in Chile (IDB-WP-190)

This paper analyzes the causal effect of product and process innovation on productivity in the Chilean manufacturing industry during the past decade. In general, product innovation does not have a contemporaneous effect on productivity, but process innovation has a positive effect. However, product innovation does show a lagged effect on productivity two years after innovation. Compared with developed countries, Chilean firms may take time to master new technologies. These slow and frequently uncertain gains in productivity could help explain the low levels of investment in research and development (R&D) activities by Chilean firms.

Artopoulos, Alejandro, Daniel Friel and Juan Carlos Hallak

Challenges of Exporting Differentiated Products to Developed Countries: The Case of SME-Dominated Sectors in a Semi-Industrialized Country (IDB-WP-166)

This paper surveys four Argentinean industries—light ships, television programs, wines, and wooden furniture—that have enjoyed substantial export growth in recent years, particularly to developed countries. Across sectors, the appearance of a pioneer is largely explained by a knowledge advantage relative to other industry participants regarding foreign markets. Diffusion occurs across as well as within sectors, as pioneers' knowledge is relevant to other industries. Since diffusion does not necessarily hurt the pioneer, public policy has a potentially important role in fostering diffusion within and across sectors.

Arza, Valeria and Andres López

Innovation and Productivity in the Argentine Manufacturing Sector (IDB-WP-187)

This paper estimates the relationship between innovation and productivity in developing countries. Based on panel data for Argentina during the period 1998–2004, the results suggest that all types of innovative activities are relevant to explain success in product and process innovation, and both are important to explain labor productivity. Moreover, investing systematically in R&D implies an extra payoff in labor productivity. These results suggest that investing in different types of innovative activities—and not only in R&D—and doing in-house activities systematically contribute to firms` innovative and economic performance.

Bastos, Paulo and Odd Rune Straume

Globalization, Product Differentiation and Wage Inequality (IDB-WP-184)

This paper develops a two-country,

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general equilibrium model of oligopoly in which the degree of horizontal product differentiation is endogenously determined by firms' strategic investments in product innovation. Consumers seek variety, and product innovation is more skill intensive than production. Stronger import competition increases innovation incentives, and thereby the relative demand for skill. An intra-industry trade expansion following trade liberalization can therefore increase wage inequality between skilled and unskilled workers. In addition, since product differentiation is resource consuming, freer trade entails a potential trade-off between production and variety.

Baz, Veronica, Maria Cristina Capela, Rodrigo Centeno and Ricardo Estrada

Productive Development Policies in Latin America and the Caribbean: The Case of Mexico (IDB-WP-168)

Productive development policies (PDPs) in Mexico are often uncoordinated, redundant or even incongruent. It is therefore important to understand the process whereby PDPs are designed and the institutional setting in which they are implemented. This paper examines whether PDPs respond to market failures and/or government failures. When PDPs are not designed to address specific market failures they can produce unwanted results or prove completely ineffective. When PDPs do address government failures, it is important to determine why the failure cannot be corrected in the first place and whether PDPs will effectively address the problem in a second-best manner.

Becerra, Oscar, Eduardo Cavallo and Carlos Scartascini

The Politics of Financial Development: The Role of Interest Groups and Government Capabilities (IDB-WP-207)

Although financial development is good for long-term growth, not all countries pursue policies that render full financial development. This paper shows that the intensity of opposition to financial development by incumbents depends on both their degree of credit dependency and the role of governments in credit markets. Lower opposition to financial development effectively increases credit markets' development only in those countries that have high government capabilities. Moreover, improvements in government capabilities have a significant impact on credit market development only in those countries where credit dependency is high (thus, opposition is low).

