

ECONOMIC REFORM AND PROGRESS IN LATIN AMERICA AND THE CARIBBEAN¹

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Abstract

In the late 1980s, after decades of poor economic management, many Latin American and Caribbean countries are experiencing a process of structural reform that places them on a path to a superior economic performance. The purpose of this paper is to examine the experience of structural reform in five areas of economic activity, namely, international trade, financial markets, labor markets, generation and use of public resources, and governance. The methodological approach used in the study consists of developing quantitative indicators for the corresponding policy reforms and/or their respective outcomes. The result is an empirical characterization of the structural reform experience in the region. The study concludes that the area where most progress has been achieved is international trade liberalization and the area of least progress is labor market regulations. In all areas, although much has been accomplished in the last few years, comparison with Asian NICs and OECD countries reveals that substantial room for improvement remains.

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EXECUTIVE SUMMARY

After years of poor economic management, many Latin American and Caribbean countries are experiencing a process of structural reform that places them on a path to a superior economic performance.¹ Two basic principles identify this process of economic reform: fiscal and monetary discipline and reliance on market forces to determine the allocation and distribution of resources.

The purpose of this paper is to examine the experience of structural reform in five areas of economic activity: international trade, financial markets, generation and use of public resources, governance, and labor markets. The methodological approach used in this study has consisted of developing quantitative indicators for the corresponding policy reforms and/or their respective outcomes. The result is an empirical characterization of the region's structural reform.

Although the processes of structural reform throughout the region have shared the same principles, they have differed in their time of initiation and in the breadth and depth of their specific reforms. Regarding the time of initiation, Chile was the pioneer of market-oriented reforms in the mid-1970s. In the mid-1980s and after a macroeconomic crisis topped by hyperinflation, Bolivia took important steps in ensuring fiscal and monetary stability, and soon after it liberalized its financial system and trade regime. This pattern of crisis followed by economic reform was repeated in Mexico in the late 1980s, in Argentina, Peru, and Nicaragua in the early 1990s, and, more recently, in Brazil, El Salvador, and Venezuela.² Colombia and Costa Rica stand out as cases where structural reforms were not implemented in a crisis environment. The process of structural reform has also been heterogeneous in other related aspects. While the region as whole has advanced in certain reform areas more than in others, the sequencing, depth and contents of the reforms have differed from country to country.

(1) **Trade liberalization**, or the reduction in the average level and dispersion of tariff and para-tariff charges as well as the sharp reduction of non-tariff barriers, is where reforms have been the deepest and most generalized in the region. In fact, in terms of reducing policy restrictions to trade the region has come quite close to the Asian NICs. These policy changes have brought about a marked increase in the trade intensity of the reforming economies.³ For the early reformers, among them Bolivia, Chile, Costa Rica, and Mexico, the expansion of international trade as a share of GDP, occurred mostly in the 1986-89 period. In the 1990s, the Mercosur countries of Argentina, Brazil, Paraguay, and Uruguay, experienced very high growth rates of the volume of trade. Whereas Colombia, Mexico, and Peru saw their respective trade shares increase rapidly (surely as result of the liberalization process) in the oil-exporting economies of Ecuador and Venezuela the improvement was not as large, despite a liberalization program similar to those of the former countries (especially Colombia). In spite of the substantial increase in the trade to GDP ratio in Latin America and the Caribbean (LAC) countries, the region as a whole and even

¹ See Edwards (1995).

² Bruno and Easterly (1996) and Tommasi and Velasco (1995) argue convincingly that in Latin American countries, as well as in many others, severe crises have had the potential of preparing the ground for structural reforms.

³ "Trade intensity" is defined as the quotient of (real) exports plus (real) imports, over (real) GDP.

its most open countries are far below the Asian NICs in terms of trade intensity (even after adjusting for most non-policy, structural factors that affect trade). This fact partly reveals that the effects of trade policy liberalization on trade intensity take time to take hold.

(2) Another area where there has been important progress in several countries in the region is *financial development*. In terms of policy changes, the pattern followed in most cases has been one of, first, radical liberalization and, second, implementation of prudential norms which moderated the initial liberalization. The policy changes related to the financial system (removal of interest rate controls, elimination of directed credit to “priority” sectors, privatization of public banks, liberalization of the foreign investment regime and, more recently, improvements in the regulatory framework) have induced growth and improvements in both the banking system and the stock market.

In the banking system, financial reform has led to greater depth in banking intermediation of medium- and long-run instruments and to more active participation of the private sector in both allocating and receiving credit. Revealing the importance of the banking industry in their economies, Panama and the English-speaking Caribbean countries of the Bahamas and Barbados have been the leaders in banking development in the region. Chile, despite a moderate setback in the second-half of the 1980s, remained the leader of banking development in South America. At the other end of the scale, Venezuela and Guyana, both of which by the mid-1980s had been among the most advanced in the region, have since then suffered a remarkable deterioration in this area. Thanks to the financial reforms it introduced in 1985 and deepened in 1991, Bolivia has been able to achieve rapid and sustained progress in banking development since the mid-1980s. Other countries in the region, particularly Argentina, Bolivia, Brazil, Colombia, Ecuador, Peru and Paraguay, also benefited from financial reform and from macroeconomic stability, and experienced gradual progress in banking development in the 1990s.

In stock markets, the result of financial reform has been an increase in stock market capitalization relative to GDP, an even stronger increase in value traded in the stock exchange, and a decline in market concentration. In other words, larger, more active and liquid stock markets have been the product of financial reforms. In this regard, Chile has shown steady progress since 1985. In the 1990s, Brazil, Mexico, and Peru have also achieved remarkable progress, whereas during the same period Venezuela’s performance declined, no doubt due to its macroeconomic crisis.

Comparisons with the Asian NICs and with OECD countries shows that, despite the improvement in financial performance in the last few years, LAC still lags far behind those high performing economies in all indicators of banking and stock market development.

(3) The third area of reform concerns the *proper use of public resources and the efficient generation of public revenue*.

In LAC countries there have traditionally been two main deficiencies in the use of public resources. The first is that a large portion of government resources has been spent on a bloated and ineffective bureaucracy; and the second is the pervasiveness of public enterprises, most of which incurred major losses and delivered services poorly. On the revenue side, tax systems have

depended excessively on trade and on inefficient taxes for revenue, and tax enforcement has been weak. Recent reforms have been attempting to remedy these deficiencies.

(i) **Public administration and expenditures.** A few countries in the region, namely, the Dominican Republic, El Salvador, Peru, and Uruguay have shown a clear tendency in the last ten years to commit fewer resources to pay for the services of the bureaucracy. By the early 1980s, Chile had already cut to less than 20 percent the share of public primary expenditures used to finance wages and salaries of public employees. Clearly, the salary-to-expenditure ratio in the public administration depends not only on whether the bureaucracy is bloated but also on structural characteristics such as whether the government is required to specialize in providing labor-intensive services. Nevertheless, it is interesting to note that the Chilean public administration, which enjoys a strong reputation for efficiency in the region (as described in the section on governance), has been absorbing a share of primary expenditures that is among the lowest in Latin America in the last ten years. Also worth noting is the marked difference in this respect among the different levels of government (federal, state and local) in Argentina and Brazil, the two most decentralized countries in the region. In both countries, the ratio of salaries to primary expenditures is significantly higher at the state (or provincial) level than at the federal level. LAC countries on average are dedicating a lower share of their primary expenditures to public administration salaries than they were in previous years. However, at the regional level, the percentage of primary expenditures devoted to paying public administration salaries is closer to that of Malaysia (36 percent) than to that of Korea, whose lean bureaucracy absorbs just 12 percent of primary expenditures. This is an area that clearly deserves more research and action.

(ii) **Public enterprises and privatization.** The reform response to the poor performance of public enterprises has been a process of privatization, which, it was hoped, would be followed by strong private investment, particularly in the areas of public utilities and infrastructure. Most countries in the region have participated in the process of privatization. The most significant cases have been Argentina, Belize, Bolivia, Chile, Jamaica, Mexico, Nicaragua, Peru, Trinidad and Tobago, and Venezuela. For most of the countries that conducted a major privatization program, the share of private investment in total investment rose significantly, approaching 80 percent in Chile, Argentina, Mexico and Peru. In this regard, Bolivia's experience is a rather disappointing one, for despite a strong privatization effort, its private investment share actually dropped from its level in 1985 and then remained about half as large as that of other countries with a similar privatization effort. In the Latin America and Caribbean region, private sector participation in investment still trails the level of the Asian NICs. Although the difference in this respect between the two groups of countries (five percentage points on average in the 1990s) does not seem to be large, it becomes indeed important when it is considered that the productivity of public investment is much larger in the NICs than in Latin America.

