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# **Structural Reforms in Latin America under Scrutiny**

by

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## Abstract\*

The future of structural reforms in Latin America is under discussion. The purpose of this document is to synthesize the facts and opinions that underlie this debate. The first section shows that although the reform process has not ground to a halt, it has been incomplete and uneven, both across countries and different areas of reform. The greatest progress has been made in reforming the trade and financial sectors. In terms of tax reform and privatization, the record has been mixed across countries. The most modest progress has been made in the area of labor code reform. The second section analyzes the status of public opinion of the reform process. Disillusionment with the reforms has been growing, particularly among the middle class. This disapproval, rather than reflecting concerns about the state of the economy or the degree of progress of the reforms, stems from the corruption that has tainted the privatization process in some countries. The third section reviews the effects of the reforms. Their impact on growth seems to have been positive, albeit temporary, but the effects on employment and income distribution have varied in different areas of reform and according to the particular context in each country. Specifically, the effectiveness of reforms has depended heavily on the quality of public institutions. The fourth section summarizes the main proposals to expand or reorient the reform agenda in the region. One set of proposals suggests broadening the Washington Consensus with more active policies aimed at addressing the need for greater economic stability, social integration and equitable income distribution. Another set of proposals, guided by a more encompassing view of the goals of development, emphasizes the interaction among civil society, the private sector, and the government. Finally, a more radical vision proposes a new national and international institutional architecture that would limit the role of markets and mitigate the effects of globalization.

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## **Introduction**

The jury is still out on the future of free-market reforms in Latin America. In Venezuela, official policy pronouncements have emphasized the explicit aim of counteracting economic “neo-liberalism,” and a series of decrees are being issued that will impose several constraints on free trade and even infringe on private property rights. Argentina, which until recently was a leader in the introduction of reforms, is suffering an unprecedented crisis that has required the imposition of restrictions on financial operations and on the purchase of hard currency. A crop of presidential candidates in several countries has promised to apply radical changes to the “economic model” in response to rising discontent over the state of economic affairs. This trend is not without exception, however. Governments in Mexico, Nicaragua, and Honduras are under the leadership of successful businessmen who believe in the benefits of private enterprise and free markets. Although the new president of Peru is a critic of the social costs associated with market deregulation, he has entrusted the management of the economy to an individual identified with orthodox economic policies.

Popular disillusionment with reforms and disenchantment with democracy are both increasing while many countries are mired in economic stagnation or outright recession. Latin America is suffering its worst crisis in several decades and both governments and public opinion in the region are searching for ways to deal with it. One of the areas of greatest debate is the future of structural reforms effected in the region over more than a decade. Closely following closely the recommendations of the Washington Consensus, the reforms sought to facilitate the operation of markets and let the private sector take responsibility for productive activities.

The debate over structural reforms is heated, ongoing, and oftentimes uninformed. It is no easy task to arrive at a definition of reforms—let alone measure them—and any attempt to determine the nature and extent of their effects may still be premature. All of these issues cannot be addressed here; rather, the purpose of this document is to shed light on the debate using current knowledge, public opinion, and the views of experts, while recognizing the inherent limitations of these sources. This document aims to describe the facts and opinions—often conflicting—on the effects of reforms and consider possible measures for improving the reforms or expanding their reach.

Section 1 describes the current state of the reforms based on a set of indicators that allows for comparisons across countries and in particular areas of reform over time. Section 2 uses the results of public opinion polls to gauge the level of dissatisfaction in various regions with regard to the state of the economy and the outcome of reforms. The third section reviews some empirical research on the economic and social effects of the reforms. Finally, the fourth section explores the most significant proposals for new reforms in Latin America.

## **1. The Current State of the Reform Process**

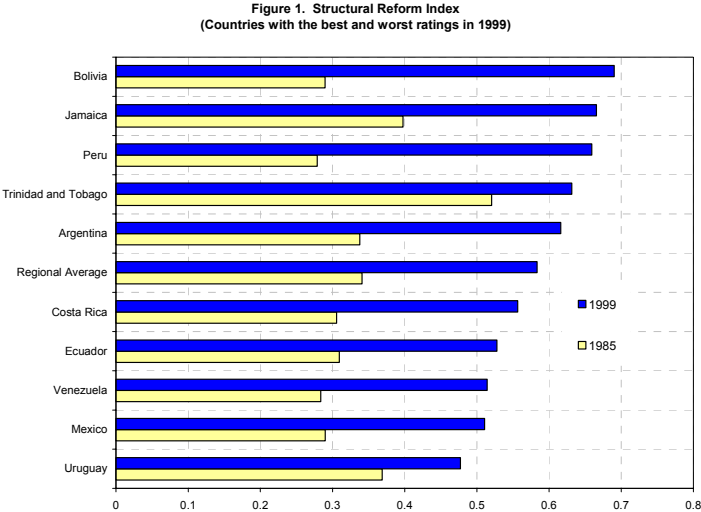
How much progress have the economic reforms made? Has the process become bogged down in recent years? Have there been setbacks? To answer these questions, it is important that the progress of reforms be measured not in terms of *results* such as the foreign trade coefficient, the degree of public spending or financial depth, but in terms of policy variables such as tariff levels, tax rates or bank reserve coefficients. Using this approach, we have taken the set of structural reform indicators originally developed by Lora (1997) and updated them in order to chart progress by gauging the quality of policies in five areas of reform: trade liberalization, financial reform, tax reform, privatization, and labor code legislation. The indicators in each area of reform (see Lora, 2001) are intended to measure the degree of openness and neutrality associated with the policies, under the assumption that the central focus of the reforms first adopted in the late 1980s has been largely to facilitate the functioning of markets and to remove controls on the allocation of productive resources.<sup>1</sup> The indices provide systematic coverage for the years 1985 to 1999.<sup>2</sup> Our examination of reforms undertaken subsequently involved the review of the documents from regular missions of the International Monetary Fund and reports of The Economist Intelligence Unit. (See the review in Appendix 1.)

The indices allow for a comparison of various policy areas within a country or of each policy across countries. The overall index is the average of all the areas of reform and provides a measure of the progress of reforms on a scale from 0 to 1. This overall index, calculated for 17 Latin American countries, had risen from 0.34 in 1984 to 0.58 by the late 1990s. This increase is significant in and of itself, yet it also suggests that many countries have a very wide margin of unexploited potential for the introduction of additional reforms. Reforms expanded the most

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<sup>1</sup> Only in the area of financial reform do the indicators assess the quality of prudential regulation, which is considered essential for the operation of financial markets.

between 1989 and 1994, when an improvement of 0.12 points was registered out of a total increase of 0.24 for the entire period. In any event, progress has been made every year and has affected every country, albeit at different rates. Only a few cases of setbacks have occurred, and they have been small and of short duration. Figure 1 compares the state of the reforms in 1985 and 1999 between the countries that displayed the best and the worst ratings in 1999. The five countries with the best records were Bolivia, Jamaica, Peru, Trinidad and Tobago, and Argentina, all of which registered final indicators in excess of 0.60, and which posted a minimum of a 0.20 point improvement above their initial rating. The five countries that lag the farthest behind in the reform process are (from worst to best) Uruguay, Mexico, Venezuela, Ecuador, and Costa Rica, whose indicators range from 0.48 to 0.55. Even the countries in this group, however, demonstrate significant advances relative to their initial situation, and all of them have managed to exceed the average level that prevailed in the region during the first few years of the period.



The progress of reform is more sharply skewed in the comparisons among areas of reform than in the cross-country comparisons. Figure 2 shows the combined total degree of progress and progress by areas (measured against the average level of each indicator in 1985). The potential for liberalization that existed in 1985 has been most thoroughly realized in the

<sup>2</sup> A detailed description of the reform indicators is found in Lora (2001).

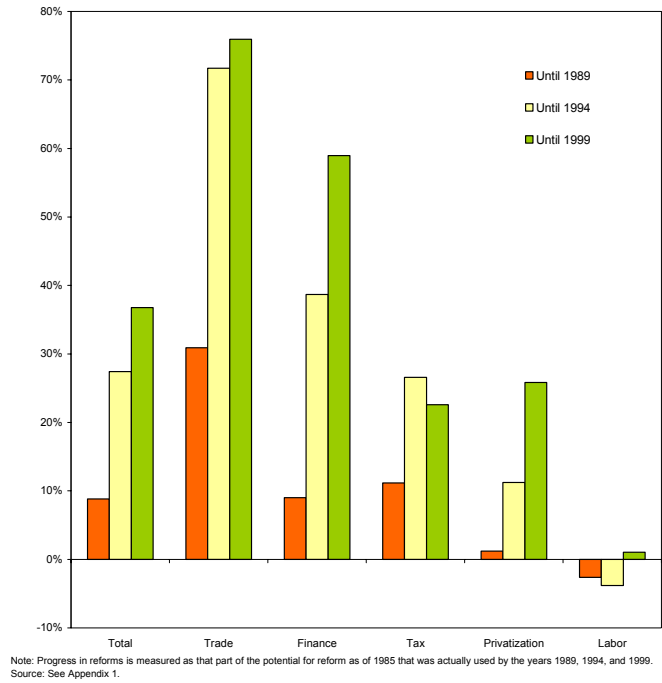
trade and financial areas, significantly less has occurred in the tax policy and privatization areas, and the area of labor reform has seen virtually no progress at all.

For example, in the area of trade policy, average import-duty levels have fallen from above 40 percent in the mid-1980s to the current levels of around 10 percent. On a scale of 0 to 1, trade reform undertaken in all of the countries is ranked at a minimum of 0.80, and the five countries that had the best tariff structures in the late 1990s (Bolivia, Chile, Uruguay, Peru, and Paraguay) boast rankings above 0.90. The greatest progress in trade liberalization took place between 1989 and 1994, although advances continued thereafter at a more modest pace. While systematic information is available only until 1999, fragmentary data indicate that in some countries (particularly in Central America), import duties have continued to decrease, and only a few countries have raised tariffs on certain products.

In the area of financial reform, the period of greatest activity was also from 1989 to 1994, although countries have continued to make headway ever since. By 1999, all of the countries had attained indices above 0.49 and the five countries with the highest indices (Argentina, Bolivia, the Dominican Republic, Jamaica, and Mexico) had surpassed levels of 0.75. This progress was due to reductions in bank reserve ratios, the removal of curbs on interest rates, and the adoption of prudential regulations, specifically the Basel guidelines for minimal capital requirements. Nevertheless, the indices factor in the constraints many countries impose on retail lending when they intervene in loan agreements in a number of ways, and allow inadequate risk assessment criteria to undermine the effectiveness of the Basel guidelines for minimum capital requirements. Since 1999, the worst setback has of course occurred in Argentina, which has had to introduce strict curbs on financial operations: limits on account withdrawals, interest rate controls, and arbitrary changes in the type of currency that can be used in financial operations. In 1999, Ecuador experienced a similar setback from which it has yet to fully recover.



Figure 2. Progress of Reforms in Latin America  
(Margin of Reform Put to Use)



Progress in other areas of reform, particularly tax reform, has proved to be more elusive. Due to the heterogeneous nature of national tax systems<sup>3</sup> and the distinct tax revenue needs of several countries, arising from historical factors or the presence of other sources of state revenues, this indicator does not admit the kind of progress comparable to that achieved in trade and financial reforms. One major area of progress has been the reduction of high marginal income tax rates for both individuals and businesses, which were extremely high in the 1980s. (Today, the maximum income tax rate in most countries ranges from 25 percent to 35 percent.) Another major step forward was the introduction of value-added taxes, with largely uniform rates in most countries. These replaced the old sales tax regimes under which different rates were applied and the so-called cascade system of taxation led to greater market distortions. The reforms most likely to produce benefits in the future will be to boost the effectiveness of tax collections and to broaden the tax base in certain cases, which would allow several countries to lower their current tax rates. The countries that are ranked highest in the tax reform area (Brazil, Dominican Republic, Guatemala, Jamaica, Paraguay) have average indices of 0.60, whereas the

<sup>3</sup> For example, in regard to the maximum individual income tax rate, the highest level encountered is 73 percent (in the Dominican Republic in the 1980s); the lowest is currently found in Paraguay and Uruguay, where there is no income tax on individuals. The norm is 30 percent.