Bellony, Annelle, Alejandro Hoyos, and Hugo Ñopo

Gender Earnings Gaps in the Caribbean: Evidence from Barbados and Jamaica (IDB-WP-210)

This paper analyzes gender earnings gaps in Barbados and Jamaica. In both countries, as in most of the Caribbean, females' educational achievement is higher than that of males. Nonetheless, males' earnings surpass those of their female peers. Depending on the control characteristics, males' earnings surpass those of females by between 14% and 27% of average females' wages in Barbados, and between 8% and 17% in Jamaica. In Barbados, the highest earnings gaps are found among low-income workers. Results from both countries confirm a recurrent finding: complete elimination of gender occupational segregation in labor markets would increase rather than reduce gender earnings gaps. The evidence is mixed regarding segregation by economic sectors. Occupational experience, in the case of Barbados, and job tenure, in Jamaica, help explain existing gender earnings gaps.

Cassoni, Adriana and Magdalena Ramada

Innovation, R&D Investment and Productivity: Uruguayan Manufacturing Firms (IDB-WP-191)

Uruguay's inability to sustain high levels of economic growth can be traced at least partly to low investment in knowledge capital. Returns on innovation were found to be significant, accelerating labor productivity gains. However, the propensity to innovate and the intensity of the effort expended critically depend on the firm's existing efficiency. Firms innovate more with processes than products, but the degree of novelty of process innovation is significantly less than that of product innovation. Inadequate choices of input mixes may be the underlying cause. Policy recommendations center on finding adequate channels to disseminate information on optimal input mixes depending on the type of innovation sought.

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

The Role of Relative Price Volatility in the Efficiency of Investment Allocation (IDB-WP-208)

This paper estimates the impact of relative price volatility on sector-level investment. Results indicate that volatility distorts efficient investment allocation in that investment is not neces-

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sarily devoted to relatively more productive sectors, especially in emerging market economies that are highly exposed and may lack the necessary institutions to deal with it successfully. This evidence supports theories that relative price volatility provides incentives for entrepreneurs to adopt more "malleable" but less productive production technologies, enabling them to accommodate more easily abrupt and frequent changes in relative prices, but at the cost of using less productive technologies.

Chisari, Omar

Notes on Optimal Growth, Climate Change Calamities, Adaptation and Mitigation (IDB-WP-212)

This paper discusses a strategy for including adaptation and mitigation expenses in an optimal growth model under threat of climate change calamities. Calamity is the result of a shock that reduces the utility level (even to extinction) and/or triggers a fundamental change in the economic structure. Mitigation expenses reduce the long-run probability of a calamity or the speed of convergence to it; adaptation expenses help boost the standard of living after the calamity. The willingness to contribute to those expenses and the effects on the long-run capital stock of the economy depend on perceptions of how these expenditures will modify the probability of a shock occurring and the standard of living after the shock.

Cova, Pietro, Massimiliano Pisani, and Alessandro Rebucci

Macroeconomic Effects of China's Fiscal Stimulus (IDB-WP-211)

This paper analyzes the macroeconomic impact of China's 2009–2010 fiscal stimulus package. It shows that the effects on China's economic activity are sizeable: absent fiscal stimulus China's GDP would be 2.6 and 0.6 percentage points lower in 2009 and 2010, respectively. Higher Chinese aggregate demand stimulates higher imports from other regions, in particular from Japan and the rest of the world, and, to a lesser extent, from the U.S. and the Euro area. However, the overall GDP impact of the Chinese stimulus on the rest of the world is limited. These results warn that a fiscal policy-driven increase in China's domestic aggregate demand associated with a more flexible exchange rate regime has only limited potential to contribute to an orderly resolution of global trade and financial imbalances.

Crespi, Gustavo and Pluvia Zuniga

Innovation and Productivity: Evidence from Six Latin American Countries (IDB-WP-218)

This study examines the determinants of technological innovation and its impact on firm labor productivity across six Latin American countries (Argentina, Chile, Colombia, Costa Rica, Panama, and Uruguay). In all countries, firms that invest in knowledge are more able to introduce new technological advances, and those that innovate have greater labor productivity than those that do not. Yet firm-level determinants of innovation investment are much more heterogeneous than in OECD countries. Cooperation, foreign ownership, and exporting increase the propensity to invest in innovation and encourage innovation investment in only half of the countries studied.