(iii) **Public revenues.** The basic principles of tax reform have been, first, tax rate unification and lower marginal rates; second, de-emphasis of steeply progressive rate structures of income and property taxes in favor of broadly based, low-rate taxes on domestic consumption, such as the value added tax (VAT); and, third, strengthening of the tax administration. The centerpiece of tax reform in the region has been the implementation of a value added tax system; its achievements as a revenue generator have allowed the easing of the tax burden on the formal sector and the reduction of trade taxes, at the same time as it has helped the ratio of tax revenue

to GDP approach a healthy 15-20 percent range. In order to evaluate the efficiency of the VAT system, the paper examines the VAT revenue productivity ratio.⁴ This ratio contains information on both the coverage of the VAT and the efficacy of the tax administration to prevent evasion. Especially since 1990, this productivity rate has improved in most countries in the region, and particularly in Argentina, Bolivia, Costa Rica, Paraguay, and Peru. For most countries, however, there is still much room for further progress. Only a few countries -- Brazil, Chile, Bolivia, Paraguay, El Salvador, and Guatemala -- have achieved moderate VAT productivity rates between 40 percent and 50 percent in contrast to the rates for OECD countries, which are normally between 50 percent and 70 percent.⁵

(4) The fourth area of structural reform deals with *governance and public institutional reform*. In this area progress has been more modest and less widespread than in the previous three reform areas previously mentioned. The approach taken in this paper to assess progress in governance has been to rely on subjective indicators provided by two independent international country risk evaluators. They are International Country Risk Guide (ICRG) and Business Environment Risk Intelligence (BERI). These sources provide information related to two aspects of good governance. The first is the quality of public institutions (evaluated by the variables “corruption in government” and “quality of the bureaucracy”), which describes the ability of the state to implement its policies through an appropriate structure of government and through honest and technically competent bureaucrats. The second is the quality of public services (evaluated by the variables “rule of law”, “enforceability of contracts”, and “expropriation risk”), which determine an environment where contractual obligations are respected by both the state and private agents, where legal disputes are effectively resolved in the judicial system, and where legal rules for investment, employment, and taxation are not arbitrarily modified by the state.

The assessment of progress in these aspects of governance differs somewhat among risk evaluators. Whereas BERI draws a picture of limited progress except for a handful of countries -- Argentina, Chile, Ecuador and Peru --, ICRG provides an optimistic appraisal of progress throughout the region. Although both suggest that there has been general improvement, a closer examination of the underlying indicators of the ICRG governance index reveals that by 1995 Latin America’s standards of governance remained well below that of the Asian NICs and the OECD countries. This gap is particularly large in the area of the rule of law (judicial and police systems) and in the quality of the public administration (technical competence and honesty of the bureaucracy, as well as procedural clarity). The difference between Latin America and the Asian NICs and OECD countries is smaller regarding respect of property rights, including the risk of nationalization of enterprise equity.

(5) The area where the least progress has been made is *labor market reform*. Except for Chile and the English-speaking Caribbean countries, most countries in the region had rather rigid and distorted labor markets in the 1980s and early 1990s; excluding a few notable cases of labor market reform, the situation in the region by 1995 remained basically the same. The main factors

⁴ The VAT revenue productivity ratio is defined as VAT revenue over GDP divided by average VAT rate.

⁵ 100 percent would imply a VAT without exceptions and full enforcement.

generating distortions in labor markets in Latin America are the following: severe constraints on the hiring and dismissal of workers, high social security contribution rates (and no clear link between individual benefits and contributions), the lack of mechanisms for non-disruptive labor dispute resolution, and the predominance of public employment in the economy. Despite the need for labor market reform in most countries in the region, only a handful of them have made some progress in this area -- Argentina, Colombia, Ecuador, Panama, and Venezuela -- and only in one country, Peru, have the policy changes covered all relevant aspects of labor market reform.

The region suffered from misguided public policies and weak public institutions for several decades. These policies and institutions induced profound distortions in the formation and allocation of physical capital and human talent, as well as a gradual erosion of overall efficiency. As a result implementing structural reforms (and, thus, altering the modes of production and the system of economic incentives) is costly and even painful. And yet, these reforms have the potential to raise substantially the living standards of most people in the region. There is indeed some evidence that the reforms initiated in most countries in the late 1980s have already borne fruit in terms of an improved growth performance.⁶ This, however, should not allow anyone forget to that economic reform is a long and arduous process, which requires both political will and social sensibility from the government to be successfully fulfilled.

⁶ See Easterly, Loayza and Montiel (1997), Fernandez-Arias and Montiel (1997), and Barrera and Lora (1997).

ECONOMIC REFORM AND PROGRESS IN LATIN AMERICA AND THE CARIBBEAN

In the late 1980s, after decades of poor economic management, many Latin American countries¹ started a process of economic reform. Although the breadth and depth of this process differed from country to country, its basic principles were similar: fiscal and monetary discipline and reliance on market forces to determine the allocation and distribution of resources. Although much has been accomplished, it has become clear, particularly in the wake of the 1994 Mexican crisis, that the reform process has a long way to go in most countries in the region.

The purpose of this paper is both to assess the state of economic reform and to provide an evaluation of economic progress in areas under reform. Economic reforms follow a complex and multifaceted process, proceeding at different speeds in several areas of public policy. Economic reforms entail policy modifications that, with time, bring about changes in the performance and structure of economic activity. Therefore, reforms can be assessed by examining their corresponding policy measures or their outcomes. In principle, both elements are relevant. In this paper, however, more emphasis is placed on outcome measures to evaluate the advance of economic reforms. There are two reasons for this approach. The first is data availability: Policy measures are difficult to isolate and quantify objectively, whereas in most cases, outcome indicators of reform are available. The second reason is that the ultimate test for the advance of economic reform lies in its impact on economic activity. Nevertheless, when information is available, policy measures are also included in the analysis.

Naturally, not all economic progress in the last few years can be interpreted as resulting from reforms; this progress can also be the result of the normal process of growth and development. This paper is not, however, concerned with isolating the portion of economic progress that is due to reform. Rather, the analysis in this paper of economic performance fulfills the dual purpose of assessing the state of reform and evaluating general economic development, under the hypothesis that in the recent experience of Latin American countries, economic development is largely a reflection of macroeconomic and structural reforms.

¹ In this document, the terms “Latin America” and “Latin America and the Caribbean” are used interchangeably.

Given that the previous paper analyzes macroeconomic stabilization throughout the region, this paper concentrates on five areas of structural reform: international trade openness, financial development, labor market flexibility, proper use of public resources and efficiency of public revenue generation, and good governance. These areas are recognized as key determinants of growth and development and have been emphasized recently in the endogenous-growth literature. According to this literature, long-run economic growth is not the result of exogenous technological progress but the outcome of purposeful investment in human capital, research and development, and public services, activities clearly influenced by government policy.

Each of the following sections analyzes the aforementioned five areas of structural reform. The paper ends with some concluding remarks.

A. International Trade Openness

There is a growing consensus in both policy and academic circles that economies that are more open to international trade have higher rates of growth, due to both higher investment and greater gains in factor productivity.² Along with faster growth rates, trade openness brings about industrial transformation and changes in the structure of employment.

The literature points out five channels through which trade affects economic growth.³ First, trade leads to higher specialization and, thus, gains in total factor productivity (TFP) by allowing countries to exploit their areas of comparative advantage. Second, it expands potential markets, which allows domestic firms to take advantage of economies of scale, thus increasing their TFP. Third, trade diffuses both technological innovations and improved managerial practices through stronger interaction with foreign firms and markets. Fourth, freer trade tends to lessen anti-competitive practices of domestic firms. Finally, trade liberalization reduces the incentives for firms to conduct rent-seeking activities that are mostly unproductive.

The empirical evidence indicates that the estimated relationship between economic growth and openness is indeed positive and significant. This is the case even after controlling for other determinants of growth, determinants that in turn may be positively affected by trade openness.

² See Balassa (1985), Edwards (1992 and 1995), Dollar (1992), and Harrison (1997).

³ See Lederman (1996).

Furthermore, this result is robust to the use of various proxies or indicators for openness. Regarding the direction of causality, the evidence points in favor of a “virtuous cycle,” by which higher openness produces growth improvements and vice versa.⁴ As to the channels through which openness affects economic growth, empirical studies show that this mechanism not only works through raising domestic investment, but also, most importantly, through efficiency gains (growth in total factor productivity).⁵ Countries with more open and less distorted foreign trade sectors exhibit faster TFP growth rates over the long run. Furthermore, TFP growth improves after trade-liberalization reforms. However, the evidence also points out that the degree of improvement is not homogeneous, as some countries (for example, Chile) benefited from trade liberalization more than others (Mexico), possibly because the extent of trade liberalization and the depth of other structural reforms were greater in the former group of countries.

In this section, two sets of indicators of openness to international trade are presented, namely, policy-instrument indicators and outcome-based indicators.