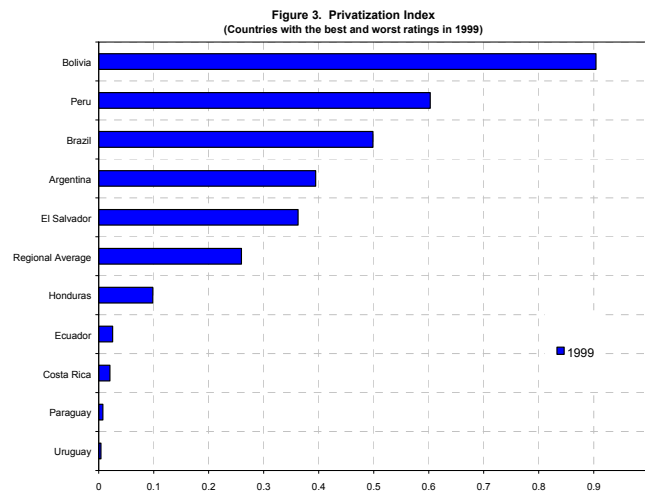
countries with the lowest levels of progress in this area (Argentina, Colombia, Mexico, Peru, Venezuela) present extremely low indices, between 0.30 and 0.41. It is important to point out that our qualitative index for tax policy assigns the highest rankings to those countries whose tax rates are both the lowest and, relatively speaking, the most effective. The intention is to assess the degree to which tax policy upsets the neutrality and free operation of the markets.

Tax reform enjoyed its greatest advances from 1989 to 1994. Between 1994 and 1999, there was a slight backslide, not because reforms were absent, but because in various countries some tax rates increased, while collections became less effective (as measured against the higher rates). Although the information available for the period after 1999 is spotty at best, it indicates that few significant changes have taken place in the process of tax reform over the past couple of years. Several countries have introduced reforms geared toward improving collections, but only a few have taken steps to reduce rates, streamline tax regimes, eliminate exemptions, or broaden the tax base in any significant way.

In the area of privatization, wide variations from one country to another have yielded an average for the region that suggests limited progress. Even so, this is the single area in which the pace of reform quickened after 1995, in contrast to earlier years. The greatest progress was made in Bolivia, Peru, Brazil, Argentina, and El Salvador, where indices range from 0.35 to 0.90; the most modest progress was in Honduras, Ecuador, Costa Rica, Paraguay, and Uruguay, all of which rank below 0.10 (Figure 3). These indicators simply reflect the cumulative value (as a proportion of GDP) of the privatization efforts that were carried out between 1988 and 1999. Thus, the indicator holds true as a measure of progress in the area of privatization, even though it does not necessarily reflect public sector participation in productive activities. For instance, Chile does not figure among the more active participants in privatization, despite the insignificant role of the Chilean state in productive sectors. The reason is that the bulk of privatization in Chile took place in the years prior to the period covered by these indices. We also need to emphasize that the index of privatization does not account for qualitative aspects of the process, which are heavily dependent on the quality and transparency of the regulatory frameworks.<sup>4</sup>

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<sup>4</sup> See IDB (2001).



Although information on privatization after 1999 is sketchy, it is clear that the process has continued in many countries in spite of the deterioration of international capital markets after the Russian crisis of 1998 and the Argentine crisis of 2001-02.

Finally, virtually no country has capitalized on the potential to introduce flexibility into labor regimes. Greater flexibility could go a long way toward providing for better-functioning labor markets. The most flexible are found in Jamaica, Trinidad and Tobago, Nicaragua, Colombia, and Brazil, while the most rigid labor markets are in Honduras, El Salvador, Mexico, Uruguay, and Bolivia. Still, none of the countries in either of the two groups showed signs of significant changes between the mid-1980s and the late 1990s. Labor market rigidities reflected in the index include difficulties in hiring employees (minimum probationary periods, curbs on temporary employment), restrictions on how the work day is structured (higher costs for extra days' work and work on holidays), extra costs for social security payroll taxes, and the high cost of dismissing employees. The few labor reforms effected in Latin America since the mid-1980s have sought to encourage temporary employment and decrease the costs of dismissals or layoffs. However, many countries in the region are subject to labor market rigidities that are far greater than those in developed countries, even though in practice they will never apply to more than a small fraction of the workforce.

In summary, the structural reform process has been incomplete and quite uneven, both across countries and across areas of reform. The greatest advances occurred in the early 1990s in the areas of trade liberalization and financial market reforms. The impact of these two areas of reform has been both profound and far-flung, encompassing every country in the region. Consequently, it is hardly surprising that these reforms have since lost much of their original momentum. The results in the areas of tax reform and privatization have been uneven. There has been progress in every country, but to very different degrees. The tax area has seen some mild setbacks in recent years. (The reforms are still in effect, but collection activities are in need of improvement, even if it comes at the cost of tax neutrality.) On the other hand, privatization increased in the mid-1990s, and even in the past two years has found a more solid footing in several countries. Labor reforms are the only area in which progress has been quite limited both in degree and in the small number of countries where it has occurred.

## **2. Dissatisfaction with Reforms**

Dissatisfaction with the economic situation pervades the region. According to a Latinbarometer public opinion survey of 17 countries in the region, two of every three Latin Americans believe that economic conditions are bad or very bad, only one in four believes that the economy will improve in the future, and three of every four believe that poverty has increased in the past five years. This dissatisfaction, moreover, has grown in recent years. Since 1997, the proportion of those who characterize the economic situation as bad or very bad has increased in 14 of the 17 surveyed countries; in half of the countries the increase has been 20 percent or more. The only countries where the situation was perceived in early 2001 as having improved over the previous four years were Costa Rica, Mexico, and Venezuela.<sup>5</sup>

Public opinion does not regard reforms favorably, either. Of the respondents who were surveyed in 2001, 63 percent believe that privatization has not been beneficial for their countries. The majority also held negative opinions in the previous year, but the proportion then had been 57 percent, up from 43 percent in 1998. Another indicator of the low public approval of privatization is that 45 percent of Latin Americans disagree with a basic principle of free market economies—that is, that the State should leave productive activities to the private sector. What

gives greatest cause for concern is that one year earlier the proportion that had disagreed was only 28 percent. Consequently, not only is public opinion on reforms negative, but recently the proportion holding this opinion has grown dramatically.

This state of discontent is reinforced by widespread dissatisfaction with the results of democracy: two of every three Latin Americans are dissatisfied with the results, and only one in two believe that democracy is the best form of government. In this regard, public opinion has also grown more negative in the majority of countries since 1997. In 14 of the 17 countries, dissatisfaction with democracy was greater in early 2001 than it had been four years earlier. (The exceptions were Brazil, Peru, and Venezuela.)

Although these indicators all suggest that the climate of public opinion has turned more pessimistic in recent years, one should not assume that this reflects a steady trend of growing discontent and dissatisfaction with democracy or with reforms. Rather, part of this discontent may reflect passing changes in the state of the economy. Actually, whereas the 1997 survey was conducted at a time when economic growth was strong, the 2001 survey was taken earlier this year during a time of economic stagnation or recession in many of the countries. In fact, upon comparing the current state of opinion with that of 1996, instead of 1997, the differences diminish significantly, and one even finds that in certain respects there has been improvement. (For instance, satisfaction with democracy is slightly higher today than in 1996.)<sup>6</sup>

Along these lines, a few simple correlations (of average results by country) suggest that the indicators of dissatisfaction are more sensitive to the results of economic growth in the prior year than they are to the extent of reforms or to changes in structural policies.<sup>7</sup> Perceptions of the results of reforms and of the advantages of a free market economy do not appear to reflect (in the aggregate for the countries) either recent economic performance or the degree of progress of the

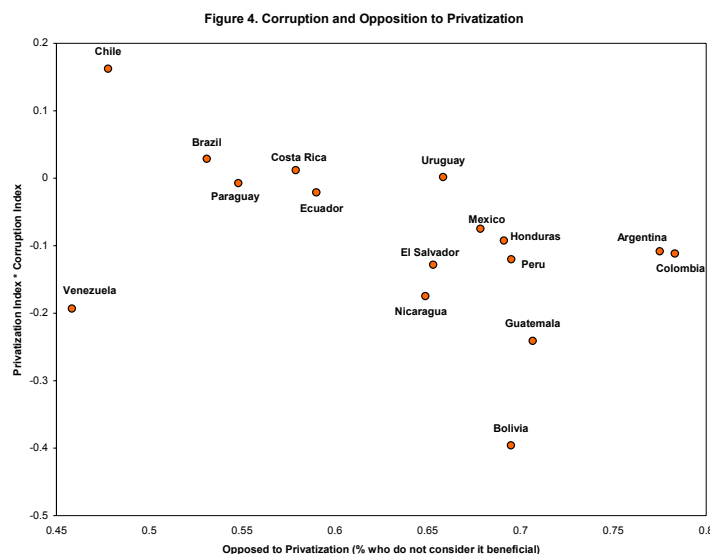
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<sup>5</sup> The changes in public opinion published in Latinbarometer's official reports are higher, due in part to changes over time in the composition of the survey sample. Here we have isolated the changes in the sample in order to adjust for these problems.

<sup>6</sup> Note that we have adjusted the biases arising from changes in the composition of the survey samples. The absence of these adjustments would exaggerate the decline in public opinion, due to the over-representation of highly educated individuals in some countries in earlier years.

<sup>7</sup> For instance, the correlation between the share of the population that considers the economic situation (in early 2001) to be bad and the rates of growth for the year 2000 in the 17 countries is -0.44. The correlation of this indicator of dissatisfaction with the total index of reforms is 0.29; with the privatization index, 0.03; and with the change in the privatization index over the past five years, 0.04.

reforms.<sup>8</sup> Instead, they may indicate disenchantment with ambitious privatization processes that have not received the support of good public institutions. Figure 4 lends credence to this position. The vertical axis of the figure represents a variable combining the extent of privatization and an indicator of corruption in the country.<sup>9</sup> A country with considerable privatization but little corruption tends to be placed in the upper area of the figure, whereas the lower area would contain countries that privatize but have higher levels of corruption. The horizontal axis represents the degree to which public opinion rejects privatization. The relationship is quite clear (with the curious exception of Venezuela, where, in contrast to the other countries, public perception of privatization is quite favorable.)<sup>10</sup> Therefore, the Latin American public would seem to conclude that privatization has failed to deliver benefits because of corruption. The same conclusion can be drawn from an analysis of individual opinions, given that those who believe their country faces severe corruption problems are substantially more likely to hold the opinion that privatization has not been beneficial.<sup>11</sup>



<sup>8</sup> The correlation between the share of the population that believes privatizations have not been beneficial and countries' growth in the year 2000 is  $-0.16$ , with the total index of reforms  $0.13$ , and with the index for privatizations  $0.28$ .

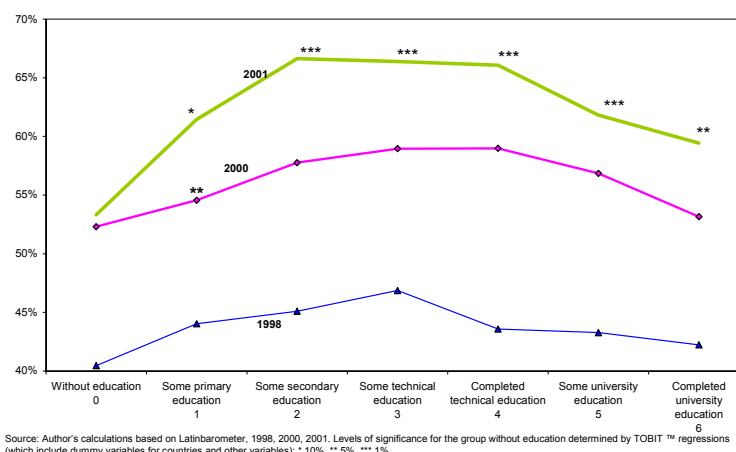
<sup>9</sup> This variable is the product of the index of 1999 privatizations multiplied by the indicator of corruption (Kaufmann, Kraay and Zoido-Lobaton, 1999) whose worldwide average is zero.

<sup>10</sup> The correlation between the two variables in the graph is  $-0.46$ ; when Venezuela is excluded as an outlier, the correlation rises to  $-0.67$ .

<sup>11</sup> The marginal (which is to say, additional) probability is 12 percent, after controlling for the level of negative responses in each country and other variables that could skew the opinion (e.g., opinion on the economic situation or on the countries future, inter alia).