Melgar, Natalia and Martin A. Rossi

A Cross-Country Analysis of the Risk Factors for Depression at the Micro and Macro Level (IDB-WP-195)

Past research has provided evidence that some personal characteristics are risk factors for depression. However, few studies have examined jointly their specific impact and whether country characteristics change the probability of being depressed. Findings indicate that depression is positively related to being a woman, adulthood, divorce, widowhood, unemployment and low income. Moreover, inequality significantly impacts depression, especially in urban areas. Finally, some populations' characteristics facilitate depression (age distribution and religious affiliation).

Prati, Alessandro, Alessandro Rebucci and Joong Shik Kang

Aid, Exports, and Growth: A Time-Series Perspective on the Dutch Disease Hypothesis (IDB-WP-114)

The available evidence on the effects of aid on growth is notoriously mixed. This paper finds that the estimated cumulative response of exports and per capita GDP growth to a global aid shock is strongly positively correlated, and both responses are inversely related to exchange rate overvaluation measures. This is consistent with the Dutch disease hypothesis. However, in countries with less overvalued real exchange rates, exports and per capita GDP growth respond positively to a global aid shock. Thus, preventing exchange rate overvaluations may allow aid-receiving countries to avoid the Dutch disease.

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Schneider, Ben Ross

Business-Government Interaction in Policy Councils in Latin America: Cheap Talk, Expensive Exchanges, or Collaborative Learning? (IDB-WP-167)

While effective industrial policy requires close cooperation between government and business, there is little agreement on what makes that cooperation work best. This paper analyzes institutional arrangements for public-private cooperation and the character of private sector representation. Questions on institutional design focus on three main issues: i) maximizing the benefits of dialogue and information exchange; ii) motivating participation through authoritative allocation; and iii) minimizing unproductive rent seeking. Key elements in the nature of business representation through associations are the quality of research staff and internal mechanisms for reconciling divergent preferences within associations. The empirical analysis also disaggregates councils by scope (economy-wide versus targeted), function (trade, upgrading, technology, etc.), sector (agriculture, industry, services), and level (national, provincial, and municipal).

TECHNICAL NOTES

Chisari, Omar and Sebastian Galiani

Climate Change: A Research Agenda for Latin America and the Caribbean (IDB-TN-164)

The objective of this research agenda is to outline the issues that need to be investigated in order to produce an informed assessment of what strategies and policies Latin America and its international organizations should pursue with respect to climate change. The report makes the three following potential contributions: i) identifying actions that could be valuable but have not been highlighted; ii) advising on actions that could be ineffective and costly, given limited resources; and iii) recommending an evaluation of what elements require further analysis before objectives are translated into action.

OUTSIDE PUBLICATIONS

Bouillon, César P, Thomas A. Gaziano, Amanda Glassman, and Federico C. Guanais de Aguiar

Confronting the Chronic Disease Burden in Latin America and the Caribbean

Health Affairs Vol. 29, No. 12, December 2010.

The United States is not alone in facing the increasing incidence and prevalence of chronic conditions as contributors to poorer health and growing health spending. Latin America and the Caribbean face similar burdens, but they have fewer resources with which to respond. Much remains to be done to cope with the emerging public health and fiscal threat posed by increases in chronic conditions. However, a set of studies sponsored by the Inter-American Development Bank brings good news on potentially cost-effective strategies to improve coverage and outcomes. They should help move the growing epidemic of chronic disease in Latin America and the Caribbean to the forefront of health policy in the region.

Bastos, Paulo and Joana Silva

The Quality of a Firm's Exports: Where you Export to Matters.

Journal of International Economics, 82(2), 99–111, 2010 (Lead article).

