2. THE ANDEAN COMMUNITY REFORMS: HOW MUCH PROGRESS? HOW FAR TO GO?

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During the late 1980s and early 1990s the vast majority of the Latin American countries—including those in the Andean Community—embarked on ambitious reforms aimed at modernizing their economies. Country after country turned away from decades of protectionism and government controls, and began to experiment with market-oriented policies. Colombia provides a vivid illustration of this regional trend. During the early months of 1990 candidate César Gaviria promised that, if elected president, he would launch a major transformation of Colombia's economic system. In every speech he argued that the development path followed by Colombia since the 1940s had become obsolete and that, in order to achieve rapid growth and improve social conditions for the majority of the population, significant reforms had to be undertaken; he called for a major shake-up of the Colombian economy. On August 7, 1990, César Gaviria was inaugurated as Colombia's constitutional president. During the next four years a set of policies aimed at drastically changing the nature of Colombia's economic structure was put into effect. Exchange controls were abolished, imports were liberalized and legislation governing ports operations was modified. Labor legislation was reformed, foreign direct investment controls were relaxed, the financial and insurance sectors were deregulated and the tax system modernized.[1]

This phenomenon was not unique to Colombia. The administrations of presidents Fujimori in Peru, Pérez in Venezuela and Sánchez de Losada in Bolivia also embarked on major reform efforts. In other countries a similar trend was followed: Presidents Menem in Argentina, Cardoso in Brazil and Arzu in Guatemala, among others, also launched important modernization programs during the 1990s.

It is not an exaggeration to say that during the first half of this decade most Andean Community countries—and in most of the region, for that matter—followed the steps of the two early reformers: Chile and Mexico. However, after an initial burst of enthusiasm, in the last year or so the pace of reform in Andean Community countries has declined significantly. With the possible exception of Bolivia, one would be hard pressed to single out a country where reforms continue to be pushed vigorously and where the modernization agenda is being pursued with dynamism and creativity. On the other hand, the news is replete with instances where there has been reform slowdown, hesitation or outright backtracking—the cases of Ecuador and Colombia come especially to mind. Moreover, the recent election of Hugo Banzer as president of Bolivia has thrown the reform prospects of that country into question. As I will argue in this chapter, the lack of recent progress in the reform agenda is particularly clear with respect to institutional—or, as they are sometimes called, "second generation"—reforms.

While each country in the region presents a unique case, I believe that by and large, it is possible to argue that the Andean Community countries present a quintessential case of an incomplete reform effort. In spite of some spectacular liberalization measures undertaken earlier, interest groups have been able to regroup—including intellectuals that all along doubted the benefits of new development programs—and to block some essential initiatives, including the reform of the social sectors and, perhaps more importantly, a profound reform of state institutions. Although in many countries privatization continues to be pursued, it is often undertaken without the implementation of competition policies and, what is even more worrisome, in many cases it is motivated by "fiscalist" reasons, due to the need to generate additional fiscal revenues. In some nations—Colombia and Peru, for example—the serious political difficulties recently faced by the political leadership has negatively affected the ability to push a meaningful agenda.

Why has the reform effort stalled in so many of the Andean Community countries and, more generally, throughout Latin America? I believe that there are two major, and somewhat related, explanations for this phenomenon. First, in virtually every country in the region a number of people—including influential analysts and intellectuals—incorrectly believe that their particular country has already advanced very deeply in the reform

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[1]On the Latin American reforms see, for example, Edwards (1995a) and IDB (1996). On the Colombian reforms, see Cepeda (1995) and Hommes, Montenegro and Roda (1994).

sphere, and that there is very little left to be done. This notion, however, is quite far from reality. In spite of substantial progress, the vast majority of the Latin American economies are still subject to major controls and regulations. To put it plainly, the Andean countries—and, I would even argue, most of the Latin American nations—are still a far cry from being modern market-oriented economies. This becomes particularly apparent when the region's current degree of liberalization is analyzed from a broad international comparative perspective. Second, there is a belief that the region's rather modest economic performance in the last three years—especially regarding real wages and social conditions—is the direct consequence of the so-called neoliberal reforms. There is, however, no compelling evidence supporting this view. On the contrary, it is possible to argue that in many countries, the current economic blues are largely the result of an incomplete reform program.

There is very little empirical support for the two recurrent themes in the recent reform-skeptic discourse—that reforms have little, if any, effect on economic performance, and that they negatively impact social conditions. In fact, recent applied comparative research has emphatically concluded that (a) broadly defined, reforms have very important positive effects on economic performance, especially on total factor productivity growth, and (b) economic reforms, in particular trade liberalization, have no discernible direct effects—either positive or negative—on social conditions and income distribution. The same evidence indicates, however, that economic reform has a positive indirect effect (through economic growth) on social conditions and income distribution.[2] This evidence suggests, then, that the deteriorating income distribution that has indeed been observed in some countries cannot be attributed (at least not easily) to the liberalization reforms.

Recent public debate in most Latin American countries in general, and in the Andean countries in particular, has tended to focus on short-run economic trends. While understandable, this is unfortunate. By emphasizing immediate issues, analysts have neglected the fact that today many countries in the Andean Community face the serious likelihood of being left behind in the next decade or so. While many countries in the world—including many European nations—are making efforts to modernize their economies, many Latin American countries appear to be paralyzed. While in many nations new, bold and creative initiatives are being debated on economic, social and institutional issues, an increasingly large number of Latin American politicians appear to be trapped in nostalgia. Naturally, the corollary to this proposition is that if the Andean nations indeed want to take off in the next decade, they will need to pursue the reform agenda with great zeal, enthusiasm and conviction. If they fail to do this, they risk being left behind, and plunging into mediocrity, sorrow and frustration.