The negative opinions of privatization and of free market enterprise hardly constitute a consensus. Therefore, it is worth asking which social groups tend to be most opposed. With regard to privatization, the middle classes appear to be more critical than either the rich or the poor. Whereas 53 percent of those without education or 60 percent of those who have completed college education do not believe that privatization has been beneficial, the proportion subscribing to this opinion rises to 67 percent among people who have had some secondary or technical education. This differentiation in opinions by social class appears to be a recent phenomenon; in 2000, this tendency was virtually undetectable. It is also curious to note that, whereas in 2000 the individuals with the greatest opportunities for income generation were more likely to support privatization, by the following year the situation appeared to have changed; the higher income groups had become more opposed to privatization than the lower income groups.<sup>12</sup>

Figure 5. Negative Opinion of Privatization by Educational Level  
Percentage that believes privatization has not been beneficial



The opposition among middle class groups to the ideology underlying the reforms appears to have become more pronounced recently. According to the 2000 survey, 28 percent of Latin Americans expressed disagreement with the idea that productive activity should be left to the private sector. There were no significant variations in the proportion of the surveyed groups with different levels of education. In 2001, the disagreement rose to 45 percent, with responses

<sup>12</sup> In order to calculate potential income-generating capacity, one must consider the array of durable goods belonging to the household rather than the current income available (for which the surveys do not provide information).

almost 10 percent above the overall median among individuals with secondary education, technical education, or some university education.

In short, public opinion in Latin America is critical of the economic situation, the state of democracy, and the results of structural reforms. Opinion in the first two of these areas is now more negative than it was in 1997, which (more than a sustained negative trend in opinion) reflects in part the changes in the pace of economic growth in the countries. The indicators for public opinion on reforms, which are useful for comparisons only in the years 1998, 2000, 2001, show a pronounced downturn in the last two years. Public opinion is more negative toward privatization where it has been made without the institutional basis for ensuring transparency. Public opinion against privatization and the free market economy has become more forceful among middle class groups, which have become radicalized recently.

### **3. The Effects of Reforms**

The disillusionment of Latin Americans with structural reform has coincided with a time of economic stagnation and outright recession in some countries. For many observers, the situation today is proof enough that reforms have been ineffective. Analysts and academics have not reached a definitive conclusion, since factors other than the reforms influence economic performance. Also under discussion is whether the effects of the reforms are permanent or temporary, and whether they are dependent on the individual circumstances in each country, particularly the nature and quality of public institutions.

This section reviews the literature and presents new results of the effects of economic reforms. We start by analyzing the relationship between structural reforms and growth, investment and productivity. Next, we briefly review the literature on the effects of the different areas of structural reform. Most empirical studies of the effects of reforms focus on their impact on aggregate variables, such as those mentioned above. However, those who oppose neo-liberal economic reforms often highlight that growth is not enough if it is not accompanied by a better distribution of resources, and they emphasize that current patterns of growth and globalization widen income disparities. This section addresses this issue by surveying the evidence on the relationship among economic reforms, growth, inequality, and poverty. The section concludes by summarizing what have we learned over a decade of reforms.

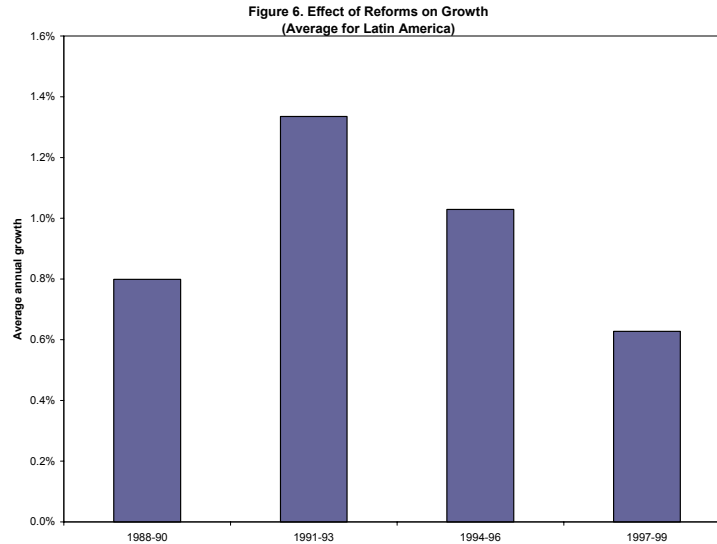


### ***3.1 The Economic Impact of Reforms***

The prevailing view on the effects of reforms was very optimistic until a few years ago. Three papers representative of that view were Easterly, Loayza and Montiel (1997), Fernández-Arias and Montiel (1997) and Lora and Barrera (1997). For instance, using the indices of reform described above, Lora and Barrera found that the reforms had an important and permanent impact on growth, productivity, and investment. Their estimates were that the economic reforms implemented until the mid-nineties accelerated Latin America's growth rate by 1.9 percentage points (or up to 2.2 percentage points once the impact of macroeconomic stabilization policies was included). These estimates were roughly consistent with those of other authors, both for the region as a whole and for specific countries (as shown in IDB, 1997 and World Bank, 2001a).

More recent studies have shown less encouraging effects. Escaith and Morley (2001), who used a modified version of the same indices and a longer period of analysis, also found a positive effect, but a much smaller and less robust one than those of earlier papers. Furthermore, they found that although some reforms were growth-promoting, others were deleterious to growth.

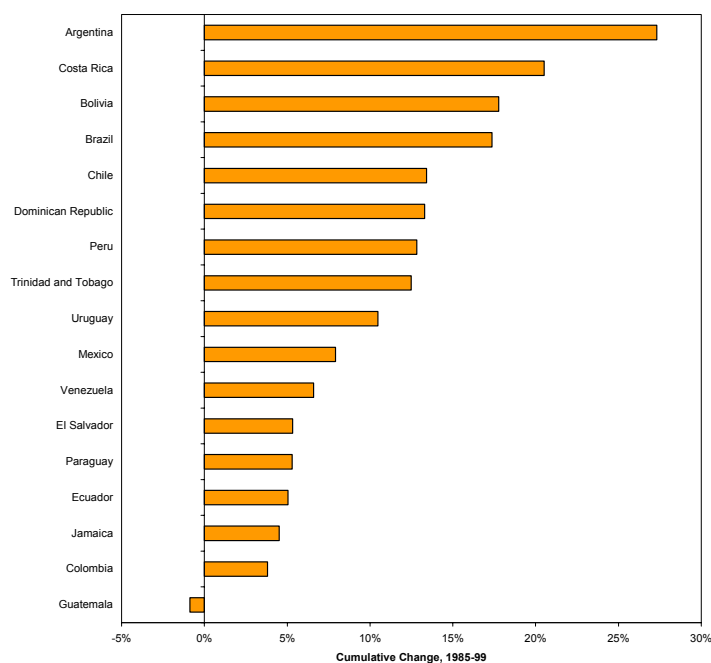
Using our updated reform indices we have reviewed the estimations presented in Lora and Barrera (see Appendix 2 for details). Contrary to what we found in the 1997 study, we now find that the reforms had only a temporary effect on growth. Our estimates imply that in the period of fastest reform, 1991-3, reforms accelerated annual growth by 1.3 percentage points. However, when the reform process started decelerating, the growth effect dropped substantially, and in the period from 1997 to 1999 it accounted for only 0.6 percentage points of additional growth (with respect to a hypothetical situation in which no additional reforms are undertaken; see Figure 6). The new results also confirm the importance of macroeconomic stability.



Notwithstanding their temporary nature, our estimates indicate that by accumulating the transitory effect of the reform process, per capita income in Latin America is 11 percent higher than it would have been without reforms. Our estimations indicate that the only channel through which reforms affected growth was by increasing total factor productivity. We find no significant effect of structural reforms on physical capital accumulation.

An important message of our new estimates is that the effect of reforms on growth and productivity is higher in countries with better institutional environments. In particular, our results indicate that reforms are more effective in countries with good rule of law. (This factor is especially important for the success of financial reforms, as mentioned below.) Taking into account the extent of reforms and the reinforcing role of institutions, the countries that most benefited from the process of reform between the mid-1980s and the end of the 1990s were Argentina, Costa Rica, Bolivia, and Brazil, with cumulative income gains between 27 percent and 17 percent. In contrast, the benefits for Colombia, Ecuador, El Salvador, Jamaica and Paraguay were quite scant (less than 6 percent) or even slightly negative (Guatemala), as seen in Figure 7.

Figure 7. Cumulative Effect of Reforms on Income by Country



It may seem surprising that Argentina leads the pack as the country that most benefited from reform. It must be remembered that Argentina moved from being one of the most heavily regulated and distorted economies in the early 1990s to one of the most market-oriented ones a decade later. Effective government institutions and fairly good rule of law gave support to these reforms. However, the case of Argentina also highlights that market-friendly policies are not enough to sustain growth. As is widely recognized now, inconsistent macroeconomic policies and a series of adverse external and political events eventually undermined Argentina's growth possibilities.

While our new estimates suggest that trade liberalization had the largest impact on growth and productivity, they do not allow for precise quantification of the separate effect of the other reforms. Below, we summarize the available evidence on the effects of the different types of structural reforms. Note that we are leaving aside any discussion on the importance of macroeconomic stability for growth. There is ample evidence that low budget deficits and low (or no) inflation are associated with higher growth (Bruno and Easterly, 1998; Easterly, 1993). In this respect, Latin America made enormous progress. The average public sector deficit in the region declined from 6.5 percent of GDP during 1980-90 to 2 percent of GDP at the end of the

1990s. At the same time, many countries that had been characterized by either high or hyperinflation adopted prudent monetary policies that cut inflation to single digits.

### *Trade Reforms*

The relationship between trade openness and economic growth is one of the most hotly debated and researched topics in the literature on economic and structural reforms. Most studies that use both cross-country (Dollar, 1992; Sachs and Warner, 1995; Frankel and Romer, 1999; Ben-David, 1993; Edwards, 1998; Dollar and Kraay, 2000; World Bank, 2001a) and in-depth analyses of country experiences (see Srinivasan and Bhagwati, 1999, for a summary of results) find a strong and positive correlation between trade openness and economic development.

Results that emphasize the benefits of trade openness have often been criticized by NGOs, the anti-globalization movement, and economists outside mainstream academia (Lance Taylor of the New School being one of the most vocal critics). However, until very recently, most economists within US academia and international financial institutions stood united behind the finding that trade openness is good for growth. This led Anne Krueger (1997: 1) to conclude that “Then and now it was recognized that trade policy . . . was central for economic development. But in the early days, there was a broad consensus that trade policy should be based on import substitution. . . . It is [now] generally believed that import substitution at a minimum outlived its usefulness and liberalization of trade is crucial for both industrialization and economic development.”

More recently, however, there have been some dissenting voices even among mainstream academic economists. Rodríguez and Rodrik (2001), for instance, show that the literature that finds a positive relationship between openness and growth is plagued by methodological and data problems and that its results are not extremely robust to alternative specifications and data sets.<sup>13</sup> Rodrik (2000a) also claims that, contrary to what is suggested by Srinivasan and Bhagwati (1999), the evidence in favor of trade openness provided by in-depth country studies is far from clear-cut. He also suggests that the results of Dollar and Kraay (2000) are biased by arbitrariness in the criteria adopted in choosing the sample of globalizers (Rodrik, 2000b) and points out a

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<sup>13</sup> However, in his comment on Rodríguez and Rodrik’s paper, Jones (2001) showed that the standard results of a positive relationship between trade openness and growth are fairly robust and that very few results that are commonly accepted in the economic literature would pass Rodríguez and Rodrik’s strict test of robustness.

hidden message in World Bank (2001): “the countries that integrated into the world economy most rapidly were not necessarily those that adopted the most pro-trade policies” (Rodrik, 2001).

Within Latin America, Lora and Barrera (1997) found that trade reforms between the mid-eighties and the mid-nineties led to a 1.5 percent increase in total growth and a 1.1 percent increase in permanent growth (with the largest effects in countries that substantially reduced and homogenized their tariffs like Brazil, Ecuador and Peru). However, as mentioned, new evidence (summarized by the tables in the Appendix) suggests that the effect of trade reforms on growth has been temporary rather than permanent. Stallings and Peres (2000: 140) also found that trade reforms had a significant impact on growth and point out that econometric estimates tend to underestimate the important impact that trade reforms are likely to have had at the sector level.

#### *Exchange Rate and Capital Account Reforms*

Besides restricting trade in goods and services, governments can restrict foreign exchange rate transactions. Such restrictions can limit capital outflows, inflows, or both. Restrictions on capital outflows are usually implemented to avoid capital flight and often generate a black market for foreign currency. Restrictions on capital inflows, on the other hand, are aimed at isolating a country from large fluctuations in capital flows and often target short-term portfolio flows.