1. Policy indicators of trade liberalization

Policies that present obstacles to trade are of two broad categories: tariff (and para-tariff charges) and quantitative restrictions. Both should be evaluated together, given that one type of restriction has often substituted for the other. The higher the average level and dispersion of tariffs and para-tariffs (for example, duties and customs fees), the more distorted the trade outcome. As recommended by the literature,⁶ the measure used to evaluate the level of tariffs and para-tariffs is the *weighted average rate of tariff and para-tariff charges, using as weights their respective shares in*

⁴ See Harrison (1996) and Easterly, Loayza, and Montiel (1996).

⁵ See Edwards (1995).

⁶ See Pritchett and Sethi (1993).

⁷ Actually, the weights are given by the respective shares in total imports of some 120 developing countries in 1985 (see UNCTAD (1994)). Using the country's *own* import shares as weights leads to an underestimation of the tariff (or quantitative restriction) because these shares are negatively affected by the restrictions.

⁸ The methodology used to construct these indices, as well as most indices in this document, is the following. The index is a weighted average of the principal components of its corresponding indicators, in which the weights are given by the share of the indicators' variance explained by each principal component. See Theil (1971) and Demetriades and Luintel (1996).

*world imports.*⁷ By the same token, the measure used to evaluate the level of non-tariff restrictions is the *weighted percent of tariff-code lines covered by various types of non-tariff barriers (licenses, quotas, prohibitions) as a percentage of all tariff code lines, using as weights the respective shares in world trade.* The dispersion of tariff and para-tariff rates is measured by their simple standard deviation. Table 1 presents data on each of these indicators for the periods 1984-87, 1988-90, and 1991-93. Unfortunately, only ten countries could be included in the table; they are the largest countries in South America and Mexico. For most of the smaller countries in the region, UNCTAD (1994), the main data source, does not report historical figures for the indicators on trade restrictions.

A summary index was computed to measure the degree of trade liberalization.⁸ This index was constructed in such a way that comparisons over time and across countries are possible. This policy-based index of trade liberalization is presented in Chart 1. It shows that Chile, the pioneer of trade liberalization in the 1970s, has also led the process in the late 1980s and early 1990s. Bolivia, Mexico, Venezuela and, to a lesser extent, Brazil, made considerable progress in trade reform in the late 1980s; all of the remaining countries conducted major trade reforms in the early 1990s. Whereas Brazil and Venezuela liberalized their tariff regime over a few years, Argentina, Colombia, and Peru conducted faster trade liberalizations. (Although not included in the index for lack of comparable data, countries such as Uruguay and Costa Rica in the late 1980s, and El Salvador, Guatemala, Nicaragua, and the members of the Caribbean Community in the early 1990s also conducted important trade liberalizations.⁹) Closer examination of the components of the index (see Table 1) reveals that the process of trade liberalization was accomplished through a balanced reduction of all trade restrictions, that is, a decrease in the level and dispersion of tariffs and para-tariffs and sharp reductions (even elimination, as in Chile and Peru) of non-tariff barriers. To appreciate the forcefulness of trade liberalization in Latin America, it is illustrative to compare the regional average of both the rate of tariff and para-tariff charges and the incidence of non-tariff measures with those of the Asian NICs. Chart 2 shows that the enormous differences in trade barriers between the two groups of countries that existed in the 1980s were considerably reduced in the early 1990s.

⁹ See Edwards (1995).

Table 2 reports simple mean tariff rates and their standard deviations for the periods 1990-93 and 1995 for a larger group of countries. This table should provide an idea (albeit imperfectly, given that para-tariffs are excluded and averages are unweighted) of how most countries in the region compare to each other in terms of trade policy. It shows that by 1995, there was considerable uniformity across countries in the region in the level and dispersion of tariff rates.

2. Outcome indicators of trade liberalization

Trade policy reform is effective to the extent that it encourages undistorted and (almost always) larger volumes of trade. The first two outcome indicators presented below are related to, respectively, changes and levels of trade intensity.¹⁰ Their usefulness as indicators is based on the proposition that trade liberalization leads to larger flows of imports and exports, relative to GDP. The third indicator, the black market premium on foreign exchange, measures the inadequacy of regulations governing foreign-exchange markets; as such, it serves as a proxy for price distortions present in both current and capital account transactions.¹¹

Using the *percentage change in the ratio of real imports plus real exports to real GDP*¹² as an outcome indicator of trade reform rests on the assumption that average changes in this ratio that occur in the medium-term (say four to five years) are mostly caused by policy changes. Under such assumption, this indicator can be used to compare improvements in trade openness over time and across countries (to the extent that initial trade openness is similar across countries¹³). Table 3 reveals that, in the case of the early reformers, among them Bolivia, Chile, Costa Rica, and Mexico, the expansion of trade as a share to GDP occurred mostly in the 1986-89 period.¹⁴ In the 1990s, the

¹⁰ The terms “trade intensity” and “volume of trade as a share to GDP” are used as synonymous with the ratio of real exports plus real imports to real GDP.

¹¹ The black market premium on foreign exchange has also been used in the literature as a proxy for overall price distortions. See Barro (1991).

¹² Real, rather than nominal, exports and imports are used in order to abstract from the effect of real exchange rate appreciations on trade measures.

¹³ Clearly, those countries that were already quite open at the start of the period would also tend to show little change in their volume of trade relative to GDP.

¹⁴ Detailed data for the period 1985-95 on this and all other indicators presented in this paper are given in the appendix.

Mercosur countries -- Argentina, Brazil, Paraguay, and Uruguay -- experienced very high growth rates in the volume of trade. While Colombia, El Salvador, Guatemala, and Peru saw their respective trade intensities increase rapidly in the early 1990s (surely as result of liberalization), the oil-exporting economies of Ecuador and Venezuela experienced less improvement, despite liberalization programs similar to those of the former countries (especially to Colombia's¹⁵).

The *structure-adjusted trade intensity (SATI)*¹⁶ consists of the ratio of real imports plus real exports to real GDP, corrected for certain structural characteristics that determine a country's trade, such as its size (both area and population) and transport costs. This indicator proxies for the level of trade explained by trade policy, and therefore allows for comparisons across countries with different structural characteristics. Chart 3 graphs the structure-adjusted trade intensity of most countries in the region for the period 1985-95. It shows Chile and Paraguay as the region's leaders in trade openness, considering both the level and rate of growth of their structure-adjusted trade intensity. Costa Rica also stands out as a country that has improved remarkably its openness standing in the region since the mid-1980s. This is true also, albeit to a lesser extent, of Mexico and Colombia. The general trend in the region is quite clear from Chart 3: Most countries have experienced, since their period of trade-regime liberalization, a noticeable increase in their trade intensity. This explains why the average (structure-adjusted) trade intensity for the region has risen significantly in the 1990s (see Chart 4). This increase has allowed Latin America to approach on average the structure-adjusted trade intensity of OECD countries. It must be noted, however, that in spite of the substantial increase in trade intensity in most Latin American countries, the region on average and even its most open countries still lag behind the Asian NICs in terms of (structure-adjusted) trade intensity, which reflects in part that the effects of trade policy liberalization on trade intensity need time to take hold.

In general, countries that implemented more liberal trade policies experienced stronger outward orientation, whether measured either by the simple share of trade in GDP or the structure-adjusted trade intensity.

¹⁵ As members of the Andean Pact, Colombia, Ecuador, and Venezuela have featured a similar trade regime since the early 1990s.

¹⁶ Chenery and Syrquin (1975 and 1989), and Pritchett (1996).

The *black market premium on foreign exchange (BMP)* measures restrictions on the availability of foreign currency, which are usually imposed in regimes with multiple exchange rates and misaligned official rates. As Table 4 shows, by 1995 most countries in the region had negligible black-market premium rates; that is, their official exchange rates equaled their market rates, except for small differentials due to transaction costs. The black-market premium on foreign exchange, persistently large in the 1980s, had dropped dramatically in the early 1990s as restrictions on foreign currency transactions were abolished; mostly, this occurred either because a regime of flexible exchange rates was adopted (as in Peru) or because a fixed exchange-rate system was made credible (as in Argentina). Even Guyana, Haiti, and Suriname, which had BMPs of well over 100 percent in the 1980s and early 1990s, had seen a sharp drop in their respective black-market premia (to less than 5 percent in the case of Guyana). Of the larger countries, only Venezuela and Paraguay had BMPs of more than 10 percent in 1995.

B. Financial Development

Ample evidence from recent empirical studies, including firm-level, industry-level and country-level studies, indicates that well-functioning financial markets promote long-run economic growth.¹⁷ The relationship between finance and economic activity goes, then, beyond the effect of financial instability on short-term macroeconomic fluctuations. Previous literature had emphasized the recessionary impact of financial crises (currency and bank runs) but had not given to financial development a positive, causal role in long-term economic activity. At present, the growing consensus is that the development of financial institutions and markets promotes more efficient investment, and thus, higher long-run growth.¹⁸

Well-functioning financial systems act positively on economic efficiency through different channels. They facilitate the trading, hedging, diversifying, and pooling of risk; they mobilize savings, and thus, allocate resources for investment. Financial systems also monitor managers and exert corporate control by allowing the market to price companies according to their expected performance;

¹⁷ See Levine (1997).