The purpose of this chapter is to evaluate the state of the reform process in the Andean countries: Bolivia, Colombia, Ecuador, Peru and Venezuela. I begin with a general discussion on the dynamics of reform, including the politics of transformation and modernization. I then turn to the case of the Andean Community and ask a number of questions: Have these countries moved forward as dramatically as many analysts in the countries themselves seem to believe? Or has the reform-skepticism mentioned above slowed down the process? In which areas have the reforms been particularly deep, and in which are they still lagging behind? What can we expect of these countries in the future? This chapter, however, does not deal directly with the merits of the Andean Community integration project itself, and makes no attempt to evaluate whether the regional integration strategy is superior to the unilateral liberalization one. Those are, after all, subjects of other chapters in this volume. This chapter, however, does deal with the relationship between openness and economic performance in a comparative context. The next section—Economic and Institutional Reforms and the Political Economy of Transformation—deals with some broad analytical issues related to the reform process. In it I argue that a truly successful reform program has to implement economic and institutional reforms side by side. Only if these two types of reforms are implemented more or less simultaneously will economic performance improve in a sustained and lasting way. I also deal with some of the most salient aspects of the political economy of reform, including the difficulties frequently faced by reformist governments. This discussion makes numerous references to the case of the Andean countries. The section—Where Do the Andean Community Countries Stand in the Reform Agenda?—provides an evaluation of the current state of the Andean Community reforms. In it I argue that in spite of considerable progress in the 1990–94 period, many of these countries—especially Colombia, Ecuador and Venezuela—are lagging dangerously in the reform effort. I present a series of indicators that

[2] See, for example, Barro (1996), Sachs and Warner (1995), Edwards (1997a,b) and Edwards (1998). For an earlier and very complete analysis of the relationship between trade regimes and income distribution, see Bourguinon and Morrisson (1989). More recent discussions on these issues can be found in Wood (1994). Robbins (1996), however, presents micro evidence that suggest that trade reform has resulted in a decline in earnings of lower-skill workers in the developing nations.

strongly suggest that these countries are doing particularly poorly—from the perspective of international comparison—when it comes to institutional reforms. I argue that unless this trend is firmly reversed in the next two years, these countries face the danger of plunging into mediocrity. In the last section I conclude by revisiting the political economy theme and discussing some issues related to income distribution and social conditions. Finally, the chapter has two appendixes. Appendix 2A presents an econometric analysis on the relationship between economic reforms, institutions and economic performances. Appendix 2B contains summary statistics on the recent economic performance of the Andean Community countries.

ECONOMIC AND INSTITUTIONAL REFORMS AND THE POLITICAL ECONOMY OF TRANSFORMATION

In recent policy discussions it has become customary to distinguish between "first" and "second" generation reforms.[3] First generation reforms are aimed at changing the course of economic policies and at altering some (very) basic aspects of the economic structure of the country in question. These reforms include trade liberalization, fiscal reform, the elimination of exchange controls, financial liberalization, the implementation of minimal social safety nets, deregulation and some (minimal) privatization.

Second generation (or institutional) reforms, on the other hand, are aimed at drastically changing the institutions of the state in order to create an efficient, effective and fair socioeconomic system. These reforms are more difficult to implement and entail changing the functioning of the judiciary; reforming the civil service; reforming labor market institutions, including the relationship between unions, business and the government; reforming the way in which social services—mainly education and health—are provided; reforming social security; implementing administrative and political decentralization; implementing a major privatization program; and creating independent, professional and strong economic institutions aimed at providing simple, impersonal and clear rules of the game that will help reduce the costs of being engaged in productive activities.

As the names "first" and "second" generations suggest, there is an implicit assumption regarding the sequencing of these two types of reforms. *Policy reforms* are implemented earlier—both for technical and political reasons—while *institutional reforms* are usually postponed and are only attempted at later stages (Naim 1995; Tomassi and Velasco 1995; World Bank 1997). Recent experiences suggest, however, that the adherence to this linear sequencing may be counterproductive, costly and inefficient. The postponement of institutional modernization until the first generation reforms are firmly in place could, in fact, generate unwanted—and even negative—economic effects. This was the case, for example, in Chile in the 1970s and early 1980s, where the liberalization of the financial sector without the creation of an adequate supervisory structure resulted in a major financial crisis. Likewise, the liberalization of international trade in the absence of the modernization of labor market institutions will in many cases generate unemployment and high dislocation costs. An inefficient and corrupt judiciary system will increase the transaction costs associated with private initiative and will result in suboptimal investment levels. Also, privatizing utilities without putting into place an appropriate competition policy will result in monopolistic pricing and distortions.

The postponement of institutional reforms will not only affect the efficiency of the economy, but it will also likely generate undesirable distributive effects. These could include, among others, the appropriation of rents by private operators of newly privatized utilities, reduction in the level of employment for certain sectors affected by labor market rigidities, the erosion of the real (expected value) of pensions for the poor, and the delivery of low-quality social services to the less fortunate groups of the population. A large number of Latin American countries have been affected by many of these problems in the last few years. All of this, of course, suggests that in order for the modernization reforms to truly bear fruit and be successful, an effort should be made to implement institutional reforms earlier—ideally alongside the proper economic reforms. This, of course, is easier said than done, as institutional transformation takes time, is difficult and often runs into serious political opposition.

Recent analyses of the political economy of reform have emphasized five interrelated angles: (a) distributive conflicts; (b) the country's political organization and structure, including the role of political parties; (c) the role of the bureaucracy; (d) the role of ideas and of professional and intellectual groups; and (e) external actors,

[3] On the distinction between "first" and "second generation" reforms, see Naim (1994, 1995), Edwards (1995a), Burki and Edwards (1995, 1996), Edwards (1997), Tomassi and Velasco (1996), Burki and Perry (1997), and World Bank (1997).

including the international multilateral institutions, such as the International Monetary Fund (IMF) and the World Bank, and in cases such as Colombia, the role of foreign governments (specifically the U.S. Drug Enforcement Agency). This broader perspective, taken by Haggard and Webb (1994), Tomassi and Velasco (1995) and the World Bank (1997), among others, recognizes the relevance of a rich list of actors in the reform process. Moreover, in this framework of coalitions—both short and longer run—play an important function, as do politically motivated compensation schemes. Although it is somewhat early to derive a definitive picture on the political economy of transformation from the recent wave of market-oriented reforms throughout the world, the existing literature has already provided an array of insights. In the rest of this section I briefly touch upon some of the more important implications of this literature.

Crises and the Initiation of Reform. Most strands of the political economy as broadly defined in reform literature have included the argument that a major economic crisis almost always precedes the launching of a reform effort. Bates and Krueger (1993) are possibly the strongest advocates of this "crisis" view of reform initiation. According to them "[t]here is no recorded instance of the beginning of a reform program at a time when economic growth was satisfactory and when the price level and balance of payments situations were stable. Conditions of economic stagnation...or continued deterioration are evidently prerequisites for reform efforts." Williamson (1994) argues that the crisis hypothesis—which he defines as meaning that "public perception of a crisis is needed to create the conditions under which it is politically possible to undertake extensive policy reforms"—is supported by most modern experiences with market-oriented reform. However, this principle is only partially supported by the experiences of the Andean Community countries. While there is little doubt that the Peruvian and Bolivian reforms were initiated in the midst of major crises, this does not seem to be the case in Colombia. In fact, Williamson (1995), Cepeda (1994) and Urrutia (1995), among others, have argued that in Colombia the modernization process was launched under stable and, one could even argue, positive economic conditions. Ecuador and Venezuela represent two cases of serious economic crises with no significant reforms.