There is ample evidence that a large black market premium induces severe distortions and rent-seeking activities and hence it is harmful for economic performance (Easterly, 2001: Chapter 11). However, the evidence on other sorts of restrictions on capital movements (be they restrictions on portfolio inflows á la Chile or restrictions on capital outflows imposed in the midst of a crisis á la Malaysia) is mixed.<sup>14</sup> In a recent paper, Arteta, Eichengreen and Wyplosz (2001) point out that while the data indicate a positive association between capital account liberalization and growth, the evidence in support of this association is extremely fragile. However, they do find that the effectiveness of capital control liberalization is contingent upon other reforms. In particular, they show that in the presence of large macroeconomic imbalances, capital account liberalization is as likely to hurt as to help. This result provides some indication

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<sup>14</sup> Grilli and Milesi-Ferretti (1995) and Rodrik (1998) found no association between capital account liberalization and growth. Using different data, Quinn (1997) found a positive correlation between capital account liberalization and growth. Alesina, Grilli and Milesi-Ferretti (1994) found a positive association between capital account liberalization and growth in a sample of high-income countries. Edwards (2001) found that capital account liberalization is positively correlated with growth in high-income countries and negatively correlated with growth in low-income countries.

of the optimal sequencing of reforms. In particular, it suggests that countries should eliminate major macroeconomic imbalances before opening their capital accounts.

A similar message is found in a recent IMF study (2001: Chapter IV). In particular, it was found that capital account liberalization of investment and financial development is associated with a half percentage point increase in yearly growth. There are, however, large cross-country differences in the effect of capital account liberalization, and its effect on growth is largely dependent on the presence of a consistent macroeconomic framework. For instance, capital account liberalization could be extremely harmful in the presence of an unsustainable pegged exchange rate or inadequate financial supervision.

### *Financial Liberalization*

The main aim of financial sector reforms is to improve the efficiency and soundness of a country's financial system by eliminating interest rate controls and other mechanisms like directed credit. Standard theory suggests that interest rate ceilings and the presence of non-market mechanisms in the allocation of credit would reduce the volume of loanable funds and the efficiency of the credit allocation mechanism (McKinnon, 1973). A well-designed process of financial liberalization can then provide large benefits by deepening the financial system and yielding a better allocation of credit. However, countries that rush into liberalization without building legal, regulatory, and supervisory structures may set the stage for a post-liberalization crisis (Caprio and Hanson, 1999).

Empirical research on the effects of financial liberalization has shown that while it does not contribute to an increase in savings (Bandiera, Caprio, Honohan and Schiantarelli, 1999), it does increase financial deepening that, in turn, is associated with growth (Levine, 1998).<sup>15</sup> In particular, cross-country analyses indicate that severe financial repression (measured by the presence of large negative real interest rates) adversely affects productivity growth. Country-level studies for Ecuador, Mexico, Chile, and Indonesia also indicate that financial liberalization leads to a more efficient allocation of capital and relaxes credit constraints faced by small firms (Harris, Schiantarelli and Siegar, 1994; Jaramillo, Schiantarelli and Weiss, 1996; Gelos and

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<sup>15</sup> Reforms that eliminate negative real interest rates seem to have the largest impact on growth.

Werner, 1999; Gallego and Loayza, 2000).<sup>16</sup> Finally, Levine (2000) shows that allowing foreign banks to enter the domestic market improves the efficiency of the banking system that in turn positively affects productivity and growth.

However, research has also shown that financial liberalization may lead to crisis. This is because the previous system of interest rate controls and directed credit may have created weak bank portfolios and not promoted a good “credit culture” (Caprio and Hanson, 1999). In such an environment, financial liberalization may put the banking system under considerable pressure and precipitate a financial crisis. While this suggests that financial liberalization should be preceded by a period of institution and infrastructure building, it also suggests that post-liberalization financial crises have more to do with the pre-liberalization environment and the sequencing of financial reforms than with the reform process itself. The results of Appendix 2 provide strong support for the hypothesis that an adequate set of public institutions is essential for the success of financial reform.

### *Tax Reforms*

The objective of tax reform should be to create a system that, while generating enough revenues to avoid unsustainable deficits, minimizes the distortionary effects of taxation. Tax reforms in Latin America have focused on shifting from excessive trade taxes and seigniorage to more broadly based consumption taxes and income taxes with lower marginal rates. Given that tax reforms are difficult to measure and quantify, empirical research on the growth effects of tax reforms in developing countries is rather limited. However, Escaith and Morley (2001) found that, for a sample of 17 Latin American countries, tax reforms had a positive and significant impact on growth. While the IDB (1997: Part 2) found a limited impact of tax reform on growth (tax reforms were associated with a 0.2 percentage point increase in growth), it found that tax reforms reduced the volatility of the fiscal deficit by 15 percent. This finding suggests that tax reforms are useful in isolating the government budget from external shocks.

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<sup>16</sup> Laeven (2000) supplies cross-country evidence for the fact that financial liberalization relaxes the financial constraints faced by small firms but does not affect large firms.

### *Privatization*

Theoretical analysis of the costs and benefits of privatization suggests that in competitive markets private firms clearly outperform public firms but that there is a role for state-owned enterprises in sectors characterized by a natural monopoly. Given that state-owned enterprises can correct market failures, one would expect that the advantages of public enterprises are greater in developing countries, where market failures are more pervasive than in developed countries.

The empirical evidence, however, seems to suggest that the opposite is true. Shirley and Walsh (2000) surveyed 52 studies of the impact of privatization on economic efficiency and welfare and found that 32 studies concluded that privatization is welfare-enhancing, 15 studies found an ambiguous effect of privatization, and five studies found a negative effect of privatization. These results are consistent with the theoretical literature in the sense that all five of the studies that found that privatization negatively affected welfare focused on natural monopolies. However, none of these five studies focused on developing countries. In fact out of 20 studies that covered developing countries, 17 found that privatization is welfare-improving and three found an ambiguous effect of privatization, but no study found a negative effect of privatization in developing countries.

Even though the evidence is overwhelmingly in favor of privatization, it should be pointed out that, as in the case of financial liberalization, a successful privatization process requires an adequate regulatory framework and political and social institutions that direct and supervise the activities of the regulatory boards (World Bank, 2001: Chapters 5 and 8; IDB, 2001: Chapter 12).

### *Labor Reforms*

Economic theory suggests that labor market regulations that aim to protect workers against the risk of unemployment, old age and sickness may also inhibit labor market efficiency and hinder the development of labor-intensive activities. As labor is often the most abundant resource in Latin American economies, this effect has important implications. The empirical evidence supports the assertion that provisions that increase the cost of dismissing workers reduce labor market flows across jobs and between employment and unemployment. Kugler (2000) finds that reducing job security provisions increases the probability of job loss and unemployment.



However, her findings also suggest that job security provisions reduce the probability of unemployed workers' finding a job. Saavedra and Torero (2000) also found higher worker rotation after labor market deregulation. Although the benefits of this improved mobility on growth have not been quantified, a large set of studies find that labor reallocation from less productive to more productive sectors and firms is the engine behind productivity growth.<sup>17</sup>

The evidence is less clear-cut in terms of the effect of labor reforms on employment and unemployment. Theoretically, the effect of regulations such as social security contributions and other payroll taxes on employment depends on whether the incidence of taxes falls on firms or workers. A degree of consensus is emerging that a large share of the cost of these taxes is paid by workers in the form of lower wages.<sup>18</sup> However, since there is not full pass-through to wages, such regulations are associated with losses in employment, particularly in the formal sector. The effect of reforms that reduce job security provisions on employment and informal activity is more ambiguous. At the theoretical level, provisions that increase the cost of dismissing workers simultaneously reduce hiring and firing rates, and therefore the effect on total employment depends on which of these two effects dominates. At the empirical level, the effects are equally inconclusive.<sup>19</sup>

There is however, growing evidence that job security provisions alter the distribution of employment. The greatest adverse impact of regulation is on youth and other groups marginal to the workforce. Insiders and entrenched workers gain from regulation but outsiders suffer. As a consequence, labor market reforms that bring about deregulation can increase equality among demographic groups.<sup>20</sup>

### ***3.2 Economic Reforms, Poverty, and Inequality***

While most economists tend to agree that most of the structural reforms described above tend to increase average income, those who criticize these kind of reforms emphasize their distribution

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<sup>17</sup> See for instance, Davis and Haltiwanger (1992); Davis, Haltiwanger and Shuh (1996); and Poirson (2000).

<sup>18</sup> Marrufo (2001); Gruber (1994, 1997); and Edwards (2001).

<sup>19</sup> Addison and Grosso (1996), Grubb and Wells (1993), Lazear (1990), Heckman and Pagés (2000), and Nickell (1997) find a negative relationship between job security provisions and employment, while Addison, Teixeira and Grosso (2000), OECD, (1999), and Garibaldi and Mauro (1999) do not find evidence of such a relationship. Regarding the evidence on the effects of job security on unemployment Elmeskov, Martin and Scarpetta. (1998), Lazear (1990), and Addison and Grosso (1996) find a positive link while Blanchard (1998), Heckman and Pagés-Serra (2000), Nickell (1997) and Addison and Grosso (2000) find no effect.

<sup>20</sup> Pagés and Montenegro (1999), Heckman and Pagés-Serra (2000).

consequences and claim that they generate a pattern of economic growth that only benefits the richest segments of the population.<sup>21</sup> The two opposing views are well summarized by the following two passages:<sup>22</sup>

Growth really does help the poor: in fact it raises their income by about as much as it raises the income of everybody else... In short globalization raises incomes and the poor participate fully (*The Economist*, May 27, 2000: 94).

There is plenty of evidence that current patterns of growth and globalization are widening income disparities and hence acting as a brake on poverty reduction (Justin Forsyth, Oxfam Policy Director, Letter to *The Economist*, June 20, 2000).

The most quoted papers in support of the first view are Gallup, Radelet and Warner (1998), Dollar and Kraay (2000a, 2000b), and a recent World Bank report (World Bank, 2001b). The basic point of these papers is that reforms (especially trade openness and globalization) increase economic growth without affecting income distribution. Therefore, these authors conclude that the increase in average income brought about by economic liberalization is fully translated into an increase in the income of the poor.

While Gallup, Radelet and Warner (1998) and Dollar and Kraay (2000b) present strong evidence in support of the fact that growth is distribution neutral, Ravaillon (2001) shows that, by going beyond averages, one discovers that there are large differences among countries in how much growth benefits the poor. In particular, he points out that the drop in the poverty rate brought about by a 1 percent increase in the growth of average household income can range between 0.6 and 3.5 percent. At the same time, Foster and Székely (2001) show that when one uses an index that emphasizes the income of the poor, the latter does not grow one-for-one with average income, but considerably less. This last result seems to indicate that reforms may hurt some groups with very low income and hence, while they do help in reducing overall poverty,

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<sup>21</sup> Given that some reforms emphasize greater international trade and capital account openness, very often the process of reform is identified with the term “globalization.”

<sup>22</sup> Both quotes are from Ravaillon (2001).

they may worsen income distribution among the poor. There is, therefore, a role for policies that take into account the distributional impact of growth.

The IDB (1997, Part, 2) found that structural reforms led to a slight improvement in income distribution and that tax reforms were not regressive (in the sense that they did not contribute to worsening income distribution). However, Behrman, Birdsall and Székely (2000) studied wage differentials in Latin America and found that during the period of 1980-1998 economic reform had a short-run disequalizing effect.<sup>23</sup> One of their main results is that, while domestic financial market reforms, capital account liberalization, and tax reforms widened wage inequality, privatization narrowed wage inequality. At the same time, they found no significant impact of trade openness on wage inequality. Spilimbergo, Londoño and Székely (1999) found that, on average, trade openness increases inequality and that the effect is stronger in countries where physical capital is relatively scarce.

The fact that economic reforms (especially trade openness) may increase inequality in developing countries seems to go against standard economic theory (or at least economic theory rooted in the Heckscher-Ohlin model of international trade) that suggests that trade openness should increase the income accruing to the relatively abundant factor of production. Given that most developing countries are abundant in unskilled labor, which is also the factor of production controlled by the poor, one would expect trade openness to improve income distribution and hence improve the relative (and not only the absolute) well-being of the poor. However, the distributional effect of reforms is extremely complex. In some countries external tariffs focused on labor-intensive products (as in the case of Mexico, Hanson and Harrison, 1999); in other countries the most abundant factor of production is land or natural resources. Finally, financial liberalization may lower the relative price of capital goods and hence favor more capital-intensive techniques that lower demand for unskilled work (World Bank, 2000: Chapter 4).