¹⁸ See McKinnon (1973); Atje and Jovanovic (1993); Demirguc-Kunt and Levine (1996); Hubbard, Kashyap, and Whited (1995); King and Levine (1993); and Roubini and Sala-i-Martin (1992).

and finally, they facilitate the exchange of goods and services, acting as intermediaries between buyers and sellers.

The conclusion that financial development promotes economic growth raises the question of whether public policy can foster growth by inducing the progress of financial institutions and markets. Several studies conclude that improvements in the financial regulatory system, namely, market liberalization accompanied by prudential norms, can indeed lead to the development of sound financial institutions. For instance, the legal system can aid the development of capital markets by advocating the rights of corporate shareholders and establishing clear bankruptcy rules;¹⁹ also, a competitive banking environment may be induced by allowing international banks to participate in the domestic market and eliminating subsidies to domestic banks, as well as by enforcing accounting rules that make transparent the financial position of all banks.

The most common pattern of financial reform in Latin America has been, first, radical liberalization, and second, implementation of prudential norms that moderated the initial liberalization. The policy changes related to the financial system (namely, the removal of interest-rate controls, elimination of mandated credit to “priority” sectors, privatization of state banks, liberalization of the foreign investment regime, and more recently, improvements in the regulatory framework) have improved both the banking system and the stock market. In the banking system, financial reform has led to greater depth in banking intermediation of medium- and long-run instruments and more active participation of the private sector in both allocating and receiving credit. In stock markets, the result of financial reform has been an increase in stock market capitalization relative to GDP, an even stronger increase in value traded in the stock exchange, and a decline in market concentration -- in other words, the creation of larger and more active and liquid stock markets.

Rather than presenting the actual changes in financial policy, this paper studies progress in financial development by analyzing several of its outcome indicators. The indicators presented below shed light on different aspects of financial markets and must be considered both separately and as a whole. Studying these indicators jointly is important because different financial institutions and markets often complement and substitute for each other; that is, the fact that the pattern of development of stock markets, banking, and other financial institutions varies across countries must be taken into

¹⁹ See La Porta, Lopez de Silanes, Shleifer, and Vishny (1996).

account. For example, it would be a mistake to consider countries with low stock-market capitalization as financially backward if, for instance, they allocate a large amount of credit to private enterprises through the banking.

Using the methodology outlined in the previous section, two indices are presented to measure the degree of a country's financial development. They were constructed in a way such that comparisons over time and across countries are possible. Each index consists of indicators that quantify different aspects of the performance of the financial system.²⁰ The first index is closely linked to the development of the banking sector. The second is related to stock markets. In order to obtain information about long-term financial development from the following financial indicators, it is important to focus on their long-run trends. Their temporary fluctuations, which may be rather large, are mostly determined by the business cycle and one-time events, such as the privatization of public enterprises.²¹

1. Banking sector development

The first element to consider in assessing the development of the banking sector is the depth of a nation's financial system relative to the size of its economy. This can be measured by *quasi-liquid liabilities of the financial system relative to GDP*, that is, $(M3-M1)/GDP$.²² Currency and highly liquid demand deposits (M1) are excluded because they are rather volatile and do not represent long-term investments in financial intermediaries. Another element to consider is the participation of private institutions in providing credit. This is important because private institutions have clearer incentives to mobilize savings toward profitable projects, exert corporate control, and facilitate risk diversification. To proxy for the participation of private institutions in the provision of credit, this paper uses *the ratio*

²⁰ Detailed data for the period 1985-95 on these and all other indicators presented in the paper are given in the appendix.

²¹ Of course, the decomposition of any economic variable into its permanent and transitory components is far from trivial. No formal decomposition technique is used in this paper.

²² The end-of-year nominal quasi-liquid liabilities is deflated by the end-of-year CPI, and nominal GDP is deflated by the yearly average CPI. This deflation is an important correction to the usual practice of taking the ratio of end-of-year liquid liabilities to nominal GDP, practice that renders an artificially high ratio for high inflation countries/periods. In this document, the same deflation procedure is used when dealing with ratios of any end-of-year stock measure (for example, a monetary or capital market aggregate) to a flow measure (for example, GDP).

of credit allocated by deposit money banks to GDP.²³ The last indicator of banking sector development considers the issue from the point of view of the recipients of credit: financial systems that allocate more credit to the private sector are more actively engaged in researching firms, monitoring managers, and facilitating risk management. To measure this indicator, *the ratio of credit allocated to the private sector to GDP* is used.

The index on banking development for the period 1985-95 is presented in Chart 5. Revealing the importance of the banking industry in their economies, Panama and the English-speaking Caribbean countries of the Bahamas and Barbados were the leaders in banking development in the region. Chile, despite a moderate setback in the second half of the 1980s, has remained the banking development leader in South America. At the other end of the scale, Venezuela and Guyana, which by the mid-1980s appeared to be among the most advanced in the region, have since then suffered a remarkable deterioration in this area. In the case of Venezuela the decline in the banking index was exacerbated by the nation's macroeconomic crisis in the 1990s. Thanks to the financial reforms introduced in Bolivia in 1985 and enlarged in 1991, this country has been able to achieve rapid and sustained progress in banking development since the mid-1980s. Also benefiting from financial reform and macroeconomic stability, most other countries --- particularly Argentina, Brazil, Colombia, Ecuador, Peru, and Paraguay -- experienced gradual progress in banking development in the 1990s. Mexico shared that trend until 1995, when its banking index fell sharply, due mainly to a decline in both credit allocated to private enterprises and credit provided by private banks relative to GDP.

2. Stock market development

This paper considers five indicators of stock market development. The first one, *the ratio of average stock-market capitalization (the value of listed shares on the country's exchange) to GDP*, measures the size of stock markets relative to the overall economy. The second indicator, *the value-traded ratio (total value of shares traded in a year divided by GDP)*, reflects liquidity on an economy-wide basis. The third indicator, *the turnover ratio (total value of shares traded in a year divided by average stock market capitalization)*, also measures liquidity but on the basis of the size of the stock

²³ This is the best proxy that is readily available. Clearly, however, it is not perfect. In some countries, notably Brazil, deposit money banks are not completely private but include state-owned commercial banks. Also, this indicator does not consider credit provided by private financial institutions other than deposit banks, credit that may be large in some countries.

market, thus reflecting the activity of the market. A high turnover ratio is usually associated with low transaction costs. The fourth indicator, *the share of market capitalization accounted for by the ten largest stocks*, measures the degree of market concentration, which may adversely affect the degree of free competition of the stock market. Finally, to measure regulatory and institutional features of these emerging stock markets, an indicator of *regulatory efficiency* is constructed from information published by the International Financial Corporation (IFC). This indicator considers whether firms listed in the stock market publish price-earnings information, the quality of accounting standards, the quality of investor protection laws, whether the country has a securities and exchange commission, and whether foreigners face restrictions on domestic investment or on dividend and capital repatriation.²⁴

These indicators complement each other. For instance, a small but active market will have low market capitalization but a high turnover ratio; this is the case, for example, of Norway, India, Brazil, and Argentina; conversely, Chile's market capitalization is well above the average of the sample reported by the IFC, whereas its turnover ratio is one of the smallest. Another instance of complementarity is between the indicators of market concentration and regulatory efficiency. For example, although Argentina, Colombia, and the Philippines present quite concentrated stock markets by international standards, they are above average in terms of the quality of regulatory efficiency.

Given that the indicators on market concentration and regulatory efficiency have a rather limited country coverage, two sub-indices on the development of stock markets are presented: The first one includes only the indicators on market capitalization and liquidity, and the second one adds to the first the market-concentration and regulatory efficiency indicator.

Chart 6 presents the first index on stock market development for the period 1985-95. In this regard, Chile showed steady improvement since 1985. Brazil, Mexico, and Peru evidenced noteworthy progress in the 1990s. By contrast, Venezuela's index declined in the same period after climbing rapidly in the late 1980s; this decline was due in part to the unraveling of the first wave of reforms in that country and the ensuing macroeconomic crisis in the 1990s. Mexico during 1987 and Argentina during 1991-92 presented temporary sharp rises in their respective indices due to their privatization programs. Peru's improvement in this regard since 1993 (and to some extent Colombia's and Brazil's)

²⁴ Details on the construction of the regulatory efficiency indicator, together with the underlying data, are presented in Appendix Table A15.

might also reflect the partially temporary effect of a privatization program. With the exception of Jamaica, Central American and Caribbean countries are less developed in this respect than the other countries in the region.

Chart 7 presents the second index on stock-market development for the period 1988-95. This second index combines the indicators included in the first index with those on market concentration and regulatory efficiency. It generally agrees with the first index that Chile, Brazil, and Mexico had an outstanding performance during this period, and that Venezuela's performance after 1992 was rather disappointing. Argentina and Colombia also showed marked improvement, mainly due to a sharp decrease in their market concentration and to enhancements in their regulatory efficiency. It is noteworthy that not only the stock market index of Mexico, but also that of Brazil, and to a lesser extent, Argentina suffered a drop in 1995 in the aftermath of the Mexican currency crisis. In this respect, Chile, Colombia, and Peru seem to have escaped the "tequila" effect.