Coalitions, Compensation Mechanisms and Political Support. During the initial phases of the process the "reformist government" needs to build coalitions and obtain political support from some of the influential groups in society. The need to rely on coalitions is particularly clear in reform efforts that intend to go beyond the (relatively short) honeymoon period enjoyed by most governments (Williamson 1995). In most historical reform episodes, both under democratic and authoritarian political regimes, early support has usually come from exporters and from the modern business sector that expects to benefit from the privatization process. As time goes by, however, it is necessary to broaden the coalition and to obtain more generalized support from voters—see the discussion in Haggard and Webb (1994) and Waterbury (1989). A number of authors have argued that in order to broaden its political base, the reformist government should (a) implement a concerted public relations program to explain the reform process to voters and interest groups (Piñera 1991, Williamson 1994); (b) obtain financial assistance—mostly from the multilateral organizations—to help lower transitions costs and reduce political opposition (Sachs 1994); and (c) devise compensation schemes that will diffuse opposition to the reforms. Table 2.1 contains a synthetic presentation of four alternative compensation mechanisms used by reformist governments during the implementation phase both to broaden their political support and to diffuse political opposition to the reform process. As can be seen from Table 2.1, most of these compensation schemes have been used by some of the Andean countries. The effectiveness of these four mechanisms varies from case to case and will depend on the specific political characteristics of the country. What is interesting to notice, however, is that some of these mechanisms—and in many cases all four of them—have been used in every country during the recent surge of economic reform in Latin America in general, and the Andean Community in particular. Some of these compensation mechanisms, however, can be fiscally expensive and create a new set of economic distortions.

Political Structure, Democracy and Reforms. The political organization of the country has an important effect on the political economy of reform. There is no systematic evidence, however, suggesting that authoritarian regimes are more prone to initiate the reform process than more democratic ones. It is interesting to note, however, that in some of the Andean Community countries the implementation of the reform process has been associated—either directly or indirectly—with serious political upheaval. The coup attempts in Venezuela, the closing of parliament in Peru and the impeachment of President Bucaram in Ecuador were all actions that hurt, in one way or another, the cause of democracy in the region. In Colombia, on the other hand, the intensification of the economic reform effort during the Gaviria administration went hand in hand with serious efforts to deepen the extent of democracy in the country. This process was launched in 1990 with the convocation of a Constitutional Assembly that wrote a new constitution for the country.

Political Parties, Fragmentation and Reform. Some of the more important elements related to the political organization of the country include the nature of the party system and the extent of political fragmentation and polarization. This latter consideration is particularly important for institutional reforms that entail a long "payback" period. If the party (or group) in office perceives a low probability of being reelected, it will be reluctant to pursue reforms with front-loaded costs (see Cuikerman, Edwards and Tabellini (1992) for an analysis within the context of stabilization programs).

The Bureaucracy as an Anti-Reform Element. The bureaucracy plays a key role in the reform process. According to Haggard and Webb (1994, p. 13), "frequently, the most vociferous opposition to a change comes not from interest groups, legislators or voters, but from ministers and bureaucrats within the government...." In almost every country in the Andean Community public sector workers have, indeed, been among the most serious opponents to the modernization process. Workers in the education sector in Peru, Colombia, Venezuela and Bolivia, for example, have demanded special treatment and have stalled efforts to modernize the educational system.

Centralization and Reform. The degree of state centralization is important. Countries with federal systems commonly face important regional conflicts, with the states exploiting the existence of (semi-) soft budget constraints. In Latin America, Argentina and Brazil are perhaps the best examples of this syndrome. Colombia has not been totally exempt from this phenomenon. In fact, it may be argued that the very large transfers mandated by the new Colombian constitution to the subnational governments constitute a destabilizing force in that country's reform effort.

TABLE 2.1 COMPENSATION MECHANISMS

Compensation Mechanisms	**Main Features and Some Historical Examples**
Direct Compensation	Groups directly affected by the reform policy are compensated through the transfer of cash or financial securities. In this way, the authorities expect to see a reduction in the extent of opposition from that group to that particular reform. Examples of this type of compensation mechanisms include the distribution of shares of privatized firms to workers in that particular firm. The increase in take-home pay following a social security reform—as in the case of Chile—is another good example of this type of direct compensation scheme.
Indirect Compensation	This mechanism implies compensating (some of) the groups affected by a particular reform through the adjustment of a different policy. In some cases, this type of indirect compensation is "automatic" and is the result of normal economic forces at work. In others, it is the result of specific policy measures. One of the most important indirect compensation mechanisms is given by the real exchange rate (RER) adjustment following a trade reform. By devaluing the real exchange rate, import substituting sectors are partially compensated, while exporters experience an additional boon. This mechanism was used effectively in Colombia as a way to facilitate the trade liberalization reform.. The subsequent real appreciation of the peso generated serious problems to the Gaviria administration, however. Providing tax exemptions to sectors affected by deregulation constitutes another common form of indirect compensation.
Cross Compensation	This mechanism entails transferring resources—either directly or indirectly—to groups not directly affected by the reform, in order to obtain their political support. Transferring shares of privatized firms to the population at large—as in Bolivia's capitalization program—is a good illustration of this mechanism at work.
Exclusionary Compensation	This procedure entails excluding certain powerful groups from the effects of a reform, in order to diffuse their political opposition. By allowing these groups to maintain their old privileges, it is expected that they will not become active antagonists. The special treatment given to the Chilean armed forces regarding that country's social security reform is a classic example of this type of compensation mechanism. Likewise, the special treatment provided to large groups of public sector employees in Colombia helped pave the way for the country's labor and social security reforms.