There is also some evidence that structural reforms may lead to a short-run increase in unemployment. In the case of trade reforms, employment losses are reabsorbed in the medium and long run. A World Bank study found that in 12 out of 13 countries, trade liberalization increased industrial employment within one year of the implementation of the reform (the exception being Chile, where industrial employment decreased but agricultural employment

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<sup>23</sup> Morley (2000) finds small regressive effects of reforms. He points out that while tax and trade reforms tend to be regressive, financial reforms are progressive.

increased, World Bank, 2000: Chapter 4). The effects of privatization are much more difficult to evaluate because it is a process that displaces a large number of workers and generates winners and losers. Several studies have found that workers retained by privatized firms enjoyed increases in real wages with larger gains for blue collar workers than for white collar workers (La Porta and Lopez-de-Silanes, 1999). However, studies have also found that privatization processes led to the dismissal of a large number of workers. For example, the Argentinean privatization of the oil, telecom, rail, and electricity sectors led to the dismissal of more than 110,000 workers (Kikeri, 1998). Unfortunately, there are very few studies that analyze what happened to workers that were laid off by newly privatized firms. Studies of Turkey and India found that laid-off workers experienced substantial welfare losses and many moved to the informal sector with earnings that were less than one third of their previous earnings (Patel and Suzuki, 1997; Tansel, 1996).

### ***3.3 What Have We Learned after More than a Decade of Structural Reform?***

It is fair to conclude that while the literature on economic reforms has found that they do affect growth and productivity, it has also found that the economic impact of reforms has been lower than expected, that economic reforms are not distribution neutral and that they do generate winners and losers. The lessons learned in more than a decade of economic reforms can be summarized by the following seven points:

1. Structural reforms are a necessary but not sufficient condition for improving the economic well-being of the poor. They are a necessary condition because poverty alleviation requires economic growth and reforms have been shown to be positively correlated with growth.
2. Structural reforms are not sufficient to raise growth to levels comparable to those of the fastest growing developing countries. The IDB (1997) estimated that by completing its process of structural reform, Latin America could increase its growth rate by anything between 1.2 and 1.7 percentage points. If we add this to the average per capita growth in the last decade of 1.5 percent, we obtain a growth rate of 3 percent. Even at this rate (which successive

research suggests may be rather optimistic, especially due to the temporary nature of the effects of reform), it would take the region 50 years to reach an average level of income per capita similar to that of the OECD countries. If the benchmark is the growth rate enjoyed by South-East Asian countries, economic reforms are clearly not sufficient to guarantee a brighter future to Latin America.

3. Not all pro-market reforms are successful. In a context of volatile terms of trade and capital flows, the liberalization of capital flows can generate instability when implemented in an environment characterized by unsustainable macroeconomic policies and an inadequate supervisory and regulatory framework.<sup>24</sup> There is also agreement that while some responsibility lies within the countries, the international financial architecture must also be reformed in order to limit sudden stops in capital flows and financial contagion.
4. It is now clear that institutions matter. The evidence surveyed in this section shows that reforms (especially financial reforms and privatization) are more effective when based on good public institutions. There are at least three reasons why that is so. First of all, institutions play a key role in determining transaction costs and therefore good institutions facilitate market exchange. Second, institutions allow society to overcome collective action problems. Finally, good institutions help in setting up a system of incentives under which individuals find it convenient to be involved in productive rather than distributive actions.<sup>25</sup>
5. There are no “one-size-fits-all” reforms. Economic reforms must be adapted to local conditions. Reforms that are imposed from outside and transplanted

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<sup>24</sup> For instance, IMF (2001, Chap. IV) shows that, without proper financial supervision and in the presence of macroeconomic imbalances, financial liberalization can increase macroeconomic instability.

without taking into account local conditions may destroy institutions that generate mechanisms of social identification and social protection. For instance, while not questioning the need for a privatization process, the International Labor Organization points out that this process should be carried out with respect to local traditions and needs and by carefully evaluating its social impact.<sup>26</sup>

6. Structural reforms cannot be evaluated only on the basis of their effect on growth; equity and social issues should also be considered. This element is important for two reasons. First of all, the well-being of the poor should have a special role in the objective function of policymakers. Second, economic reforms that do not reduce inequality and do not improve social indicators tend to generate discontent and are ultimately unsustainable.
  
7. There is a need to widen the reform agenda and to merge pro-market reform with social reforms aimed at reducing economic vulnerability, poverty, exclusion, and inequality. These two kinds of reforms need to be integrated not only for the sake of political sustainability but also because they tend to complement each other and there is some evidence that inequality is harmful for growth (Perotti, 1996).<sup>27</sup> Thus, the last part of this paper discusses some of the main proposals that have been put forth to widen the reform process in Latin America.

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<sup>25</sup> For a more encompassing view of the influence of institutions on development see Knack and Keefer (1995), Burki and Perry (1997), Hall and Jones (1999), Kaufmann, Kraay and Zoido-Lobaton (1999), and Acemoglu, Johnson and Robinson (2001).

<sup>26</sup> “The question now is not whether or not to privatize; it is rather how the privatization should take place providing adequate safeguard of the interests of all parties: workers, employers and the general public. Interests of the public and workers would be safeguarded only when there is periodic examination of the methods of privatization and when there is a greater degree of discussion on the ways in which social consequences are to be dealt with. Public consensus as far as possible on the methods of privatization would ensure not only the success of the privatization but also equitable distribution of the fruits of such success. Such equitable distribution can take place only when the restructuring of the public enterprises before or after privatization takes into consideration the social effect and proceeds with the approach and mechanism that will ensure that adverse effects on the interests of the workers are handled through discussion and consensus” (Joshi, 2000).

#### 4. Towards a New Reform Agenda

In 1990, a group of Latin American policymakers met with development practitioners and academics in a conference organized by the Institute of International Economics in Washington, DC. In an extremely influential article that followed the conference, John Williamson (1990) pointed out that conference participants had reached a substantial agreement on a package of economic reform policies. This package, which Williamson labeled the “Washington Consensus,” contained the following ten items:

- fiscal discipline;
- more public expenditure in education and health;
- tax reform;
- market-determined interest rates;
- competitive exchange rates;
- liberal trade policies;
- openness to foreign direct investment;
- privatization;
- deregulation;
- respect for property rights.

Latin American policymakers enthusiastically embraced the Washington Consensus and in the 1990s the region was swept by an unprecedented wave of structural reforms. More prudent fiscal and monetary policies were implemented, trade, financial markets, and capital accounts were liberalized, and large sectors of the economy were privatized, as described in Section 1 of this document. While these reforms were extremely successful in taming inflation, reducing government deficits and attracting foreign direct investment, the results were more discouraging in terms of economic growth, poverty reduction and improvement in social conditions.<sup>28</sup>

This disappointing outcome led to a state of “reform fatigue” in which more and more Latin Americans started blaming the reform process for what they perceived to be a deterioration

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<sup>27</sup> There is, however, some controversy on the true relationship between inequality and growth. See Forbes (2000), Banerjee and Duflo (2000), and Panizza (2002).

<sup>28</sup> Birdsall and de la Torre (2001) point out that in the 1990s growth was not much higher than growth during the lost decade of the 1980s (3 percent versus 2 percent), social indicators were only slightly better and inequality was still extremely high.

of their quality of life (Birdsall and de la Torre, 2001). As shown in Section 2, the discontent with the main tenets of structural reform has increased over time and tends to be stronger in the countries that have advanced in the process of reform without the support of good public institutions.

As pointed out by Birdsall and de la Torre (2001), it would be wrong to blame the reform process for this unsatisfactory outcome. There is, in fact, enough evidence that without reforms things would have been even worse. However, it is now recognized that the original reform process was too narrow and that it is necessary to develop a policy package aimed at improving equity and reducing poverty.

While the beginning of the 1990s were characterized by ample consensus on what should be done to improve the economic fortunes of the developing world, there are now various views on the path that should be taken. One vision is still very much rooted in the original Washington consensus but emphasizes a major role for public policies aimed at reducing poverty, inequality, and social exclusion. A second vision emphasizes the role that civil society and the private sector should play in strengthening institutions and working jointly with the government in pursuing wider development goals. Finally, there is a vision that challenges more head-on the role of markets and asks for a new order that would limit international trade and finance and reshape both global and national institutions. In what follows, we highlight the main elements of these three visions.

#### ***4.1 The View from Washington***

While there is widespread agreement that countries should implement policies aimed at making development more inclusive, it is on how to make that a reality that the Washington Consensus becomes what Birdsall and de la Torre (2001) have labeled “Washington Contentious.”

On the one hand, there are those who say that growth is inclusive in and of itself and that policies like social spending on health and education that are supposed to target the poor have no systematic effect on poverty reduction (Dollar and Kraay, 2000b). On the other hand, there are those who advocate policies directly targeted at improving the lot of the poor. Birdsall and de la Torre, who have distilled the main proposals of this view, summarize in ten policies the new reform agenda aimed at marrying equity with growth:

- build institutions to enforce rule-based fiscal discipline;



- build monetary and fiscal institutions that can implement counter-cyclical policy and smooth the business cycle;
- build social safety nets that trigger automatically;
- decentralize education and improve access to education for the poor;
- tax the rich more heavily and spend more on the poor;
- build institutions that help the creation of small firms;
- protect workers' rights;
- address discrimination;
- implement a new generation of land reforms;
- improve public service delivery.

While some of these ten policies are completely aligned with the old Washington Consensus (like building institutions that improve fiscal discipline) others seem to deviate from the old consensus. The most controversial points are likely to be those related to tax and labor reform. While traditional tax reforms advocated lower marginal tax rates and greater emphasis on consumption taxation, Birdsall and de la Torre suggest focusing more on income taxation and taxing the rich more heavily (by eliminating loopholes and opportunities for tax evasion). While traditional labor reform emphasized the need for greater labor market flexibility, Birdsall and de la Torre ask for more worker protection and anti-discrimination policies.

One other important element is the emphasis on the role and responsibilities of developed countries. First of all, there is now agreement that developed countries should play a key role in building a new financial architecture aimed at reducing international financial volatility and contagion. Two interesting proposals in this direction are the establishment of an international bankruptcy court (recently advocated by the IMF deputy executive director) and the creation of an emerging market fund, as advocated by Calvo (2001). Other voices call for an increase in foreign aid (the importance of which has been emphasized by both politicians like Britain's Chancellor of the Exchequer Gordon Brown and academic economists like Jeffrey Sachs, 2001) and investments in projects with high social returns, such as the development of a malaria vaccine (Hamoudi, Kremer and Sachs, 1999). Finally, and perhaps more importantly, there have been calls to increase the trade openness of developed countries. This is particularly important because developed countries tend to have high tariffs (either explicit in the form of quotas or

anti-dumping policies or implicit through the imposition of labor standards or strict health standards) on agricultural and textile products. These are exactly the goods in which developing countries tend to have a competitive advantage and that tend to employ most of the poor in developing countries. Lowering these barriers would have a large effect on poverty and inequality in the developing world.

#### ***4.2 The View from Santiago***

A second view, heralded by José Antonio Ocampo of CEPAL,<sup>29</sup> holds that a new relationship must be established between the market and the public interest, which must be pursued not only through government policies, but also through a more active engagement of civil society. Public policies should aim at wider goals in several ways. Macroeconomic policies should not only seek price stability, but also less pronounced economic cycles. In addition, and not only lower fiscal deficits but also less private indebtedness. Economic policies should not be confined to the macro variables; they should give more emphasis to the development of new productive activities, which should be supported by active industrial policies, stronger regulation and a much closer cooperation between the government and the private sector. Social policies should also interact more closely with economic policies, and should be oriented along three principles: universality, solidarity and efficiency. Finally, development goals should not be restricted to economic growth and poverty reduction, but to a wider set of values, including freedom, social cohesion and cultural identity.

#### ***4.3 The View from Porto Alegre***

As the biggest movers and shakers in business and politics met at the World Economic Forum that was held in New York on February 1-5, more than 40,000 representatives of NGOs and “civil society” met at the World Social Forum (WSF) in Porto Alegre, Brazil. Although the people that met in Porto Alegre represented an extremely varied group of interests, they all shared a high level of suspicion (or hostility) towards economic neo-liberalism and the globalization of trade and financial markets.<sup>30</sup> As it is difficult to summarize the deliberation of

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<sup>29</sup> See CEPAL (2001) and Ocampo (2001).

<sup>30</sup> Groups present at the WSF ranged from the “World Association for Esperanto” to “Religion in a Globalized Age.” The anti-globalization movement often identifies as its enemy a globalization troika formed by the International Monetary Fund, the World Bank, and the World Trade Organization. The World Economic Forum is

the more than 800 parallel sessions that were held at the WSF, we focus on one of the four main themes touched on at the conference: the production of wealth and social reproduction.<sup>31</sup> On this theme, the anti-globalization movement reached agreement on the following five points:

*i Free trade does not guarantee wealth and development.*

While participants in the WSF did not call for the elimination of international trade, they did call for reforms aimed at eliminating WTO rules on intellectual property and limiting the role of the WTO in the liberalization of the service industry. Delegates called for tariffs and subsidies aimed at creating and protecting manufacturing industries in developing countries and advocated the creation of a system of fair prices for agricultural products and natural resources.