Charts 8 and 9 compare the averages of Latin American and the Caribbean with those of OECD countries and Asian NICs for the banking and stock market indicators, respectively.²⁵ Although many countries in the region have made considerable progress in both aspects of financial development, the region in general and even the most advanced Latin American countries lag substantially behind OECD and the newly industrialized Asian countries. In 1995, the Latin American average for each banking development indicator was between one-fourth and one-fifth of the corresponding indicator for the Asian NICs. The differences are no less marked in terms of stock market size, market activity, and market liquidity.

C. Labor-Market Liberalization

The problem of high and persistent unemployment rates in many European and some Latin American countries, such as Argentina, as well as the continuous presence of informal employment in Latin America and its rising level in Eastern Europe have made labor market liberalization an important reform issue around the world. Labor market liberalization would remove the distortions, many of them induced by government regulations, that make labor too costly and risky relative to its abundance

²⁵ Regional averages must be analyzed with caution because they mask differences in trends and levels across countries in the region. However, it must be noted that in Latin America, the intra-regional dispersion of most indicators, measured by their respective annual standard deviation over the region, has been decreasing in the 1990s.

in the economy. Undistorted labor markets enjoy greater flexibility²⁶ that allows the economy to adjust efficiently to changes in aggregate demand coming from either external or internal sources. In times of negative shocks, a flexible labor market minimizes the rise of unemployment, thus promoting a timely output recovery. In times of booming economic activity, labor market flexibility guarantees that output growth is accompanied by full employment and rising real wages.

Undistorted labor markets are important not only for the short-term adjustment to shocks, but also for ensuring a “broad-based” long-run growth, the kind of growth that brings about a rise in income not only to the owners of physical capital, but also to most workers. When firms perceive that labor is too costly or risky, they will choose investment strategies that are excessively capital intensive; this is particularly problematic for developing countries, given that they are relatively abundant in labor. This excessive capital intensity in the formal economy (relative to the country’s factor endowments) implies a segmentation of firms, under which a formal, industrialized sector coexists with an informal sector, in which enterprises tend to be smaller and technology rudimentary. This segmentation also applies to the labor force, as workers in the formal sector receive a higher wage than in the informal sector, given that the capital-labor ratio (and thus, labor productivity in the formal sector) is higher.²⁷ In this condition of high perceived labor costs and the resulting segmentation of the economy, growth will tend to be concentrated in the industrialized sector, and this growth will be reflected in higher capital profits and higher wages for only some workers in the economy. If growth in the industrialized sector continued, and the distorted costs of labor employment did not rise more rapidly, eventually the market segmentation would disappear; nonetheless, before that point, economic growth would not have been broad-based.²⁸

In contrast to the focus of the other sections of this paper, the indicators of labor market liberalization involve policy instruments or institutions rather than outcome indicators, such as the employment response to aggregate demand shocks or the degree of labor-market segmentation.

²⁶ Clearly, labor-market flexibility depends also on factors other than regulations. For example, it also depends on the level of education of the labor force, whether firms have proper training mechanisms, and whether technologies across different sectors are similar.

²⁷ See Harris and Todaro (1970) and Fields (1990).

²⁸ See Loayza (1994).

Evaluating these outcome indicators involves a level of specialized analysis that is beyond the scope of this document.

The indicators of government-induced labor-market distortions to be considered are divided into four groups.²⁹ Most of these indicators are qualitative and based on comparisons across countries in the region. (See Table 5.) The first group of indicators refers to *constraints on the hiring and firing of workers*. If this process is burdensome, employing labor becomes more costly and risky, especially if economic conditions are uncertain, and the ability to match workers' characteristics with the needs of the firm is limited. These constraints on hiring and firing have several aspects; in what follows, an indicator is presented for some of the most important of them. (See Table 5.) The first aspect is whether labor legislation considers dismissals caused by economic difficulties of the firm as unjustified, thus ignoring that in an active economy, some firms and sectors shrink as others expand. The second aspect is whether at least a portion of severance payments are periodically deposited in accounts in the name of the workers, so that these funds and their associated market yields are available to workers even if they resign from the firm. The existence of these funds signals that labor legislation considers severance payments as deferred compensation rather than as penalties designed to prevent firms from shedding labor. The third aspect relates directly to the monetary compensation for dismissal that represents an actual cost to the firm, that is, the amount excluding what would have been paid even in the event of a worker's resignation; the corresponding indicator, measured as multiples of the last monthly wage, varies with the level of workers' seniority and across countries. To account for this fact, it is presented at one-year and ten-year seniority levels. High compensation for dismissal is especially distortionary for the labor market and costly to the firm if economic difficulties are treated as unjustified causes for dismissal. In this case, firms find themselves trapped in a situation in which downsizing may be the only way for them to manage their economic difficulties but is too expensive to undertake. The fourth aspect to be considered is restrictions on temporary contracts; this type of contract is needed to fulfill particular needs of the firm and when, as result of an active economy, new

²⁹ An important group of labor-market distortion indicators, not considered in this document for lack of comparable information across countries, refers to the relations between labor and the management of a firm. This would consider issues such as how decentralized and flexible] collective bargaining is and whether the government stays out of the negotiation process. It would also analyze how efficient unions are in advocating workers' rights by considering whether labor legislation allows workers, at least in principle, to choose their own union; the freedom to make this choice would generate more efficient worker representation through improved competition, or at least the contestability, of unions.

and rather uncertain ventures frequently appear. In economies in which rigid constraints on the hiring and firing of permanent workers exist, temporary contracts may provide a way, albeit imperfectly, to make labor markets more flexible. It is important that when temporary contracts become less restricted, permanent contracts be also liberalized. Otherwise, the prevalence of temporary workers will be abnormally large, creating labor segmentation within the firm that lowers the incentives for it to invest in workers' training. Moreover, to the extent that temporary workers are not represented in the firm's trade union, labor segmentation induces unions to demand pay raises that are inconsistent with job stability of temporary workers.

The second group of indicators of government-induced labor-market distortions is related to *payroll taxes*. These taxes are social security-related contributions, comprising old age, disability, death, sickness, maternity, work injury, unemployment, and family allowances. If there were a strong link between contributions and benefits from the perspective of the individual, then these taxes would not be distortionary but would represent a form of remuneration to the worker. As such, these contributions (including the share paid by the firm) would be taken into account when firms and workers negotiate on the remuneration package. Unfortunately, in Latin America and the Caribbean, as well as in most other regions, the link between social security contributions and benefits at the individual level is, in general, rather weak. The most clear example of this weak relationship is old-age pension systems, which in this region are mostly of the pay-as-you-go kind. Generally, what is paid into this type of pension system during work years bears little relation with what is received at retirement. Following this discussion, two indicators are used to measure labor-market distortions due to payroll taxes. The first is the rate of social security contributions, paid both by employers and employees, expressed as a percentage of basic wage. The second indicator attempts to control for the degree to which contributions and benefits are connected. Focusing on old-age pension systems, this indicator grades countries according to the extent that their pension regimes are based on a capitalization system. The highest score is given to pension regimes that feature a fully-funded capitalization system with individual accounts managed by private companies; these are present in countries that have undertaken major pension reform, namely, Chile in 1981, Colombia in 1993, Peru in 1993, Argentina in 1994, and Mexico in 1996. The lowest score is given to pension regimes that are mostly based on a pay-as-you-go system, and an intermediate score is given to systems that, although not fully funded, receive at least 25 percent of their revenues from investment income from established pension funds.

The third category of indicators on labor-market distortions concerns the *lack of mechanisms for peaceful resolution of labor disputes*, measured by the amount, per worker, of annual hours not worked due to strikes in the modern sector.³⁰ The prevalence of labor strikes indicates not only that labor legislation does not provide the means to settle labor conflicts, but also that such legislation may induce labor stoppage by making one party (usually the firm) bear most of its costs. For instance, in countries such as Ecuador and Nicaragua, legislation requires that workers be paid even when they are on strike. Both workers and firms should have something to lose if delays in reaching agreement occur; in this way, the bargaining process will move more speedily toward compromise.³¹

The last category of labor-market distortions is related to the prevalence of *public employment* in the economy, measured by the ratio of public to total employees in the non-agricultural sector. In most Latin American countries, public employment has traditionally been used both as a way to solve unemployment problems during economic downturns and as a political tool to reward allegiance to the governing party; therefore, the process of hiring public employees has often neglected to adequately match workers to the needs of public administration. This overstaffing and excessively high remuneration in public administration (relative to productivity) has bid up labor costs in the private sector; the ensuing welfare loss is caused by the fact that the marginal productivity of labor in the public sector has not equaled that in the private sector. Apart from this static distortion, low productivity in the public sector has had harmful consequences on the development of human capital of those employed by the state. Generally, public employees have lacked incentives to remain well-trained, so their preparation and training have soon become obsolete, which has made them unfit to compete with their private-sector counterparts. This contention is supported by preliminary findings of studies on public downsizing;³² these studies indicate that former public employees find it hard to adjust to the demands of the private sector, even when their human capital is generally sufficient to be applied to both private- and public-sector jobs.