Sequencing and Speed. The sequencing and speed of reform matter, not only from a purely technical point of view, but also from a political economy one. It is not the same to privatize the banking system earlier and then to postpone it at the end of the process; it matters whether social security is reformed at an early stage or whether this takes a long time. In particular, it is important to truly reform labor markets early in the process. Also, independent supervisory institutions should be created before the financial sector is liberalized and banks are privatized. In deciding on a specific sequencing, care should be taken to avoid real exchange rate overvaluation. Regarding speed, it has been found that more rapid reforms are usually more credible and that, contrary to popular belief, if undertaken effectively and accompanied by the implementation of safety nets, they will not have serious social effects. It has been argued, for example, that the early opening of the capital account in Colombia helped generate the significant real appreciation experienced by the country after 1991. This, in turn, has been credited with the increasing political difficulties faced by the Gaviria administration to further the reforms in 1992–93. Also, the privatization of public monopolies without first having set up the appropriate supervisory bodies has resulted in high public service prices in a number of countries, including Peru and Colombia.

The Role of Ideas. Ideas are important. Distributional conflicts are not the only force behind reform efforts. In most cases a group of intellectuals—many times trained in the Anglo- Saxon world—have developed a strong logical argument for reform. As argued above, in times of crises these ideas become more attractive or less esoteric and are tried out by politicians. This has clearly been the case in the launching of the Andean Community reforms. The *Club Suizo* group in Colombia, the *techno-troika* (Rodríguez -Naim-Haussman) in Venezuela, the Bolaños-boys in Peru and the HIID-supported technocrats in Bolivia all played key roles in the launching of the reforms in these countries.

External Influences. International financial institutions do play a role, but a much less important one than attributed by the popular media. The multilateral organizations' role is usually confined to the sphere of ideas and technical assistance. Conditionality-based lending has played almost no part in the recent massive move toward reform in the world economy. In the case of the Andean countries, the multilateral s—and especially the World Bank—have played an important role in helping launch the reform process in Colombia (with two important trade liberalization loans in the 1980s), Bolivia (where the Bank supported privatization and educational reform) and Peru.

WHERE DO THE ANDEAN COMMUNITY COUNTRIES STAND IN THE REFORM AGENDA?

For a long time economists have analyzed the connection between economic policies and economic performance. This line of inquiry has been particularly active during the last decade when, as a result of a series of theoretical developments, there was a resurgence of professional interest in growth issues. There is by now mounting evidence suggesting that, all other things given, countries that follow market-oriented policies tend to outperform those with heavy policy distortions. The work of Robert Barro and his associates possibly contains the most extensive empirical results in this area. (See Barro 1997) and the literature cited there; see also Sachs and Warner (1995) and Easterly, Loayza and Montiel (1997) for an analysis of the Latin American economies.) These works have produced evidence indicating that the following policy variables are extremely important determinants of long-run growth: (a) the degree of openness of the economy, (b) macroeconomic stability, (c) efficiency and soundness of the financial sector, (d) the degree of efficiency of the tax system and (e) education policy. These works have also found that the political environment plays an important role in determining long-term growth trends. More importantly, perhaps, these authors have found that the degree to which markets are liberalized also matters. Timid market economies—or what used to be called euphemistically "mixed economies"—do not do as well as countries where the market system is more deeply implemented.

As argued in the preceding section, however, recent analyses have tended to move away from emphasizing exclusively narrow economic variables, and have investigated the role played by institutions in explaining cross-country performance. Work by the World Bank (1997), Rauch (1996) and Edwards (1998), among others, has tended to support the view, for a long time advanced by Douglass North, that institutions play a key role in explaining long-term differences in performance. The World Bank (1997), for example, has found that the degree of credibility of the state—a variable directly related to institutional strength—plays a fundamental role in explaining cross-country differences in growth performance. In Appendix 2A to this chapter, I present new econometric results for a large group of countries—including the Andean Community nations—suggesting that the degree of protection of property rights is the most important (where importance is measured by the standardized beta coefficient) variable explaining cross-country differences in total factor productivity growth over the course of a decade. From a policy point of view, this means that to generate significant and lasting effects, the reform process cannot stop after a few economic policies have been altered or mildly corrected. Successful reformers are, in general those that implement deep economic changes and that also are able to launch the "second generation" institutional reforms.

The purpose of this section is to analyze where the Andean Community stands today in the reform process. I basically ask two related questions: First, how far have the Andean *economic reforms* advanced? I address this question from both a temporal and comparative perspectives. Second, I ask how the countries of the Andean Community stand in terms of *institutional reforms*. In both cases, the emphasis is on recent progress, or the lack thereof, in pushing modernization.

Economic Reforms

There is generalized acknowledgment that most of the Latin American countries experienced tremendous progress in the economic reforms front during the first half of this decade. Trade regimes were opened, financial distortions were eased, currency controls were abolished, some general deregulation was put into place, and a large number of state-owned enterprises were privatized. The pace and intensity of reform varied significantly across countries, however, as did the initial conditions. This positive momentum in the reform sphere during the 1990–94 period has been documented by a number of authors, including the World Bank (1993), Edwards (1995a), the Inter-American Development Bank (IDB) (1996) and Burki and Perry (1997).

In their comprehensive cross-country study on economic policy stance, Gwartney, Lawson and Block (1996) list two Latin American countries—Chile and Costa Rica—among the 15 nations with greater progress in terms of market orientation in the 1975–90 period. They also list four countries in the region—Argentina, the Dominican Republic, El Salvador and Peru—among the 15 that made the most progress between 1990 and 1995.

By early 1996, however, and in spite of the progress made during the first half of the decade, most of the region still faced significant challenges in terms of modernization. Basic economic reforms remained to be implemented or deepened—including fiscal retrenchment leading to stabilization and a substantial reduction in inflation—and most of the institutional reforms had to be initiated.[4] For example, according to Gwartney, Lawson and Block (1996), Chile, which is usually considered to be at the forefront of the Latin American reforms, had a market orientation index of 5.8 (out of 10) in 1995, significantly below the average of the industrial (6.4) and Asian nations (6.2). When alternative, broad, comparative indexes, such as those developed by Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997) are used, a similar picture emerges.

The positive momentum observed in so many Latin American countries—including the members of the Andean Community—during the first half of the decade has recently slowed down significantly. Although there are obvious exceptions—both in terms of countries and areas of the reform process—during the last two years, most countries in Latin America (and in the Andean Community) have made modest headway toward advancing the modernization agenda. This assessment is supported by recent analyses by Lora and Pages (1997) and Burki and Perry (1997). These authors show that almost no country in the region has made progress in trade reform since 1993. Moreover, they show that there has been virtually no forward movement in terms of labor market modernization in the last few years. Interestingly enough, this passivity has taken place at a time when many countries in the world—including in South Asia and Eastern Europe—are taking serious strides toward liberalizing their economies. In the competitive and globalized world of the end of the century, the *relative* inclination toward improving efficiency is becoming particularly important. Those countries that still hesitate in the modernization front are likely to be left behind.