What drives export quality? Using firm-level data on exports by product and destination market, this paper finds that f.o.b. unit values increase systematically with distance, and tend to be higher in shipments to richer nations. These relationships reflect not only the sorting of firms across markets, but also the within-firm variation of unit values across destinations. Within product categories, higher-productivity firms tend to ship greater quantities at higher prices to a given market, consistent with higher quality. In addition, firm productivity tends to magnify the positive effect of distance on within-product unit values, suggesting that high-productivity, high-quality firms are more able to serve difficult markets.

Blyde, Juan, Christian Daude and Eduardo Fernández-Arias.

Output Collapses and Productivity Destruction. *Review of World Economics* **146:359–387**

This paper analyzes the long-run relationship between output collapses—defined as GDP falling substantially below trend—and total factor productivity (TFP). Using a panel of 76 developed and developing countries during the period 1960–2004, the paper identifies episodes of output collapse and estimates counterfactual post-collapse TFP trends. Collapses are concentrated in developing countries, especially Africa and Latin America, and were particularly widespread in the 1980s in Latin America. Overall, output collapses are systematically associated with long-lasting declines in TFP. The paper explores the conditions under which collapses are least or most damaging, as well as the type of shocks that make collapses more likely or severe. It also provides a quantification of the associated welfare loss with output collapses.

Look Who's Talking

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

Fiscal Quality: A Development Country's Priority

Marcelo Giugale presented a Policy Seminar at IDB Headquarters on Sept. 22, 2010

While growth in the developed world is expected to remain relatively stagnant until at least 2015, developing countries are likely to enjoy significant growth in the years ahead. The sources of that growth, which are independent of developments in the G-7, include the following: i) greenfield investment, ii) rapid increase in the size of developing countries' middle-class populations, iii) South-South trade, iv) broad-based learning with accompanying productivity growth, and v) commodity wealth based on high prices.

This growth will change all areas of the policy agenda in developing countries and may well lead to better fiscal management. This situation contrasts with that of the G-7 countries, which have emerged from the recent world financial crisis in a weak position. Those countries, which have growing debt, must meet challenging quantitative goals in order to avoid major sovereign defaults. Developing countries, on the other hand, will see their debt decrease in coming years and will be positioned to make qualitative fiscal adjustments.

The developing world's improving fiscal quality is driven by a combination of seven factors. The first of these is the recent success of countercyclical policies in countries that saved in the good times preceding the recent crisis; notable examples include Chile, China and Mexico. The success of countercyclical policies, moreover, increases support for them and the policymakers who apply them; readiness to respond matters. Three caveats nonetheless apply: i) better automatic stabilizers are needed, ii) more flexibility among public accounts is needed, and iii) decentralized stimulus is not always successful.

A second driver is a universe of fiscal rules adopted by an increasing number of countries. These rules include expenditure and deficit ceilings, as well as structural fiscal balance requirements, and in some cases they are accompanied by enforcement mechanisms such as fiscal responsibility laws. The fiscal rules adopted so far, however, are generally rigid, and questions have arisen regarding the desirability of "escape hatches."

Third, independent fiscal agencies—both public and private—have arisen, and the failure of credit rating agencies in recent years increases the scope of activity for existing and new actors. Monitoring compliance with fiscal rules, for instance, represents a promising area. Given anticipated levels of new investment in the developing world, the market for independent fiscal assessment should expand. Nongovernmental councils are particularly likely to grow in number and/or importance in coming years. In contrast to monetary policy bodies, governmental fiscal agencies with a multiplicity of objectives are unlikely to have hierarchical mandates or policies, with the possible exception of output stability policies.

A fourth factor improving fiscal quality is the advent of sovereign wealth funds (SWFs), which in many instances have grown vastly as a result of high commodity prices. The credibility and viability of SWFs has been further bolstered by the increasing adoption of fiscal rules, which in fact have paralleled the creation of SWFs in recent years. Although SWFs face challenges of institutional design and set-up because of the pay levels needed to attract qualified managers, the success of SWFs is likely to be encouraged by the following factors: i) the need for accountability attending the amount of money involved; ii) accompanying media scrutiny; iii) intergenerational distribution concerns; and iv) the low borrowing costs encountered by countries with successful SWFs, which represent a form of implicit collateral.