³⁰ This indicator may also vary as a result of events unrelated to the lack of proper dispute-resolution mechanisms. For example, it could increase in times of political unrest or macroeconomic shocks. At any rate, the fact that strikes can be used as means of political protest reveals excessive union power.

³¹ See World Bank (1995).

³² See Rama (1997).

Table 5 presents information on each of these indicators of labor market liberalization for most countries in Latin America and the Caribbean. In order to provide a summary measure of progress in this area, two indices were computed. The first, presented in Chart 10, includes only the first two groups of labor-market distortions (constraints on hiring and dismissal and payroll taxes) in order to cover a larger range of countries. The second index, which also includes information on labor dispute resolution and public employment, has a more limited country coverage. (See Chart 11.) Following the common law tradition, the English-speaking countries of the Caribbean, especially the Bahamas, Belize, and Guyana, are the least rigid in the region, particularly in regard to monetary compensation for dismissal, constraints on temporary contracts, and the rate of payroll taxes. Among the other Latin American countries, Chile has been the leader in labor-market liberalization, even since the 1980s. Of the countries that undertook labor-market reforms in the early 1990s, Peru's endeavors towards an undistorted labor market are impressive; it has made progress in all aspects of labor-market liberalization, and even its mild increase in payroll taxes cannot be regarded as distortionary, given that the contribution-benefit link of social security was strengthened by the adoption of a fully funded pension system. The progress of the other reforming countries has been more limited. Argentina reduced distortions in its labor market by introducing legislation that distinguishes between unjustified dismissals and those produced by economic difficulties of the firm, by adopting a fully funded pension system, and by easing some constraints on temporary contracts. Nevertheless, Argentina's payroll tax rate remains the highest in the region, and its mandated compensation for dismissal has rates double those in neighboring Chile. Furthermore, some additional downsizing of public-sector employment is still needed at the provincial level. Colombia also experienced progress in labor-market flexibility; however, its strengthening of the link between social security benefits and contributions was to some extent reversed by the steep rise in the social security contribution rate, from 21.1 percent to 33 percent of wages. Countries that also made progress in this area are Ecuador, Panama, and Venezuela. Finally, Brazil and Mexico are two of the most distorted labor markets in the region; in the case of Brazil, this is due to a high compensation for dismissal, without distinguishing between unjustified and economic reasons; and a high incidence of labor conflict. In the case of Mexico, the large presence of public-sector employment in the economy contributes to the country's lack of progress regarding labor-market liberalization.

In closing this section, it is important to note that the indicators of labor-market distortions used in this document are policy instruments rather than outcome indicators. This clarification is important, for there may be cases in which labor markets remain undistorted, despite having potentially distortionary policies, because those policies are not enforced (or not binding).

D. Proper Use of Public Resources and Efficiency of Revenue Generation

Previous studies have examined the effects of public deficits on macroeconomic stability. In this paper, the analysis emphasizes how government obtains its revenues and allocates its expenditures, and their impact on economic development. Effective management of government resources is linked to both good governance (to be analyzed in the following section) and good policies. On the expenditure side, good policies attempt to allocate expenditures so as to promote human capital development and provide essential public goods. An important lesson learned from failed populist regimes is that public resources cannot be used properly when government intervenes directly in market activities, except when it serves as a regulator in cases where clear externalities exist. Another aspect of the same lesson is that the private sector should be encouraged to participate in providing public services. Following this logic, the recent privatization of public enterprises, including public utilities, represents an improvement in the way governments use public resources. On the revenue side, an efficient system of revenue generation seeks to minimize the distortionary effect of taxation, while securing enough revenues both to avoid unmanageable deficits and to finance essential public goods and services.

1. Indicators on the proper use of public resources

The historical paradox of Latin American governments is that, while they have been almost omnipresent in the economy, they have also been weak.³³ Their weakness consisted of being unable to provide essential public services and being easily manipulated by particular interest groups. The challenge Latin American governments face is to become strong by specializing in economically essential areas in which the private sector does not perform or performs poorly. A successful response to this challenge requires a reform of government institutions and the way they manage their resources.

³³ Burki and Edwards (1996).

The next section, titled “Governance,” evaluates progress achieved in the area of institutional reform. This section deals with the way governments manage their resources.³⁴ In this respect, Latin American countries have generally had two deficiencies, which the current wave of reforms are attempting to remedy. The first is that a large share of government resources was spent on a bloated and ineffective bureaucracy. Public employment was used to reward political loyalties, and in order to accommodate the surplus of employees, new government departments were created, tasks were duplicated, and bureaucratic paper work was made more lengthy and complicated. The recent empirical-growth literature provides substantial evidence that in countries whose government spends a large share of its revenues to maintain a large bureaucracy, economic-growth performance suffers. Using pooled cross-country and time-series information, these empirical studies³⁵ find that an increase in government consumption, of which wages and salaries to public employees are the largest component, negatively affects the rate of per capita GDP growth. In order to measure the progress achieved by Latin American countries in this respect, the *ratio of wages and salaries of government employees to primary expenditures* is considered. The level of government used in the evaluation is the central government, except in the case of Argentina, Brazil and Colombia, countries for which the general government is used. Given the decentralized nature of these countries’ governments, and the fact that fiscal reform in local governments there is not proceeding at the same pace as in the central government, it is essential to consider general government as the unit of analysis for those countries.

As Chart 12 shows, a few countries in the region -- namely, the Dominican Republic, El Salvador, Peru, and Uruguay -- have shown in the last ten years a clear tendency to spend less for the services of the bureaucracy. Chart 12 also shows that there is considerable variation in the share of government primary expenditures devoted to public employees’ salaries, from nearly 50 percent in the Bahamas, Costa Rica, and Ecuador in the mid-1990s to below 20 percent in Chile and Peru, in the same period. Clearly, the salary-to-expenditure ratio in public administration depends not only on whether the bureaucracy is bloated, but also on structural characteristics such as whether the

³⁴ The distinction made between appropriate government institutions and policies for proper management of public resources is conceptual, and thus, artificial. The distinction is made here for the ease of exposition and to provide emphasis on different aspects of reform in the public sector.

³⁵ See Barro and Sala-i-Martin (1995); Barro and Lee (1994); Caselli, Esquivel, and Lefort (1996); and Easterly, Loayza, and Montiel (1997).

government is required to specialize in providing labor-intensive services. Nevertheless, it is interesting to note that the Chilean public administration, which enjoys a strong reputation for efficiency in the region (as described in the section on governance), has been absorbing a share of primary expenditures that is among the lowest in Latin America in the last ten years. Also worth noting is the marked difference in this respect between government levels (federal, state, and local) in Argentina and Brazil, the two most seriously decentralized countries in the region; in both countries, the ratio of salaries to primary expenditures is significantly higher at the state (or provincial) level than at the federal level. In Argentina in 1995, this ratio was 23 percent for the federal government and 54 percent on average for provincial governments; in Brazil, the corresponding figures were 28 percent and 49 percent. These numbers support the notion that the fiscal problems of expenditure control and deficit reduction in Argentina and Brazil mainly reside at the provincial (or state) level of government. Comparing the percentage of primary expenditures that go to the bureaucracy in Latin America, the OECD, and the Asian NICs, Latin America on average remains closer to, say, Malaysia (36 percent) than to Korea, whose lean bureaucracy absorbs 12 percent of primary expenditures.

The second deficiency in the use of public resources in Latin American concerns the pervasiveness of public enterprises. By the mid-1980s in most countries in the region, public enterprises performed quite poorly, which meant that they not only provided deficient public services, but they also incurred major losses that imposed a heavy burden on government finances, thus exacerbating the fiscal imbalance that resulted in high inflation.³⁶ To address this deficiency in the use of public resources, many Latin American governments have included privatization of public enterprises in their process of reform. Privatization of public enterprises is advocated on two grounds. The first is that public enterprises are generally loss-making, due to both poor management and improper pricing policies, thus draining fiscal resources that could be applied to more productive uses. The second reason in favor of privatization is that substituting private for public firms in areas of economic activity inclusive of natural monopolies creates higher productivity, meaning better products and services at a lower cost. Privatization also results in better public infrastructure and utility services, because it allows the government to concentrate on its role as an efficient regulator.

³⁶ Edwards (1995).

In order to evaluate progress in this area, two indicators are used. The first, *privatization proceeds as a ratio to GDP*, measures privatization effort; this indicator is clearly imperfect because it implicitly assumes that all countries start from similar levels of public enterprise participation in the economy. Privatization proceeds as a ratio to total initial value of public enterprises would be a better indicator of privatization effort; unfortunately, data on the initial *market* value of the public enterprise sector is unavailable.