The case of trade policy and protectionism is particularly telling. According to Edwards (1995a) and Burki and Perry (1997) in three of the five Andean Community countries, average import tariffs were higher in 1995

[4] The apparent contradiction between having made major progress and still needing to move forward drastically can be solved, once it is recognized that in the vast majority of the Latin American countries, the initial conditions were characterized by extremely heavy government intervention and distortions. In that context, a country can make significant progress and still be far away from achieving a significant degree of market orientation.

than in 1990–92, as was the degree of dispersion of import duties. And data presented by Lora and Pages (1997) indicate that after tremendous progress between 1987 and 1992–93, the process of trade liberalization has come to a virtual end in Latin America as a whole. In fact, this data shows that the standard deviation of tariffs has increased in the last two years. Of course, this slowdown in the trade reform front would be totally justified if the region had already reached a very high degree of openness. But, is this the case? Not quite. Burki and Perry (1997), for example, show that the Structure-Adjusted Trade Intensity Index in Latin America is still significantly below that of the East Asian newly industrialized countries (NICs).

A similar picture emerges when the financial sector is analyzed. Burki and Perry (1997) construct two alternative indexes of financial sector development: one closely linked to the banking sector and the other to the stock market. Their evidence suggests that in many of the Latin American countries, although still positive, progress in this area has slowed markedly in the recent two years. And, as in the case of trade discussed above, this is not quite a reflection of the fact that the Latin countries have "already made it" in terms of financial liberalization. In fact, it is illustrative to quote what these two senior World Bank officials have to say regarding this sector: "[T]he region in general and even the most advanced Latin American countries lag substantially behind OECD and the newly industrialized Asian countries.... [T]he Latin American average for each banking development indicator was between one-fourth and one-fifth of the corresponding indicator for the Asian NICs (p. 37)."

Fiscal reform provides another interesting perspective to the analysis of the Andean Community's modernization process. Between 1990 and 1993 every country in the area made tremendous progress in reforming its tax system. The implementation of a value added tax system, the harmonization of tax rates and the reductions in tax rate dispersion provide, perhaps, the most vivid indications of this trend. However, very little has happened since then. In most countries tax administration continues to be as inefficient as always—if not worse—and the reliance on highly distortive taxes (including trade taxes) continues to be very high. Burki and Perry (1997), for example, show that trade taxes as a percentage of total tax revenue has remained constant during the last two years and still stands at more than twice the Organisation for Economic Co-operation and Development (OECD) ratio.

Comparing policy stances across countries (and time) is an extremely difficult endeavor, and one that is packed with dangers. For this reason, analyses based on cross-country comparisons should be interpreted carefully and, sometimes, with a grain of salt. From a methodological perspective it is advisable, then, to try to rely on more than one indicator and, if possible, on more than one statistical source to evaluate policymaking. In this chapter I have tried, to the extent possible, to follow this principle. Tables 2.2 through 2.4 contain comparative indicators of the degree of market orientation for 1995 to 1997, for the five Andean countries, for a selected group of other Latin American countries, for some East Asian nations and for a handful of smaller advanced countries. These data provide an international comparative perspective of the Andean Community reforms in the last few years.[5] The indicators presented in these tables range from 0 to 10, with a lower number indicating a higher degree of distortion, and a higher value reflecting a higher degree of market orientation. Table 2.2 deals with overall market orientation and presents the value of the summary indicator, as well as the ranking for the various countries. Tables 2.3 and 2.4, on the other hand, focus on six specific policy areas: trade, taxation, foreign investment restrictions, wage and price distortions, business regulations and the extent of the underground economy (black market).

A number of interesting facts emerge from these tables. First, as can be seen in Table 2.2, in three of the five Andean countries, the overall index was lower—reflecting a lower degree of market orientation—in 1997 than in 1996. Second, the median value of the index for the Andean Community countries is 4.88, substantially lower than the median for the East Asian countries (6.38) and the advanced nations (7.13). Moreover, the highest index for the Andean countries is equal to the lowest index for the East Asian nations. Interestingly enough, when the broader group of Latin American nations is considered, a similar picture emerges: In only four of the ten countries is there progress in 1997 relative to 1996, and the median value for the indicator for the 10 countries is 5.1.[6]

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[5] These indicators were constructed from raw dated obtained from Johnson and Sheehy (1995, 1996) and Holmes, Johnson, and Kirkpatrick (1997).

[6] Note that when a two-year time span is considered, the picture is somewhat brighter. In six of the ten countries, there is some progress in broadly defined market orientation.

Tables 2.2 and 2.3 contain market orientation indexes for six specific economic policies, and tell a story similar to that found in Table 2.1. Only two of the five Andean countries have made trade policy progress in 1997. Interestingly enough, in terms of restrictions on foreign investment, most have already moved significantly in the liberalization arena and are out-indexed only by Hong Kong and Singapore. Table 2.3 shows that although the Andean Community is fairly liberal when it comes to price and wage controls, it still has a long way to go in terms of deregulation, especially in reducing the importance of the underground economy. The information contained in these tables tends to confirm the proposition made above—supported by recent work undertaken both at the World Bank and the IDB—that (a) there has been a slowdown in the reform effort, and (b) in most—although not in all—policy areas, the Andean countries are still far from having reached the level usually identified with the more modern nations in the world. When this demanding benchmark is taken—as I believe it should—there is an unmistakable sense that the region still has a long way to go.

TABLE 2.2. INDEX OF MARKET ORIENTATION (Maximum points: 10)

	1995	**1996**	**1997**
LATIN AMERICA			
Argentina	5.38	5.88	5.88
Bolivia	*4.50*	*5.63*	*5.38*
Brazil	4.25	3.88	4.13
Chile	6.25	6.38	6.88
Colombia	*5.25*	*5.00*	*4.75*
Costa Rica	5.25	5.50	5.50
Ecuador	*4.38*	*4.63*	*4.88*
Mexico	4.88	4.13	4.13
Peru	*4.00*	*5.00*	*5.25*
Venezuela	*5.00*	*3.75*	*3.50*
EAST ASIA			
Hong Kong	9.38	9.38	9.38
Indonesia	4.13	5.38	5.38
Korea, Rep. of	7.13	6.75	6.38
Malaysia	7.13	6.50	6.00
Philippines	4.25	5.25	5.50
Singapore	9.38	9.25	9.25
Thailand	6.75	6.75	6.75
SELECTED DEVELOPED			
Australia	7.00	7.25	7.13
Austria	7.38	7.38	7.13
Canada	7.50	7.50	7.25
Finland	NA	6.75	6.75

Note: the Andean countries are represented in italics

Source: Based on raw data from Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997).