*ii Transnational corporations have too much power.*

WSF participants emphasized the need to separate corporations from the state, tighten and enforce anti-corruption laws, and prevent creative accounting. They also found that corporations should not only be accountable to their shareholders but also to society as a whole.

*iii Financial liberalization has increased global inequality and has been the main cause of financial crises and contagion.*

The position of WSF delegates on international financial transactions focused on establishing policies to control capital flows and reinforcing regulations on markets and financial actors (ATTAC, 2002). Somewhat in agreement with the Washington consensus, WSF delegates agreed that if countries decide to liberalize their capital accounts, there should be a sequencing of reforms.

Short-term capital flows should be limited by using measures similar to the ones adopted by Malaysia and Chile. However, national policies should be corroborated by international limitations to capital flows. Toward this end, the

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usually held in Davos (Switzerland) but in 2002 it was moved to New York as a sign of solidarity after the terrorist attacks of September 11. The main source of information for this section is the official web site of the World Social Forum: <http://www.forumsocialmundial.org.br/eng/>.

anti-globalization movement is highly supportive of the so-called Tobin tax.<sup>32</sup> This is a tax with a low rate (0.05 percent in Tobin's original proposal) that would be irrelevant for long-term capital flows but very costly for daily or weekly transactions. Anti-globalizers also support two other taxes aimed at limiting foreign direct investments and avoiding transfer pricing from multinational corporations.

*iv. International financial institutions should be reformed.*

WSF delegates agreed on the need to make international financial institutions more transparent and accountable and increase the role of developing countries in IFIs' decision-making process. They suggested putting the Bretton Woods Institutions and the WTO under direct guidance of the United Nations.

Regarding financial crises, WSF delegates embraced the moral hazard view and suggested that international financial institutions (IFIs) should focus on private sector involvement and should not bail out bondholders and multinational financial institutions. There were also proposals for the creation of a Currency Exchange and Raw Materials Market Stabilization Fund and a global fund for development.

*v. Developing countries' external debt should be reduced and new lending mechanisms should be implemented.*

WSF participants observed that external debt payments absorb a substantial amount of resources and that poor developing countries should stop repaying their debt and find new sources of funding for "socially just and ecologically sustainable development." These development initiatives should be funded with revenues that were previously earmarked for debt repayment, recuperation of wealth stolen by third world rulers, increases in official development aid, and one-

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<sup>31</sup> The other three themes were: political power and ethics in the new society; civil society and the public arena; and access to wealth and sustainability.

<sup>32</sup> James Tobin originally proposed the idea of a tax on short-term capital flows during the 1971 Janeway lectures at Princeton University (Tobin, 1974). In an article which appeared in the Financial Times on September 11, 2001 (!), Tobin distanced himself from the anti-globalizers' adoption of the Tobin tax.

off property taxes on the wealthiest ten percent of the citizens of each country (Toussaint and Zacharie, 2002).

Finally, WSF delegates also suggested that IFIs should implement a lending mechanism based on the principle of “reverse conditionality,” according to which debt should be repaid only if the borrowed money has been used properly and has contributed to the country’s economic and social development.

The purpose of this section was to summarize the different views on the new policy agenda for the developing world. While the voices from Washington, Santiago, and Porto Alegre agree that development should be more inclusive and shift from a framework that focuses purely on efficiency to one that focuses on efficiency with equity, there is no clear agreement on how to achieve these targets. The main point of disagreement is over the role of market institutions. Many argue that markets must remain central for achieving rapid growth and poverty reduction; others are suspicious of markets and would like to introduce more controls and limitations on the mobility of goods and capital.

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## **Appendix 1. Progress and Setbacks in the Process of Reform in 2000-2001<sup>33</sup>**

In **Argentina**, payroll taxes, which had reached 49 percent of gross wages, were pared down to 43 percent in the year 2000, thanks to several discount mechanisms that reduced employer contributions to the pension systems. Yet in other ways the effectiveness and fair-handedness of the tax system (which has been particularly unstable in recent years) has in fact been undermined by policies. In January 2000, tax amnesties were reintroduced. These were supposed to have been eliminated when the permanent system of “spontaneous filing” was instituted in 1997. The moratorium in 2000 took an immediate and significant toll, reducing collections by \$600 million in forgone payments. In late 2000, in a move to boost competitiveness and encourage investment, the tax on commercial borrowers’ interest payments was reduced in stages. Credits were established for payment of value-added taxes (VAT) to be applied against several other taxes. Extensions were given on the time available in which to use deductions from business losses to pay the minimum business tax. Furthermore, a policy was instituted to award individual income tax credits for a proportion of the interest payments made on home mortgages. In April 2001 “competitiveness” plans for specific economic sectors were introduced. These consisted of tax benefits, such as exemptions from employer charges and other taxes in recognition of VAT payments and the use of tax credits to pay off debts to the central government.

In the finance area, a policy was instituted in April 2001 to impose immediate surcharges of six-tenths of one percent (0.6 percent) on financial transactions in the hope of narrowing the gap between fiscal revenues and expenditures. However, this particular measure was bound to have an adverse, longer-term effect on finances.

In trade policy, non-Mercosur import-duties were raised to 35 percent. Subsequently a so-called “fiscal” devaluation of about 8 percent was established for trade operations.

In the area of social security, a proposal was voted down which would have reformed the pension system by reducing the standard pension payment and providing incentives for women to retire at the age of 65 instead of 60, as well as cut benefits from special public sector systems.

Other important areas of financial reform included the introduction in 2000 of a system of safeguards to encourage private sector participation in infrastructure projects, and a measure to strengthen the financial market and its oversight systems. However, these steps to improve the

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<sup>33</sup> Based on the document series of the International Monetary Fund, titled *Staff Report for the Article IV Consultation and Selected Issues for 2000 and 2001*, and the *Country Reports* of The Economist Intelligence Unit.

financial system were watered down when it became necessary to block withdrawals from accounts in response to a run on bank deposits in late 2001. Once the peso was devalued in early 2002, debts to financial institutions were converted to an exchange rate below the rate used for the conversion of deposits, which exposed the financial sector to heavy losses that were supposed to be offset by the government. These measures have had a tremendous impact on banking operations and the availability of credit.

In **Bolivia**, the ambitious privatization process continued in 2000 and 2001, as sales of assets took place in the gas, hydrocarbon, and electric energy sectors. But little progress was evident in other areas. In the tax arena, significant steps were taken to strengthen customs administration and tax management. However, a postponement was announced of the most comprehensive tax reform, which had been agreed upon with the IMF for the year 2000. A reform geared at strengthening the regulation of the financial system was also put off. In the labor area, where comprehensive reform would be necessary, there has been no progress whatsoever.

In **Brazil**, the privatization process has remained on track. Electrical power and cellular telephone concessions were awarded, and reforms were adopted to encourage the deregulation of the hydrocarbon market. Nevertheless, critical disruptions in the supply of electric energy led to the postponement of a program to sell off energy companies. Federalized state banks continue to be privatized and the process is slated to conclude in early 2002. Although reforms in other areas were more tepid, the passage of pension system reform measures creates a framework for the operation of complementary funds, and Congress has been debating reforms to strengthen and streamline some taxes.

In **Chile**, requirements for cash reserves as a prerequisite for investment of foreign capital were eliminated, as were other administrative controls on transactions involving foreign capital. Measures were taken to facilitate multipurpose banks and to loosen controls on operations in capital markets. In the tax reform area, the individual tax rate, one of the highest in Latin America, was reduced, whereas the corporate tax rate was raised. In terms of privatization, the government moved ahead with its program to award infrastructure concessions, but it has not contemplated new programs to sell state enterprises to the private sector. In labor legislation, a system of unemployment insurance was passed, which would combine individual accounts with a collective insurance fund, and measures were adopted to facilitate union activities. However,



more rigorous controls were imposed to restrict employee layoffs or dismissals and regulate workers' overtime.

In **Colombia**, plans to privatize two major electric power companies did not materialize, and the private sector's anticipated announcement that it would raise capital for domestic power distributorships was put off due to a lack of interest and unclear regulatory conditions. Nevertheless, the government managed to launch the successful public sale on the stock market of a 15 percent stake in ISA, as part of a program to democratize stock holdings. The financial sector, however, did witness the sale of some financial institutions, and the recapitalization and restoration of some bank portfolios that had encountered difficulties in 1999. After considerable delays, a proposal was debated in Congress that would reform the pension system. There was no action in the area of labor legislation, despite the critical unemployment situation.

In **Costa Rica** the attempt to set up a legal framework that would open the door to privatization in the telecommunications and television areas was defeated. (The 2000 legislative session of the Assembly enacted the legislation, which the Supreme Court subsequently voided.) Trade conditions continued to be eased as duties on imports from countries outside Central America were reduced, a small tariff on Central American imports was removed, and a free trade agreement with Chile was successfully passed. In the area of financial reform, a regulation was implemented requiring banks to list offshore holdings on their balance sheets and file reports, and guidelines for credit classifications were improved. The administration delivered a proposal to Congress to rein in the privileges of the state banks; the proposal was met by opposition from several quarters.

In **Ecuador**, the private sector received approval to participate in several areas of hydrocarbon activity, allowing for the groundbreaking on a construction project to build an oil pipeline traversing the country from the Amazon region to the Pacific Coast. The project is estimated to be receiving \$1 billion in direct foreign investment. Drinking water and waste treatment services in Guayaquil were contracted out, but then suspended due to fears that private ownership of companies that generate and distribute electric power would be found unconstitutional. Labor legislation was enacted in the form of a modest amendment that will make it easier to engage temporary employees. The Supreme Court signed off on private sector participation in pension fund management, raising the possibility of a significant reform of the pension system.

In **El Salvador**, a new banking law was passed in late 1999, followed the next year by the passage of legislation on the other financial intermediaries, in order to improve oversight and prudential regulation. The banking law provides for consolidated oversight of financial conglomerates, and sets increased requirements for the capital-to-asset ratio (weighted according to the level of risk) until it reaches 12 percent in the year 2005. In the tax area, some VAT exemptions were eliminated along with personal income tax credits for VAT payments. In the interest of promoting trade integration, El Salvador signed a free trade agreement with Mexico in the year 2000 and is engaged in discussions on similar agreements with the Andean Group, Canada, the Dominican Republic, and Panama.

**Guatemala** lowered its duties on imports from Honduras and El Salvador within the framework of a free trade agreement, and enacted a reform in the social security system (which is operated as a pay-as-you-go system) resulting in increases in the rates of individual contributions and, as of 2008, the retirement age. The value-added tax (VAT) was raised from 10 percent to 12 percent, which was considered essential in order to increase public revenues. In the financial area, new legislation gave the Central Bank greater independence, and in late 2001, measures to improve financial oversight and prudent legislation were under discussion.

**Honduras** signed a trade integration agreement with Mexico. It also once again postponed the sale of minority shares in the state telephone company. In response to a financial crisis that affected several banks, steps were taken to strengthen prudent regulation.

**Jamaica** did not make significant progress in any area of structural reforms. However, in March 2001, the Parliament approved the passage of measures to strengthen financial supervision. In the tariff arena, the government proposed additional duties on imported agricultural products.

**Mexico** made major advances in its structural policies for the financial sector, including: re-privatizing banks that had undergone interventions, strengthening the regulatory framework, introducing more stringent reporting requirements, and new bankruptcy and loan collateral legislation, which substantially improve creditors' rights. Important advances were made in tax policy, but the new government's proposals for reform of the value-added tax and a measure to streamline several different taxes did not receive the support they required. Nor did the government make headway with its initiative to open up the electricity and hydrocarbon areas to the private sector.

In **Paraguay**, Congress approved proposals to sell off the state phone company and the water and sanitation state enterprise (anticipated in 2002). The administration called for discussions in Congress on restructuring the largest public bank and consolidating into one second-floor entity several smaller financial agencies. No progress was made in other areas begging for attention, in particular the social security system.

In **Peru** leases were awarded to the private sector for the transportation and distribution phases of the Camisea gas project, forest management, administration of the Lima airport, and the management of several regional ports. Privatization revenues in 2000 were US\$ 418 million (or 0.8 percent of GDP), a significant amount, although it is one-third less than original government projections. Several measures were also taken to invest in and strengthen the banking system, which since 1998 has engendered a cumulative cost that could reach 3.9 percent of GDP. A tax reform was approved in 2000 that lowered the income tax rate but left intact the exemptions the government had wanted to eliminate. In early July 2001, the tight fiscal situation forced the government to abandon its earlier plan to abolish a payroll tax. It raised the commercial tax rate and established a system with more gradual adjustments in the individual tax rate. The government also announced its interest in creating public banks and carrying out other interventionist schemes, but these proposals were not implemented.