Fifth, fuller public accounting is likely to take the form of a "balance sheet for the State" that is more exhaustive than current measures. Such accounting is expected to include contingent as well as other forms of debt and patrimonial accounting that would include ownership of assets such as financial shares. This development can be seen as both a corollary to and a consequence of the rise of SWFs.

The sixth driver of improving fiscal quality is the advancement of results-management technology, facilitated by the diffusion of information and communications technology at subnational as well as national levels of government. These technologies include widely disseminated goals, benchmarks and international standards in areas as diverse as education, security and infant growth. This increase in transparency and accountability effectively leaves policymakers and officials "nowhere to hide." At the same time, politicians can use successful results as selling points in their campaigns.

Seventh, decentralization of revenue collection and devolution of spending from national to subnational

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governments is closing the distance between service providers and beneficiaries. Expected gains include less overlapping among governmental units and programs, with fewer externalities; developments in this area are expected to improve with more widespread and sophisticated databases. From a political perspective, decentralization and devolution are likely to be favored by high-level leaders who can diffuse blame to lower levels of government.

International Migration in the Age of Crisis and Globalization

Andrés Solimano presented his new book at the IDB on Oct. 14, 2010

Several key facts and associations provide a context for discussing migration in the Americas and around the world. While migration often features prominently in public policy debates, only 200 million people—approximately 3 percent of the world population—reside outside of their countries of birth. Migrants from Latin American and Caribbean (LAC) countries account for 26 million of that total, of whom 23 million live outside the region, including 19 million in the United States. The remaining 3 million live outside of their countries of origin within the region. Migration rises in eras of global prosperity and integration, such as the periods of 1870–1914 and 1980–2007, and it accompanies increases in capital mobility.

Within this context, migration stems from multiple causes. Perhaps the most obvious is the presence of development gaps between countries of origin and host countries in terms of per capita income, job opportunities, and, in the case of elites, prospects for career development. Migration also results from differences in countries' phases of the economic cycle; more concretely, individuals will leave countries with sluggish growth for countries with higher growth rates and greater prosperity. Interestingly, however, weak growth in recent years in the United States has apparently not produced a massive return migration to home countries. Other inducements include: i) a higher quality of social services in the host country; ii) the quality of urban life, an important factor at a time when much immigration is city-centered; iii) access to housing; iv) respect for diversity and migrant rights; and v) forced emigration due to civil unrest and/or persecution.

Current migration raises several new issues with accompanying policy challenges. The first of these is the prominence of "high-value" migrants such as scholars, professionals and students, who are relatively small in number but have a disproportionately large impact in academia and trade, among other areas. Whether this development represents a valuable circulation of talent or a return to the "brain drain" of previous eras is a matter of debate. This question is further complicated by the rise of "South-South" talent mobility among developing countries, and the presence of dual labor markets in the destination economies of the North, with greatly differing prospects for skilled and unskilled workers.

A variety of current and prospective changes in the global economy will further influence migration and policy responses. Particularly significant factors include the following:

- Slow growth prospects in the United States and Europe may diminish their appeal as destinations, thus deterring migration.
- Unemployment remains high after the 2007–2009 global financial crisis.
- Growth is anticipated in Latin America, and high growth in Asia.
- North-South and East-West development gaps are expected to narrow.
- New economic possibilities are likely to arise in Latin America and the Caribbean, as well as in Asia, as economic power shifts among world regions.
- Migrants' skill and education levels continue to differ by region. Latin America and the Caribbean, for example, provides relatively few H1B workers in the United States compared to the number from Asia.
- It remains to be seen whether developed countries will adopt labor market protectionism in response to ongoing economic difficulties.