TABLE 2.3. ECONOMIC POLICIES AND MARKET ORIENTATION—I (Maximum points: 10)

	Trade			Taxation			Foreign		
	1995	1996	1997	1995	1996	1997	1995	1996	1997
LATIN AMERICA									
Argentina	2.5	2.5	2.5	3.75	3.75	3.75	7.5	7.5	7.5
Bolivia	*7.5*	*7.5*	*7.5*	*5.0*	*6.25*	*6.25*	*7.5*	*7.5*	*7.5*
Brazil	2.5	2.5	2.5	5.0	3.75	6.25	5.0	5.0	5.0
Chile	2.5	2.5	7.5	5.0	6.3	3.75	7.5	7.5	7.5
Colombia	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	*2.5*	*7.5*	*7.5*	*7.5*
Costa Rica	2.5	2.5	2.5	5.0	5.0	5.0	7.5	7.5	7.5
Ecuador	*2.5*	*2.5*	*5.0*	*6.25*	*6.25*	*6.25*	*7.5*	*7.5*	*7.5*
Mexico	5.0	5.0	5.0	3.75	3.75	3.75	7.5	7.5	7.5
Peru	*0.0*	*2.5*	*5.0*	*5.0*	*5.0*	*5.0*	*7.5*	*7.5*	*7.5*
Venezuela	*2.5*	*2.5*	*2.5*	*5.0*	*2.5*	*2.5*	*5.0*	*5.0*	*5.0*
EAST ASIA									
Hong Kong	10.0	10.0	10.0	8.75	8.75	8.75	10.0	10.0	10.0
Indonesia	0.0	7.5	7.5	3.75	3.75	3.75	5.0	7.5	7.5
Korea, Rep. Of	5.0	7.5	5.0	3.75	2.5	1.25	5.0	5.0	5.0
Malaysia	5.0	5.0	0.0	6.25	5.0	5.0	7.5	5.0	5.0
Philippines	0.0	0.0	0.0	5.0	5.0	5.0	5.0	5.0	5.0
Singapore	10.0	10.0	10.0	6.25	5.0	5.0	10.0	10.0	10.0
Thailand	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
SELECTED DEVELOPED									
Australia	7.5	7.5	7.5	2.5	2.5	1.25	7.5	7.5	7.5
Austria	7.5	7.5	5.0	1.25	1.25	1.25	7.5	7.5	7.5
Canada	7.5	7.5	7.5	2.5	2.5	0.0	5.0	5.0	5.0
Finland	NA	7.5	7.5	NA	2.5	2.5	NA	7.5	7.5

TABLE 2.4. ECONOMIC POLICIES AND MARKET ORIENTATION—II (Maximum points 10)

	Wage/Prices			Regulation			Black Market		
	1995	1996	1997	1995	1996	1997	1995	1996	1997
LATIN AMERICA									
Argentina	7.5	7.5	7.5	7.5	7.5	7.5	5.0	7.5	7.5
Bolivia	*10.0*	*10*	*10.0*	*2.5*	*2.5*	*2.5*	*0.0*	*2.5*	*2.5*
Brazil	5.0	5.0	5.0	2.5	2.5	5.0	5.0	2.5	2.5
Chile	5.0	5.0	7.5	7.5	7.5	7.5	5.0	5.0	5.0
Colombia	*7.5*	*7.5*	*7.5*	*7.5*	*5.0*	*5.0*	*0.0*	*0.0*	*0.0*
Costa Rica	7.5	7.5	7.5	5.0	5.0	5.0	5.0	5.0	5.0
Ecuador	*5.0*	*5.0*	*5.0*	*2.5*	*2.5*	*2.5*	*0.0*	*2.5*	*2.5*
Mexico	5.0	2.5	5.0	2.5	2.5	2.5	5.0	5.0	5.0
Peru	*7.5*	*7.5*	*7.5*	*2.5*	*2.5*	*2.5*	*0.0*	*2.5*	*2.5*
Venezuela	*5.0*	*5.0*	*5.0*	*7.5*	*5.0*	*5.0*	*0.0*	*0.0*	*0.0*
EAST ASIA									
Hong Kong	10.0	7.5	7.5	10.0	10.0	10.0	10.0	10.0	10.0
Indonesia	5.0	5.0	5.0	2.5	2.5	2.5	0.0	0.0	0.0
Korea, Rep. of	7.5	7.5	7.5	5.0	5.0	5.0	7.5	7.5	7.5
Malaysia	7.5	5.0	5.0	7.5	7.5	7.5	7.5	7.5	7.5
Philippines	7.5	7.5	7.5	2.5	2.5	5.0	0.0	2.5	2.5
Singapore	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0	10.0
Thailand	5.0	5.0	5.0	5.0	5.0	5.0	7.5	7.5	7.5
SELECTED DEVELOPED									
Australia	7.5	7.5	7.5	5.0	5.0	5.0	7.5	7.5	7.5
Austria	7.5	7.5	7.5	5.0	5.0	5.0	10.0	10.0	10.0
Canada	7.5	7.5	7.5	7.5	7.5	7.5	10.0	10.0	10.0
Finland	NA	5.0	5.0	NA	2.5	5.0	NA	10.0	10.0

Note: Andean countries represented in italics *Source for Tables 2.3 and 2.4:* Based on Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997).

The analysis presented above may lead some readers to believe that in the last few years the Andean countries have made no progress *whatsoever* in reform. This, of course, would be an extreme and incorrect conclusion. Naturally, the fact that the reform effort has slowed down significantly—as suggested by the above discussion and by the indicators in Tables 2.2 and 2.3—does not mean that there have been no advances. Many countries continue to pursue privatization and/or are now allowing private sector participation in areas that until recently were reserved for the state—the case of oil exploration in Venezuela, electric utilities privatization in Colombia and mining concerns in Peru are important in this regard. Also, in some countries, such as Colombia, there has been an effort to develop a framework for allowing private sector involvement in infrastructure provision. The capitalization-privatization program in Bolivia has attracted considerable attention throughout the world. In a number of countries in Latin America, there has also been a clear recognition of a looming social security crisis, and of the need for reform in the pension system. For every step forward, though, one can find some backtracking. For every modernization measure, one can find some decision that moves the countries back toward regulation and control. The rules governing the *Fondo de Regalías del Petróleo* in Colombia, the completely out-of-line salary increases granted to public sector workers in Venezuela, the competition restrictions in cellular telephones in Colombia, the restrictions to entry into the Chilean banking sector, the change of heart toward labor reform in Argentina and the imposition of import finance restrictions in Brazil, just to give a few examples, are all signs of weaknesses in the reform process.