Table 6 presents proceeds from privatization as a percentage of average GDP for the periods 1988-89 and 1990-95. It shows that most countries in the region participated in the process of privatization. The most significant cases are Argentina, Belize, Bolivia, Chile, Jamaica, Mexico, Nicaragua, Peru, Trinidad and Tobago, and Venezuela. Brazil, Colombia, and Honduras entered the process rather timidly. As of 1995, the remaining countries, among them, Ecuador, Guatemala, Panama, Paraguay, and Uruguay remained outside the privatization effort.

The second indicator, the *ratio of private to total investment*, attempts to measure the reaction of the private sector following privatization, that is, whether the private sector, enlarged by newly privatized enterprises, becomes more active in capital formation. This is especially important in the area of infrastructure and public utilities, for which one of the main objectives of privatization was to promote fresh investment. In order to assess this particular point, it would have been preferable to use as an indicator the ratio of private investment in infrastructure and utilities to total investment in the same activities; however, data on private investment in infrastructure is as yet unavailable. At any rate, since the privatization effort has included all kinds of enterprises, from mining firms and commercial banks to power-generation companies and port authorities, it is informative to examine the behavior of total private investment before and after privatization.

Chart 13 presents gross private investment -- that is, gross domestic investment minus general government and public enterprise investment -- as a percentage of gross domestic investment for most countries in Latin America and the Caribbean. In most countries that conducted a major privatization program in the 1980s or early 1990s, the private investment share of total investment became more than 80 percent by the mid-1990s. This was the case for Chile, Argentina, Mexico, and Peru. Having pioneered privatization in the 1980s, Chile's private investment share remained high and stable in the late 1980s and early 1990s; the other three countries experienced an increase in private-sector participation in total domestic investment of more than ten percentage points over the same period.

Brazil and Colombia also experienced an increase in their private investment shares; an increase that accorded with the small size of their privatization programs. Bolivia's experience is a rather disappointing one, for despite a strong privatization effort, its private investment share actually dropped from its 1985 level, and then remained about half as large as that of other countries with a similar privatization effort. The decline of Venezuela's private investment share in the ten years after 1985 cannot be associated with its privatization program, which started only recently; rather, this significant drop was initially due to macroeconomic instability, and subsequently, to an adjustment program. It is interesting to note that some of the countries that did not initiate a privatization effort already had private investment shares in the 1980s of around 80 percent. It is likely that for these countries, namely, Guatemala, Panama, and Paraguay, privatization was not needed as much as in other Latin American countries. Finally, a comparison with the Asian NICs³⁷ reveals that, for the Latin America and Caribbean region on average, private-sector participation in investment is still below that of the NICs. The difference in this respect between the two groups of countries (five percentage points on average in the 1990s) is larger than it seems given that the productivity of *public* investment is much greater in the Asian NICs than in Latin American countries.

2. Indicators on the efficiency of revenue generation

Clearly, the ability of the state to undertake an expenditure program without incurring an unmanageable deficit depends on efficient revenue generation. Latin American countries have relied excessively on trade taxes and seigniorage through money creation to finance their spending programs. High tax rates coupled with a weak tax administration induced many firms to become part of the informal sector. This undermined the ability of the state to generate revenues from income and domestic sales taxes, prompting the state to obtain revenues through both the inflation tax and taxes on imports and exports, which can be more easily monitored. In the late 1980s, many countries reformed taxes to diminish the distortionary effects of taxation and to increase revenue, thus allowing trade liberalization and disinflationary policies and reducing the tax burden on the formal sector.

³⁷ Comparison with OECD countries is problematic, given that the available investment figures for this group of countries do not disaggregate corporate investment into its public and private components. Therefore, the "private" investment figures reported for OECD countries in the text and in the appendix include public enterprise investment.

The specific measures of tax reform varied across countries but had in common the following three principles: first, tax-rate unification and lower marginal rates; second, de-emphasis of steeply progressive rate structures of income and property taxes in favor of broadly based, low-rate taxes on domestic consumption, such as the value added tax (VAT); and, third, strengthening of the tax administration.³⁸

In evaluating the efficiency of revenue generation, it is informative to consider the variables that, as outcome indicators, best capture the purposes of tax reform. An increase in the *ratio of tax revenues to GDP* measures, to some extent, the success in raising revenues through noninflationary means; the *ratio of international trade taxes to total tax revenues* evaluates the reliance on the type of taxation that distorts the country's trade position; and, finally, the *VAT revenue productivity ratio*³⁹ measures the comprehensiveness of the VAT and the strength of the tax administration.

Tax revenue as a ratio to GDP signals government's reliance on taxes, as opposed to debt accumulation, money creation, or transfers from public enterprises, as a way to finance its expenditures. It can not be said, however, that a higher tax-revenue ratio is always better. There is in principle an "optimal" tax rate in which the productivity-enhancing effect of tax-financed public goods just compensates for the negative effect of the tax burden on the economy's net rate of return. The ideal indicator is, therefore, the difference between actual and optimal tax ratios. The determination of this optimal tax ratio for a given country is difficult in practice. Even more difficult is to compare optimal rates across countries, given that an optimal rate's determinants -- namely, the efficiency of tax-financed public goods, the extent to which government consumption substitutes for private consumption, and the strength of the tax administration -- vary substantially from country to country.

Although cross-country comparisons are difficult in this respect, the demands on most modern states are such that countries whose tax revenues are below 10 percent of GDP are quite likely to run into financing difficulties. Chart 14 shows that several countries in the region found themselves in that predicament around 1990. They were Argentina, Bolivia, Colombia, the Dominican Republic, El Salvador, Guatemala, Paraguay, and Peru. By 1994, however, all countries except Guatemala had a tax-revenue ratio of above 10 percent, with most countries in the region approaching ratios of 15

³⁸ See Shome (1992).

³⁹ The VAT revenue productivity ratio is defined as the ratio of VAT revenues over GDP to the average VAT rate.

percent to 20 percent, which, revealingly, are quite similar to the average of the Asian NICs. Nicaragua is an interesting example of a country for which an improvement in tax policy actually meant a decrease in tax revenues relative to GDP from a high level of 32 percent in the mid-1980s to a more moderate 23.6 percent of GDP in 1995.

The behavior of the *ratio of international trade taxes to total tax revenue* also reveals a positive development for the region. A stylized fact revealed by cross-country studies is that as countries develop, international trade taxes represent a smaller share of tax revenues.⁴⁰ Largely motivated by tax and trade reforms, this drop in international trade taxes seems to be the Latin American trend in recent years. As Chart 15 shows, despite large increases in the volume of trade in most countries, their respective trade tax shares show a decreasing trend, with the exceptions of Guatemala, Jamaica, and Nicaragua. A comparison across countries reveals, not surprisingly, that the countries relying most heavily on trade taxes tend to be those that, because of their small size and location, are more open to international trade. Even including those countries, the share of trade taxes in total tax revenue fell on average for Latin America and the Caribbean below 20 percent; this is a remarkable achievement, especially considering that it did not weaken the countries' fiscal stance. It must be noted, however, that the regional average for the trade-tax share of total taxes is almost 8 percentage points higher than that of the Asian NICs.

The *productivity rate of the value-added tax* is arguably the most important indicator of the efficiency of revenue generation in the region. It measures, in part, the success of the recently adopted tax system, for which the VAT is the centerpiece. In a context of weak tax administration, the VAT with its self-monitoring feature, has become the best option for revenue generation with limited distortions. Its achievements as a revenue generator have allowed the easing of the tax burden on the formal corporate sector and the reduction of trade tax rates. The VAT revenue-productivity ratio contains information on two aspects of the VAT system: the coverage of the VAT, in terms of the share of national expenditure included in the system; and the strength and efficacy of the tax administration in preventing tax evasion. Furthermore, the VAT productivity rate indicates the ability of the state to raise additional revenues from taxes when needed.

⁴⁰ See Easterly and Rebelo (1993).

Chart 16 presents a *trade-adjusted* VAT revenue-productivity rate. Given that imported goods, included in virtually all VAT systems, are the easiest to monitor, an increase in imports relative to GDP will be surely reflected in a higher VAT productivity ratio. In order to analyze the effects of improved tax enforcement or an expansion of VAT coverage on domestic expenditure, which is the purpose of this section, it is necessary to control for the changes in the revenue-productivity ratio explained by import growth.⁴¹ In most countries, especially since 1990, this productivity rate has increased, particularly in Argentina, Bolivia, Costa Rica, Paraguay, and Peru. The recently established VAT systems in El Salvador, Nicaragua, and Venezuela also show remarkable progress with respect to their status at inception. For many countries, however, there is much room for further progress, given that only a few countries (Brazil, Chile, Bolivia, Paraguay, El Salvador, and Guatemala) have achieved trade-adjusted VAT productivity rates of over 40 percent.