Jacqueline Mazza, Commenter

While Dr. Solimano's book advocates a freer and more humane regime for international movements of people, institutional changes must take into account several notable features of migration from and within Latin America and the Caribbean. First, in contrast to the migration from poorer to richer countries that characterized previous periods, significant migration is taking place among low-income countries. Especially noteworthy is the regionalization of certain labor market sectors, such as agriculture in Central America. Second, migrants face two major asymmetries: i) the contrast between the free flow of capital and the restricted flow of labor, and ii) asymmetry in treatment between knowledge workers and manual laborers. In regard to the latter asymmetry, labor market segmentation is increasing, with sharpening contrasts between workers in the formal and informal sectors. Although some bilateral agreements exist, no single approach prevails for LAC countries, and the Region could benefit from a multilateral framework for migration.

In addition, the characteristics of

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migrants themselves deserve attention and further study. A known pattern of note is that LAC emigrants display subregional differences in education, and that migrants within the region are largely less educated than those who reach the United States. Much more needs to be known, however, regarding skill loss (the difference between skill level in the country of origin and skills used in the destination country) and whether certain groups experience greater skill downgrading than others. Further study is also required to assess the characteristics and understand the outcomes of migrants' children.

Going forward, the policy discussion must move from a passive emphasis on "brain drain" to an active engagement with "brain circulation" among countries. Policy should also respond to the realities of migration by making pensions portable.

Maurice Schiff, Commenter

The discussion of migration should encompass several considerations beyond those already discussed. First, migrants' movements between home and host countries must be considered in light of adaptation costs, particularly in regard to migrants with children. Given economic uncertainty in either the home or host country, there is additionally an option value of waiting to leave or return.

Second, the discussion of migrants' skill levels and outcomes must be expanded. While scholars and policymakers have long acknowledged labor market segmentation between highly skilled professionals and unskilled labor, little attention has been paid to labor markets for unexceptional professionals. Such professionals often experience "brain waste" in host-country jobs incommensurate with their level of education. Determinants of brain waste appear to include degree of proficiency in the host country's language, distance from the migrant's home country, quality of jobs available, and discrimination in the host country.

Proposals for an international framework to regulate migration, possibly including an international organization comparable to the World Trade Organization, appear either undesirable or unlikely to be realized. One such proposal, the creation of financial mechanisms or institutions to reduce the costs of remittances, has been rendered largely unnecessary by private sector competition and the growing role of information and communication technology in banking (which has speeded transactions and reduced transactions costs), as well as by agreements between governments and banks. Other proposals regarding the creation of international standards for immigration regimes, the management of unskilled labor flows and rules for naturalization appear politically unfeasible. Multilateralism inherently involves some loss of sovereignty, which proves politically problematic even in less controversial policy areas such as trade. Conceding control in the far more sensitive areas of controlling territory and residence in a country is unlikely to appeal to voters or politicians, though this constraint could be diminished by changes in communication and integration, such as may eventually take place in Europe. It is also uncertain whether authoritarian and democratic regimes could agree on a migration framework. Absent the preconditions for a multilateral regime, existing bilateral agreements between sending and receiving nations, based on common interests, represent the best available model for regulating migration.

Network News

Latin American and Caribbean Research Network

Proposals selected for the research project *Subnational Revenue Mobilization in Latin America and the Caribbean*:

- *Subnational Revenue Mobilization in Argentina.* FIEL – Fundacion de Investigaciones Económicas Latinoamericanas
- *Subnational Revenue Mobilization: Case Study of Colombia.* CEDE – Centro de Estudios Económicos, Universidad de los Andes
- *Subnational Revenue Mobilization in Mexico.* IMCO – Instituto Mexicano para la Competitividad A. C.
- *Subnational Government Mobilization: The Case of Peru.* INDE Consultores.
- *Subnational Government Mobilization: The Case of Venezuela.* Universidad Católica Andres Bello, Escuela de Economía – Facultad de Ciencias Económicas y Sociales
- *Subnational Revenue Mobilization in Bolivia.* INESAD – Instituto de Estudios Avanzados del Desarrollo

www.iadb.org/res/researchnetwork