Institutional Reforms

One of the main themes of this chapter has been that *institutions matter*. Tables 2.5 through 2.8 present comparative data for the same group of countries, but different time frames on the strength of a number of state institutions. As in the preceding tables, these indexes rank from 0 to 10, with higher numbers reflecting stronger institutions. The indexes in Tables 2.5 to 2.7 have been constructed from raw data compiled by the IBC International Country Risk Guide, while those in Table 2.8 are from Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997). Table 2.5 provides an index on the quality of the judiciary and the countries' tradition of law and order. Table 2.6 concentrates on the prevalence of corruption in government, with a higher number meaning a more transparent—and thus less corrupt—system. Table 2.7 summarizes the quality of the national bureaucracy; again, a higher number reflects a stronger institution. Finally, Table 2.8 presents an index on the degree of protection of property rights taken from Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997).

I first concentrate on Tables 2.5, 2.6 and 2.7. The picture that emerges from these tables is rather frightening. The Andean countries appear to have some of the weakest—and continually deteriorating—set of institutions in the sample. The medians for the Andean Community are in every case significantly below those of the East Asian or advanced nations. Moreover, when 1997 is compared with 1994, there has been progress in only 1 out of 15 indicators (3 institutions for each of the 5 Andean countries). These marks reflect, among other things, the inefficiency of the region's civil service, its legendary ineffectiveness and its well-known corruption. It also captures the Kafkaesque nature of the region's judicial system, with trials that go on for ages, defendants that are held in prison for years without being brought to trial, and judges that are appointed (or removed, for that matter) in a discretionary fashion by the executive committee. This, of course, is not good news and reflects the tremendous challenge that these countries will face in the years to come. The reform effort should not only be devoted to accelerating, perfecting and deepening economic reforms, but also (and more importantly) to the gigantic task of recreating the institutions of the state. The magnitude of the challenge should not be underestimated; its urgency cannot be emphasized sufficiently.

I now turn to Table 2.8, which contains summary statistics on the extent to which institutions protect property rights. The picture emerging here, once more, is troublesome. No Andean country appears to have experienced institutional strengthening between 1995 and 1997, and two of them—Peru and Ecuador—show deterioration. Moreover, the median for the Andean countries is 5, while for the East Asian nations and the smaller advanced nations in the table, the median is 10. In Appendix 2A of this chapter, I use this property rights indicator in an empirical cross-country analysis on the determination of productivity growth. I find that, after controlling for other variables, this indicator plays a fundamentally important role in explaining productivity growth differentials.

TABLE 2.5. QUALITY OF THE JUDICIARY (Maximum points: 10)

	1990	1994	1997
LATIN AMERICA			
Argentina	4	8	8
Bolivia	*0*	*2*	*4*
Brazil	6	4	4
Chile	6	8	8
Colombia	*0*	*2*	*2*
Costa Rica	6	6	6
Ecuador	*6*	*6*	*6*
Mexico	4	4	4
Peru	*0*	*4*	*4*
Venezuela	*6*	*6*	*6*
EAST ASIA			
Hong Kong	6	10	8
Indonesia	2	6	6
Korea, Rep. of	2	8	6
Malaysia	4	8	8
Philippines	0	6	6
Singapore	8	10	10
Thailand	6	8	8
SELECTED DEVELOPED			
Australia	10	10	10
Austria	10	10	10
Canada	10	10	10
Finland	10	10	10

TABLE 2.6. DEGREE OF TRANSPARENCY (NONCORRUPTION) IN GOVERNMENT (Maximum points: 10)

	1990	1994	1997
LATIN AMERICA			
Argentina	6	4	2
Bolivia	*2*	*4*	*4*
Brazil	6	4	4
Chile	4	4	6
Colombia	*4*	*4*	*2*
Costa Rica	8	8	8
Ecuador	*4*	*4*	*4*
Mexico	4	4	2
Peru	*4*	*4*	*4*
Venezuela	*4*	*4*	*4*
EAST ASIA			
Hong Kong	8	8	8
Indonesia	—	4	2
Korea, Rep. of	2	8	6
Malaysia	6	6	6
Philippines	2	4	4
Singapore	6	6	6
Thailand	4	4	4
SELECTED DEVELOPED			
Australia	8	8	8
Austria	8	8	6
Canada	10	10	10
Finland	10	10	10

Note: the Andean countries are represented in italics

Source for Tables 2.5 and 2.6: Based on raw data from IBC International Country Risk Guide.

TABLE 2.7. QUALITY OF CIVIL SERVICE AND BUREAUCRACY (Maximum points: 10)

	1990	1994	1997
LATIN AMERICA			
Argentina	4	4	4
Bolivia	*0*	*2*	*2*
Brazil	6	6	6
Chile	4	4	6
Colombia	*6*	*6*	*2*
Costa Rica	4	4	4
Ecuador	*4*	*4*	*4*
Mexico	4	4	4
Peru	*2*	*2*	*2*
Venezuela	*4*	*4*	*4*
EAST ASIA			
Hong Kong	4	6	8
Indonesia	0	4	4
Korea, Rep. of	6	8	8
Malaysia	4	4	6
Philippines	0	2	4
Singapore	8	8	8
Thailand	8	8	6
SELECTED DEVELOPED			
Australia	10	10	10
Austria	10	10	10
Canada	10	10	10
Finland	10	10	8

Note: the Andean countries are represented in italics

Source: Based on raw data from IBC International Country Risk Guide.