In **Trinidad and Tobago**, the process of structural reforms ground to a halt in 2000 but restarted in 2001. The sale was announced of several issues of stock belonging to the state holding company, which controls a number of firms that are the property of the state. The sale of a share of the government sugar company was agreed to, and Parliament approved private sector participation in telecommunications, water supply, and radio broadcasting companies. Parliament also approved a one-point reduction in corporate and individual income tax rates.

The authorities in **Uruguay** proposed beginning a process of deregulating and breaking up monopolies among the main public sector corporations that market hydrocarbons, natural gas, and asphalt, as well as opening to private participation telecommunications services, sales of insurance policies, real estate brokerage activities, and port administration. These proposals met stiff opposition, and simultaneously, the public telephone company and the state petroleum company undertook ambitious investment schemes. In the area of financial reform, capital requirements were raised, oversight guidelines were improved, and measures were taken to improve the efficiency and transparency of the operations of public banks.

Finally, **Venezuela** would require a chapter unto itself. Reforms there continue in some areas and have become bogged down or suffered setbacks in others. Progress was evident in the enactment of laws that provide for equal treatment of foreign and national investment. Other laws establish legal frameworks for activities in such areas as electric power, gas, telecommunications, and mining, all sectors in which foreign investment is being actively sought. The government has sought to increase the role of the private sector in a number of these areas. Rather than privatize industry, however, it has sought to award franchises, or form strategic partnerships and joint ventures. The main area of reform that has stagnated is social security; a reform package had been approved under 1998 legislation, but the issue is once again a matter of debate. The setbacks seem to be associated with a series of *ad hoc* measures to provide incentives in many different sectors and the announcement of rules that grant the Executive discretionary powers to expropriate farmland and to intervene in a broad array of private activity. This has fed the perception that property rights have been weakened. Legislation in the hydrocarbon sector, however, has been a source of as much forward movement as setbacks, at least in terms of the conditions on and for private sector participation. Income taxes were reduced, but royalty fees were raised in order to encourage investment in downstream activities. Nevertheless, in late 2001 additional charges and restrictions on foreign capital were announced. In the area of financial policy, setbacks have been associated with the imposition of a minimum share of loans that banks are required to make to small businesses and the announcement of similar measures that would provide support for other sectors.

## **Appendix 2. Estimates of the Effect of Reforms on Growth, Productivity and Investment**

The main, if not only, objective of structural reforms was to boost economic efficiency and growth by encouraging a more fluid functioning of the market. Dissatisfaction with the results of the reforms is based on the low growth levels that remain evident in the majority of the countries of the region—more than a decade of reforms notwithstanding. To examine the validity of this assertion, this appendix presents the results of a series of regressions performed with an eye toward tracking the influence of structural reforms on growth, productivity, and investment. The main conclusion is that reforms do appear to have had a significant effect on growth, but one that is temporary: in 1991-1993, the most active period for reforms, they raised average annual growth in the region by 1.3 percent; later, in 1997-1999, this effect dropped to 0.6 percent. The results reflect an understanding that each country's growth depends not only on reforms, but also on macroeconomic stability, changes in the terms of trade, capital flows, and other global factors that may impact all of the countries. According to the estimates presented here, the (temporary) improvements in the countries' growth rates attributable to the reforms were essentially produced by growth in productivity and not higher rates of investment. The estimates do not allow for a precise breakdown of effects by area of reform; however, they do suggest that the two most effective areas of endeavor are the removal of trade restraints and financial reform. The estimates also demonstrate an important point: the effectiveness of reforms was greatest in the countries with the best public institutions. In fact, the quality of the institutions would seem to have been a decisive factor in the impact of financial reform in the countries.

### **Definition of Variables**

The regressions were run using as dependent variables the rates of economic growth, the increase in total factor productivity, and the investment rates. The first and last of these variables are found in the national accounts listings on the World Bank databases. We estimated overall factor productivity using the traditional Cobb-Douglas residuals method of production functions. (For further details, see IDB, 2001, Appendix 1.1). We ran regressions with these three dependent variables, both in levels and in changes. (For example, Table 1 shows estimates for economic growth and Table 2 shows changes in economic growth.)

To measure the level of reforms, we used the indices presented in the first section of this document. (See Lora, 2001, for details.) The indices for overall reforms and for areas of reform are the explanatory variables of greatest interest for this study. Accordingly, they are used in several ways in the regressions: in levels, in changes, and multiplied by our quality indicator for institutions, a measure of the “rule of law” found in Kaufmann, Kraay, and Zoido-Lobaton (1999), which synthesizes an array of indicators for public and expert opinion on the transparency, stability, and effective enforcement of laws in each country. Given that this indicator is only available for the year 1998, the same value is used throughout for each country. (That said, we believe the differences in institutional quality between one country and another are of far greater significance than the changes over time in each country.) Because economic growth, productivity, and investment may be dependent on other factors, we have included the following as explanatory variables in all of the regressions:

- Inflation tax, defined as the loss of real value of the money supply. This variable, which reflects the quality and stability of the macroeconomic environment, appears to have a decisive impact on growth, as shown in our estimates.
- Terms of trade: the coefficient of the price index for the exports and imports of each country, as calculated by the World Bank. Although it does not appear to be significant, we have left it in our estimates because of the a priori assumption that it may affect growth.
- Capital flows: a country’s net capital receipts as a proportion of GDP (calculated with information from the IMF as the sum of the current account deficit plus the accumulation of international reserves divided by GDP in current dollars). This variable is significant only occasionally, but we believe its inclusion is necessary because reforms may be correlated with capital flows. (Consequently, if left out, the effect of reforms might be overestimated.)
- All of the regressions also use dummy variables for the time periods (defined below) in order to control for factors that may be common to the countries but not captured by other variables.
- In additional regressions not presented here we have examined how well the results hold up when combined with other independent variables (e.g., fiscal deficit, real exchange rate, composition of capital flows according to whether they are foreign direct investment, inter alia). None of the additional variables we considered turned out to be

significant or to have a reasonable influence on the results (with the sole exception of the breakdown of capital flows as an explanatory variable of the investment rate, which is included in Table 5).

### *Method of Estimation*

The variables are organized in three-year periods, as follows: 1985-87, 1988-90, 1991-93, 1994-96, 1997-99. By using triennial instead of annual periods we reduce the problems from autocorrelation associated with countries' cycles and attenuate the need to introduce adjustments between the time when reforms are adopted and when their effects appear.

The regression methodology employs a fixed-effect panel, which is equivalent to estimating a single coefficient, common to all of the countries for each independent variable, disregarding differences between average levels per country, for both dependent and independent variables. The panel comprises a maximum of 19 countries, of which only 16 have information available for all three-year periods. (The countries without complete information are the Dominican Republic, Honduras, and Nicaragua.)

### **Main Results**

The estimates of GDP growth (Table 1) show that *changes* in the level of reforms exert a greater influence than the level itself. This holds true for reforms taken as a set or for trade policy reform, where the effects encountered have the greatest statistical significance. The results indicate that reforms have only a temporary impact on growth. However, the level of reforms does have a significant impact when it interacts with the rule of law. The rule of law also has a significant temporary effect on the (changes in) commercial and financial reforms.

The estimates for the changes in growth (Table 2) tend to confirm the results mentioned above. Growth is stepped up when reforms take place, especially in the cases of trade and financial policy reforms. The latter case again confirms the important impact of the rule of law on the (temporary) effectiveness of reforms.

Estimates of growth in productivity and changes in this growth (Tables 3 and 4) are consistent with the two sets of regressions mentioned above. Generally, they show the highest levels of significance with the variables for overall reform, trade policy, and financial policy

reforms. Comparisons of the coefficients show that productivity accounts for practically all of the effects that the reforms could have had on growth.

The above is confirmed by the estimates for the investment coefficient and its changes (Tables 5 and 6). The estimates with constant variables suggest that the reforms may *temporarily diminish* the investment coefficients (or even do so permanently as in the case of trade policy reform). Nevertheless, this result is not confirmed when changes in the investment coefficients are analyzed. In this case, the results suggest that the investment rate may temporarily increase at the time of reform in countries with a greater rule of law. These inconsistencies in the results indicate that no single unambiguous conclusion can be drawn here about the effect of reforms on investment.

### **Some Simulations and Implications**

On the basis of the above analysis we have quantified the total impact of reforms on growth, using coefficients for regression 3 in Table 4 (which are quite similar to the coefficients for regression 3 in Table 2, albeit with a higher level of significance). The reforms increase the rate of growth by 0.8 percent annually in the triennial (relative to its initial level in 1985-87); 1.3 percent in 1991-93; 1 percent in 1994-96; and 0.6 percent in 1997-99. These changes represent a cumulative increase in the average income of the region of 11.4 percent over the entire period. Table 7 presents the results by country. The greatest gains were found in Argentina, Costa Rica, Bolivia, Brazil, Chile, the Dominican Republic, Peru, and Trinidad and Tobago (between 13 percent and 27 percent of the increase in income). Because of weak rule of law, some countries experienced only small gains in spite of the reforms they undertook. The most extreme example is Guatemala, where the estimates do not indicate any gains at all.

Although these estimates are suggestive, they have a large margin of error, particularly with regard to the rule of law since its coefficient is not statistically significant. Even so, the results for trade and financial reforms are much more reliable when considered separately, judging by the level of significance of their coefficients. Table 7 indicates that the main beneficiaries of trade reform were Brazil, Costa Rica, Argentina, Uruguay, and Peru, with cumulative increases in income levels ranging from 17 percent to 27 percent. In the case of financial reform, the results suggest that the principal winners were Argentina, Costa Rica, and Chile, all three of which had experienced income increases of at least 12 percent. However, due to



their institutional weaknesses, nine countries appear to have lost out as a result of financial liberalization. It should be cautioned, however, that the results from different reforms cannot simply be added together in order to arrive at a total measure, because they result from different regressions.

<b>Table 1</b>								
<b>Dependent Variable: GDP Growth</b>								
	<b>Total Structural Reform Index +</b>			<b>Trade Reform +</b>	<b>Financial Reform +</b>	<b>Tax Reform +</b>	<b>Privatization +</b>	<b>Labor Reform +</b>
	<b>1</b>	<b>2</b>	<b>3</b>	<b>4</b>	<b>5</b>	<b>6</b>	<b>7</b>	<b>8</b>
Constant	0.01 (0.209)	0.02 (0.275)	-0.03 (-0.476)	0.04 (0.718)	0.02 (0.79)	0.06 (1.746)*	0.05 (3.219)***	0.21 (1.354)
Inflation tax	-0.09 (-3.812)***	-0.09 (-3.722)***	-0.07 (-2.914)***	-0.09 (-3.299)***	-0.09 (-4.717)***	-0.09 (-4.518)***	-0.08 (-3.900)***	-0.09 (-4.130)***
Terms of trade	-0.05 (-0.265)	0.07 (0.355)	0 (-0.004)	0.01 (0.054)	0.05 (0.577)	0.13 (0.781)	0.04 (0.412)	0.05 (0.532)
Capital flows		-0.25 (-0.931)	-0.31 (-1.202)	-0.32 (-1.265)	-0.29 (-1.321)	-0.34 (-1.415)	-0.42 (-1.62)	-0.44 (-1.719)*
Change in capital flows		0.26 (1.695)*	0.28 (1.905)*	0.24 (1.68)	0.27 (2.340)**	0.27 (1.859)*	0.3 (2.321)**	0.35 (2.467)**
Reform index <sup>+</sup>	0.03 (0.249)	0.03 (0.305)	0.17 (1.297)	0.04 (0.462)	0.05 (1.222)	0.03 (0.353)	0.05 (0.999)	-0.38 (-1.059)
Change in reform index (R.I.) <sup>+</sup>	0.19 (2.016)*	0.15 (1.561)	0.16 (1.517)	0.17 (3.589)***	0.04 (1.293)	-0.04 (-0.544)	0 (0.003)	0.24 (0.833)
R.I. * Rule of law <sup>+</sup>			0.19 (1.887)*	0.11 (1.198)	0.04 (0.994)	0.16 (1.543)	0.1 (1.065)	-0.45 (-0.779)
Change in R.I. * Rule of law <sup>+</sup>			0.14 (1.004)	0.16 (2.525)**	0.09 (2.054)**	-0.16 (-1.757)*	-0.07 (-0.589)	0.41 (0.919)
Observations	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.479	0.519	0.581	0.628	0.621	0.552	0.538	0.536

**Table 2**  
**Dependent Variable: Change in GDP Growth**

	Total Structural Reform Index +			Trade Reform +	Financial Reform +	Tax Reform +	Privatization +	Labor Reform +
	1	2	3	4	5	6	7	8
Constant	-0.03 (-3.165)***	-0.03 (-3.040)***	-0.03 (-2.986)***	-0.02 (-2.632)**	-0.02 (-2.936)***	-0.02 (-2.633)**	-0.02 (-2.530)**	-0.02 (-2.775)***
Change in inflation tax	-0.16 (-6.040)***	-0.16 (-5.936)***	-0.16 (-5.729)***	-0.16 (-5.955)***	-0.16 (-6.754)***	-0.19 (-7.227)***	-0.17 (-6.736)***	-0.18 (-6.204)***
Change in terms of trade	-0.03 (-0.267)	-0.05 (-0.314)	-0.06 (-0.376)	-0.04 (-0.268)	0.03 (0.355)	0.04 (0.273)	0.02 (0.175)	0.02 (0.175)
Change in capital flows		-0.02 (-0.171)	-0.01 (-0.04)	-0.06 (-0.435)	0.06 (0.514)	-0.04 (-0.322)	0.04 (0.3)	0.04 (0.336)
Change in reform index (R.I.) <sup>+</sup>	0.18 (1.591)	0.18 (1.581)	0.24 (1.862)*	0.17 (2.386)**	0.07 (1.893)*	-0.1 (-1.151)	0.03 (0.459)	-0.28 (-0.769)
Change in R.I. * Rule of law <sup>+</sup>			0.2 (1.022)	0.13 (1.369)	0.12 (2.133)**	-0.13 (-0.944)	0.03 (0.31)	-0.48 (-0.913)
Observations	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.605	0.605	0.615	0.632	0.623	0.605	0.58	0.586

<sup>+</sup> Refers to the reform index corresponding to the heading of each regression.