Table 7 compares VAT revenue-productivity ratios, along with information on tax and collection rates, in a sample of countries from different regions. It shows that even mature tax systems, which mostly rely on income taxes, present VAT revenue-productivity ratios that vary between 0.3 (Canada) and 0.7 (New Zealand and Portugal).

E. Governance

A growing body of literature points to the importance of public institutions and services in originating and implementing welfare-enhancing economic policy. The state can potentially provide the private sector with an environment in which property rights are respected; legal contracts are enforced; and government regulations, rather than complicating business transactions, correct market imperfections. This requires not only a government with enlightened policies, but also with the ability to implement them efficiently and credibly.

There are various interrelated mechanisms through which good governance can affect economic performance. First, the state can act as an efficient protector and guarantor of property and contractual rights. When these rights are infringed, investment decreases sharply and tends to focus, wastefully, on small and short-term projects in which the need for property and contractual rights is

⁴¹ It must be noted, however, that the simple and trade-adjusted VAT revenue productivity ratios are very similar to each other; in fact, their correlation coefficient is 0.94.

lower.⁴² The state can fulfill the role of protector of property rights by having a body of laws and regulations designed to credibly advocate those rights and an autonomous and strong judicial system in charge of supporting and enforcing those laws. Second, the government administration can adequately provide public services, including making decisions on the types and locations of public infrastructure projects and the awarding of contracts and licenses; protecting public spaces, including the environment; providing a safety net for the poor; and offering police protection for the public. Public institutions can ameliorate adverse social or economic conditions by planning appropriate policies and implementing them effectively; for instance, properly run public institutions can diminish the harmful effects of ethnic conflict⁴³ and can help disadvantaged people escape the poverty traps of lack of education and health care.

These high responsibilities for government can be achieved only when the public administration behaves both efficiently and honestly. Corruption in government, especially of officials with decision-making power, is detrimental to social welfare because it makes the state pursue public policies and programs that benefit certain groups rather than society in general and because it encourages wasteful rent-seeking activities.⁴⁴ Corruption of high-ranking officials is mostly due to both a lack of proper monitoring and clear accountability rules. It must be recognized, however, that corruption among lower ranks of the bureaucracy is linked not only to their ethical strength or the lack of proper monitoring, but most importantly, to the lack of procedural clarity; the complexity of bureaucratic requirements; the imposition of overly restrictive regulations; and excessively high rates of taxes, tariffs, and other public charges.

Good governance is difficult to measure objectively. When analyzing the success of public policies, it is quite hard to isolate the share due to good governance. There is, however, the possibility of assessing the quality of public institutions and services by the way they are perceived by businessmen and economic and political consultants, who deal with various government branches on a daily basis. These subjective indicators are collected by a handful of international agencies, and then sold to

⁴² See Knack and Keefer (1995 and 1997).

⁴³ See Easterly and Levine (1996).

⁴⁴ See Mauro (1995).

prospective international investors. Most of the papers cited above have, in fact, used these subjective indicators as measures of good governance.

This section makes use of the information provided by two independent country-risk evaluators, *International Country Risk Guide* (ICRG) and *Business Environment Risk Index* (BERI), which present ratings for various aspects of governance. ICRG provides ratings on five variables, including the *rule of law*, measuring the extent to which there are mechanisms for peaceful dispute resolution; *expropriation risk*, assessing the risk of nationalization of enterprise equity; and *repudiation of contracts by government*, measuring the state's commitment to fulfill its contractual obligations and proxying for its ability to enforce contracts between private-sector agents. It also analyzes *corruption in government*, evaluating the extent to which bribes to public officials are needed to expedite bureaucratic requirements, circumvent regulations, force a change in policy to benefit a given interest group, or obtain public contracts without a lawful bidding process; and *quality of the bureaucracy*, evaluating both procedural clarity and the technical competence of government officials. Although in principle these ratings measure different aspects of governance, in practice they are highly correlated. Because of this, an overall index is presented here. This index is based on the simple average of the ratings for the five variables. A similar procedure is used with the BERI ratings, which consist of three underlying variables: *enforceability of contracts*, *nationalization risk*, and *bureaucratic delays*.

The ICRG and BERI indices presented below provide information related to two aspects of good governance. The first is the quality of public institutions (evaluated by the variables *corruption in government* and *quality of the bureaucracy/bureaucratic delays*), which describes the ability of the state to implement its policies through both an appropriate structure of government and honest and technically competent bureaucrats. The second is the quality of public services (evaluated by the variables *rule of law*, *enforceability of contracts/repudiation of contracts by government*, and *expropriation/nationalization risk*), which determine an environment where contractual obligations are respected both by the state and private agents, where legal disputes are effectively resolved in the judicial system, and where legal rules for investment, employment, and taxation are not arbitrarily modified by the state.

The BERI Index (see Chart 17, left panel) shows that Argentina, Chile, Ecuador, and Peru made some progress in the area of governance from 1990 to 1995. For the latter two countries, this meant a recovery toward their 1985 level after a fall in the late 1980s. By contrast, governance in

Brazil and Venezuela worsened substantially in the same period. In cross-country comparisons, according to BERI, Chile is clearly above all other Latin American countries in the sample, approaching the high level of governance of the OECD and Asian NICs.

The ICRG Index (see Chart 18, right panel) presents a more optimistic picture of progress in governance in Latin America and the Caribbean.⁴⁵ Although in general there are signs of improvement between 1985 and 1990 (especially in Argentina, Bolivia, Chile, and Mexico), outstanding progress only occurs in most countries between 1990 and 1995. The countries of Bolivia, El Salvador, Guyana, and Peru experienced an improvement in governance that is particularly remarkable given their low ratings in the mid-1980s. Of the larger countries, only Brazil, Mexico, and Venezuela present little progress in the same period. According to ICRG, from 1990 to 1995, the region's governance index improved on average by 35 percent. However, despite this general improvement, closer examination of the underlying indicators of the ICRG governance index (see Chart 18) reveals that, by 1995, Latin America remained well below the Asian NICs and OECD countries. This gap is particularly large in the area of the rule of law (judicial and police systems) and in the quality of public administration (technical competence and honesty of the bureaucracy, as well as procedural clarity). The difference between Latin America, Asian NICs, and OECD countries is smaller with regard to the risk of nationalization of enterprise equity.

F. Concluding Remarks

The purpose of this paper has been to examine the experience of structural reform in Latin America and the Caribbean in five areas of economic activity, namely, international trade, financial markets, labor markets, generation and use of public resources, and governance. The methodological approach used in the study consists of developing quantitative indicators for the corresponding policy reforms and/or their respective outcomes. The result is an empirical characterization of the region's structural reform.

⁴⁵ A note of caution: The optimistic assessment of this rating agency must be viewed with prudence, for there exists the possibility that, despite its efforts to be accurate, reforms in other areas and the ensuing stronger economic investment and growth could be confused with improvements in governance, properly defined. A conservative measure of progress in governance in Latin American countries should be between BERI's and ICRG's assessments.

Although the processes of structural reform throughout the region have shared the same principles, both the time of initiation and the depth and contents of the reform process have varied from country to country. Similarly, the region as whole has advanced in certain reform areas more than in others.

To review the region's structural reforms in the order of most successful to least successful, one must start with *trade liberalization*. It is in this area that reform has been the deepest and most generalized reform in the region; in fact, in terms of reducing policy restrictions to trade, the region has come quite close to the Asian NICs. Much has also been accomplished in the area of *financial development*, particularly in terms of depth of financial intermediation, of private sector participation in banking, and of size and activity of stock markets, and in the area of *efficient generation and use of public resources*, notably in terms of the efficiency of the VAT system and the privatization of public enterprises. Reform gains in the area of *governance* have been more modest. In this respect, Latin America remains well below the Asian NICs and OECD countries, especially concerning the rule of law (judicial and police systems) and the quality of the public administration (the technical competence and honesty of the bureaucracy, as well as procedural clarity). *Labor-market reform* is the area of structural reform where the least progress has been made in the region. In most countries there are still severe constraints on the hiring and dismissal of workers, high payroll tax rates, a lack of mechanisms for non-disruptive labor dispute resolution, and a prevalence of public employment in the economy.

Latin America suffered for several decades from mistaken public policies and weak public institutions, which induced profound distortions in the formation and allocation of physical capital and human talent, and gradually eroded overall efficiency. These deep distortions make it costly and even painful to implement structural reforms (and thus, alter the modes of production and the system of economic incentives). At the same time, these reforms have the potential to raise substantially the living standards of most people in the economy. There is indeed some evidence that the reforms initiated in most countries in the late 1980s have already borne fruit in terms of improved growth performance;⁴⁶ this, however, should not allow anyone to forget that economic reform is a long and arduous process, which requires both political will and social sensibility from the government to be successfully fulfilled.

⁴⁶ See Easterly, Loayza, and Montiel (1997); Fernandez-Arias and Montiel (1997); and Barrera and Lora (1997).

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