Notes: (1) All estimates include fixed effects for countries and dummy variables for each triennial period.

(2) The *t* value is given in parentheses.

(3) \*\*\* Significant to 1%, \*\* significant to 5%, \* significant to 10%.

**Table 3**  
**Dependent Variable: Productivity Growth**

	Total Structural Reform Index +			Trade Reform +	Financial Reform +	Tax Reform +	Privatization +	Labor Reform +
	1	2	3	4	5	6	7	8
Constant	-0.04 (-0.746)	-0.04 (-0.67)	-0.08 (-1.315)	-0.04 (-0.904)	-0.03 (-1.541)	0 (-0.003)	0 (0.12)	0.2 (1.4)
Inflation tax	-0.08 (-3.839)***	-0.08 (-3.721)***	-0.07 (-3.142)***	-0.07 (-2.807)***	-0.09 (-5.293)***	-0.09 (-4.905)***	-0.08 (-4.256)***	-0.09 (-4.315)***
Terms of trade	-0.05 (-0.304)	0.01 (0.04)	-0.05 (-0.284)	-0.1 (-0.606)	0.01 (0.162)	0.11 (0.713)	0.05 (0.49)	0.02 (0.26)
Capital flows		-0.21 (-0.84)	-0.28 (-1.191)	-0.34 (-1.45)	-0.18 (-0.951)	-0.23 (-1.032)	-0.19 (-0.77)	-0.31 (-1.327)
Change in capital flows		0.17 (1.172)	0.2 (1.541)	0.19 (1.429)	0.16 (1.661)	0.15 (1.143)	0.18 (1.522)	0.23 (1.733)*
Reform index <sup>+</sup>	0.06 (0.596)	0.07 (0.643)	0.18 (1.558)	0.1 (1.396)	0.06 (1.809)*	0.05 (0.763)	0 (0.067)	-0.54 (-1.635)
Change in reform index <sup>+</sup>	0.13 (1.444)	0.1 (1.063)	0.13 (1.355)	0.14 (3.140)***	0.04 (1.494)	-0.07 (-1.085)	0.05 (0.81)	0.29 (1.095)
Reform index * Rule of law <sup>+</sup>			0.18 (1.904)*	0.17 (2.055)**	0.02 (0.612)	0.15 (1.577)	0.02 (0.24)	-0.82 (-1.548)
Change in reform index * Rule of law <sup>+</sup>			0.24 (1.904)*	0.16 (2.753)***	0.13 (3.269)***	-0.16 (-1.828)*	0.06 (0.504)	0.51 (1.229)
Observations	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.48	0.497	0.595	0.627	0.663	0.552	0.51	0.528

<sup>+</sup> Refers to the reform index corresponding to the heading of each regression.

Notes: (1) All estimates include fixed effects for countries and dummy variables for each triennial period.

(2) The *t* value is given in parentheses.

(3) \*\*\* Significant to 1%, \*\* significant to 5%, \* significant to 10%.

**Table 4**  
**Dependent Variable: Change in Productivity Growth**

	Total Structural Reform Index +			Trade Reform +	Financial Reform +	Tax Reform +	Privatization +	Labor Reform +
	1	2	3	4	5	6	7	8
Constant	-0.02 (-3.073)***	-0.02 (-2.860)***	-0.02 (-2.814)***	-0.02 (-2.355)**	-0.02 (-2.783)***	-0.02 (-2.455)**	-0.02 (-2.422)**	-0.02 (-2.593)**
Change in inflation tax	-0.15 (-5.917)***	-0.15 (-5.934)***	-0.14 (-5.730)***	-0.14 (-6.019)***	-0.15 (-6.603)***	-0.17 (-7.241)***	-0.15 (-6.541)***	-0.17 (-6.143)***
Change in the terms of trade	0.02 (0.192)	-0.03 (-0.214)	-0.04 (-0.294)	-0.03 (-0.216)	-0.01 (-0.064)	0.06 (0.515)	-0.02 (-0.246)	-0.02 (-0.248)
Change in capital flows		-0.09 (-0.746)	-0.07 (-0.581)	-0.13 (-1.077)	0 (0.005)	-0.1 (-0.772)	-0.02 (-0.181)	-0.02 (-0.164)
Change in the reform index <sup>+</sup>	0.18 (1.678)	0.19 (1.710)*	0.25 (2.105)**	0.18 (2.794)***	0.07 (2.083)**	-0.1 (-1.254)	0.05 (0.799)	-0.32 (-0.945)
Change in reform index * Rule of law <sup>+</sup>			0.24 (1.298)	0.16 (1.930)*	0.13 (2.352)**	-0.13 (-1.068)	0.06 (0.575)	-0.55 (-1.111)
Observations	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.61	0.615	0.63	0.653	0.618	0.611	0.569	0.575

<sup>+</sup> Refers to the reform index corresponding to the heading of each regression.

Notes: (1) All estimates include fixed effects for countries and dummy variables for each triennial period.

(2) The *t* value is given in parentheses.

(3) \*\*\* Significant to 1%, \*\* significant to 5%, \* significant to 10%.

**Table 5**  
**Dependent Variable: Investment Rate**

	Total Structural Reform Index +				Trade Reform +	Financial Reform +	Tax Reform +	Privatization +	Labor Reform +
	1	2	3	4	5	6	7	8	9
Constant	0.2 (3.497)***	0.21 (4.504)***	0.2 (3.697)***	0.17 (2.864)***	0.31 (6.491)***	0.22 (7.967)***	0.24 (7.052)***	0.2 (14.545)***	0.02 (0.144)
Inflation tax	0 (0.057)	-0.01 (-0.614)	0.01 (0.285)	0.01 (0.614)	-0.03 (-1.155)	0.03 (1.423)	0.01 (0.654)	0.03 (1.429)	0.02 (1.121)
Terms of trade	0.13 (0.763)	0.15 (0.898)	0.32 (1.826)*	0.28 (1.564)	0.25 (1.484)	0.1 (1.027)	0.11 (0.607)	0.05 (0.532)	0.09 (0.918)
Capital flows			-0.05 (-0.219)	-0.08 (-0.352)	0.14 (0.578)	-0.12 (-0.515)	0.04 (0.166)	-0.04 (-0.181)	-0.06 (-0.218)
Change in capital flows			0.24 (1.863)*	0.25 (1.931)*	0.13 (0.97)	0.24 (1.900)*	0.15 (0.996)	0.2 (1.698)*	0.24 (1.680)*
Reform index <sup>+</sup>	0.03 (0.345)	-0.06 (-0.638)	0.03 (0.356)	0.1 (0.884)	-0.13 (-1.840)*	0 (0.048)	-0.1 (-1.269)	0.14 (2.931)***	0.49 (1.363)
Change in reform index <sup>+</sup>	-0.13 (-1.483)	-0.12 (-1.452)	-0.16 (-1.820)*	-0.15 (-1.674)	0.02 (0.546)	-0.06 (-1.636)	0 (0.038)	-0.11 (-1.927)*	-0.11 (-0.385)
Reform index * Rule of law <sup>+</sup>				0.1 (1.087)	-0.04 (-0.504)	0.02 (0.608)	-0.11 (-1.00)	0.07 (0.736)	0.61 (1.056)
Change in reform index * Rule of law <sup>+</sup>				0.07 (0.583)	0.03 (0.604)	-0.01 (-0.232)	-0.03 (-0.288)	-0.01 (-0.091)	0.05 (0.118)
Direct Foreign Investment (as % GDP)		0.94 (2.219)**							
Change in DFI		-0.34 (-0.822)							
Change in capital flows (excluding DFI)		0.05 (0.222)							
Change in other capital flows excl. DFI		0.07 (0.522)							
Observations	68	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.179	0.489	0.315	0.348	0.377	0.319	0.232	0.393	0.287

<sup>+</sup> Refers to the reform index corresponding to the heading of each regression.

Notes: (1) All estimates include fixed effects for countries and dummy variables for each triennial period.

(2) The *t* value is given in parentheses.

(3) \*\*\* Significant to 1%, \*\* significant to 5%, \* significant to 10%.

**Table 6**  
**Dependent Variable: Change in the Investment Rate**

	Total Structural Reform Index +			Trade Reform +	Financial Reform +	Tax Reform +	Privatization +	Labor Reform +
	1	2	3	4	5	6	7	8
Constant	0 (0.435)	0 (-0.148)	0 (-0.051)	0 (-0.265)	0 (0.311)	0 (-0.424)	-0.01 (-0.706)	0 (-0.286)
Change in inflation tax	0.01 (0.188)	0.02 (0.675)	0.02 (0.982)	0.02 (0.866)	0.03 (1.488)	0.03 (1.058)	0.04 (1.726)*	0.07 (2.623)**
Change in terms of trade	-0.2 (-1.529)	0.03 (0.198)	0.01 (0.083)	0.01 (0.078)	0.12 (1.497)	0.03 (0.238)	0.08 (0.913)	0.12 (1.457)
Change in capital flows		0.41 (3.261)***	0.44 (3.604)***	0.4 (3.137)***	0.52 (4.484)***	0.46 (3.478)***	0.53 (4.182)***	0.52 (4.396)***
Change in reform index <sup>+</sup>	-0.02 (-0.135)	-0.04 (-0.338)	0.06 (0.511)	0.02 (0.308)	-0.02 (-0.664)	-0.02 (-0.257)	0.08 (1.32)	0.75 (2.204)**
Change in reform index * Rule of law <sup>+</sup>			0.36 (2.014)*	0.04 (0.458)	0.13 (2.392)**	-0.05 (-0.412)	0.1 (0.943)	0.83 (1.708)*
Observations	68	68	68	69	75	73	75	75
R <sup>2</sup> Observations	0.057	0.244	0.311	0.246	0.447	0.286	0.363	0.407

<sup>+</sup> Refers to the reform index corresponding to the heading of each regression.

Notes: (1) All estimates include fixed effects for countries and dummy variables for each triennial period.

(2) The *t* value is given in parentheses.

(3) \*\*\* Significant to 1%, \*\* significant to 5%, \* significant to 10%.

**Table 7.**  
**Estimates of the Cumulative Effects of Reforms on Productivity**  
**(and Income) 1985-99**

	Reform Index		
	Total	Trade	Financial
Argentina	27.3%	19.7%	24.6%
Costa Rica	20.5%	21.2%	20.8%
Bolivia	17.8%	3.8%	4.8%
Brazil	17.4%	27.8%	3.2%
Chile	13.4%	11.3%	11.9%
Dominican Republic	13.3%	5.5%	9.3%
Peru	12.8%	17.1%	0.3%
Trinidad and Tobago	12.5%	-4.8%	6.8%
Uruguay	10.5%	19.3%	8.6%
Mexico	7.9%	3.7%	1.3%
Venezuela	6.6%	9.3%	-1.3%
El Salvador	5.3%	4.2%	-1.6%
Paraguay	5.3%	3.4%	-3.5%
Ecuador	5.0%	11.5%	-2.3%
Jamaica	4.5%	3.6%	-3.6%
Colombia	3.8%	7.6%	-3.6%
Guatemala	-0.9%	0.4%	-5.6%