TABLE 2.8. DEGREE OF PROTECTION OF PROPERTY RIGHTS (Maximum points: 10)

	1995	1996	1997
Latin America			
Argentina	7.5	7.5	7.5
Bolivia	*5.0*	*5.0*	5.0
Brazil	5.0	5.0	5.0
Chile	10.0	10.0	10.0
Colombia	*5.0*	*5.0*	*5.0*
Costa Rica	5.0	5.0	5.0
Ecuador	*5.0*	*5.0*	*2.5*
Mexico	7.5	5.0	5.0
Peru	*5.0*	*5.0*	*2.5*
Venezuela	*5.0*	*5.0*	*5.0*
East Asia			
Hong Kong	10.0	10.0	10.0
Indonesia	5.0	5.0	5.0
Korea, Rep. of	10.0	10.0	10.0
Malaysia	7.5	7.5	7.5
Philippines	5.0	7.5	7.5
Singapore	10.0	10.0	10.0
Thailand	10.0	10.0	10.0
Selected Developed			
Australia	10.0	10.0	10.0
Austria	10.0	10.0	10.0
Canada	10.0	10.0	10.0
Finland	NA	10.0	10.0

Note: the Andean countries are represented in italics

Source: Based on raw data from Johnson and Sheehy (1995, 1996) and Holmes, Johnson and Kirkpatrick (1997).

CONCLUSIONS

This chapter has dealt with the current state of the market-oriented reforms in the member countries of the Andean Community. It was argued that in order to evaluate the reform process in any country, it is convenient to focus on both the dynamics of transformation, as well as on the political economy of reform. The section on Economic and Institutional Reforms and the Political Economy of Transformation in this chapter addressed these issues from a general perspective. One of the most important points made in that section is that the implied sequencing between economic ("first generation") and institutional ("second generation") reforms may be costly. The postponement of institutional modernization will hold productivity growth down and may generate an unsustainable political economic situation.

In the section on Where Do the Andean Community Countries Stand in the Reform Agenda? both of these broadly defined reforms were evaluated in the case of five countries in the Andean Community. I presented evidence that suggests quite strongly that in most of the Andean countries economic reforms have slowed down significantly during the last few years and that there has been, in fact, some retrogression in the institutional reforms front.

One of the major concerns about accelerating market-oriented reforms refers to the potential negative effects on social conditions and income distribution. Four points are worth making here: First, most existing empirical evidence suggests that more open economies have (all else equal) a more even income distribution, and that market reform (including trade opening) has no direct effects—either positive or negative—on distribution. In fact, to the extent that the labor market is truly flexible, the distributive effects of the reforms will be positive. Second, market reform does generate losers and winners. Losers are usually highly vocal groups that will do all they can to stop and reverse the reforms. The efficient implementation of compensation mechanisms will often diffuse some of the opposition to reform. Third, targeted safety nets will ease the transitional effects of the reform process. Finally, improving the efficiency of public services delivery—a fundamental result of successful institutional reform—should also improve the distributive effects of the reform process. All of this, then, suggests that if implemented correctly, market-oriented reforms can indeed result in higher growth, better overall performance and improved social conditions. Attaining this desirable combination, of course, is not easy.

APPENDIX 2A: REFORMS, INSTITUTIONS AND INNOVATIONS

Are institutions truly important in explaining historical cross-country differentials in economic performance? Or are they part of an intellectually plausible story with little empirical support? In this appendix I use a new data set on total factor productivity to investigate the relationship between trade openness—arguably one of the most (if not the most) important component of the reform agenda—and institutions, politics, and innovations. If institutions play the role ascribed to them in the body of this chapter, with other things given, countries with a higher level of institutional strength would be expected to exhibit a faster rate of total factor productivity growth.

DATA

Ten-year averages of total factor productivity (TFP) growth were constructed for 93 advanced and developing countries—see the appendix for the list. The starting point was the estimation of a random effect growth equation using panel data for 1960–90. The raw data on total physical capital, human capital and real gross domestic product (GDP) were taken from Nehru and Dhareshwar (1993). The following equation was estimated using a panel data set of 3,555 observations:

$$g_{j\,t} = \alpha \mathrm{dlog}\, K_{j\,t} + \beta \mathrm{dlog}\, L_{j\,t} + \lambda + \zeta_j + \varepsilon_t + \xi_{jt}, \qquad \textbf{(2.1)}$$

where ζ, ε and ξ are a country-specific, time-specific and common i.i.d error terms, and λ is a common fixed effect term. $\alpha + \beta$ were restricted to add up to one. The estimated factor shares were then used to construct yearly estimates of TFP growth. Finally, these were averaged to construct decade-long estimates of TFP growth. A 1960–90 average was also constructed. In addition to equation (2.1), a growth equation that included human capital as an additional regressor was estimated. These estimates were used to construct a second set of TFP growth series, called TFPH. These two TFP growth variables behave very similarly—a regression of average TFP on average TFPH for the complete 1960–90 period yielded a slope coefficient of 0.93 with a standard error of 0.04.

Two batteries of consistency checks suggest that these new estimates of TFP growth are “reasonable.” First, correlation coefficients between these new indexes and those calculated by Nehru and Dhareshwar (1994) and Fischer (1993) were high (between 0.77 and 0.91). And second, the orders of magnitude of the new TFP growth estimates for a number of randomly selected countries correspond approximately to what has been calculated by other authors. Cook’s (1977) distance statistic, however, indicated that Iraq was a gross outlier, with an estimated average rate of TFP growth of -13 percent in the 1980s. After removing Iraq from the sample, the number of observations was 92 countries. Table 2A.1 contains summary statistics for the new estimates of average TFP growth for 1960–90 and the 1980s. As may be seen, during the 1980s there was a productivity slowdown; moreover, the variability of TFP growth across countries (measured by the standard deviation) increased greatly during this decade.[7]

These data on TFP growth are used in a cross-country regression analysis in an effort to understand the role played by different variables in explaining productivity growth differentials.

TABLE 2A.1. NEW TFP GROWTH ESTIMATES: SUMMARY STATISTICS

	TFP 1960–90	TFPH 1960–90	TFP 1980–90	TFPH 1980–90
First quartile	0.004	0.004	-0.007	-0.008
Median	0.011	0.010	0.008	0.007
Third quartile	0.018	0.018	0.016	0.015
Average	0.009	0.009	0.003	0.003
Standard deviation	0.013	0.012	0.026	0.022

Source: Text.

The following regressors were used: initial level of development, education, degree of trade distortions, property right protection, political instability and property right protection. A more detailed explanation of these regressors follows.

Initial Level of Development. The log of initial GDP per capita (GDP65), obtained from Summers and Heston was used. This variable captures the existence of TFP convergence, and its coefficient is expected to be negative.

Human Capital. Initial level of human capital. This variable, measured as the mean number of years of education in 1965, captures the view that countries with a more developed educational system have a greater ability to innovate and absorb new ideas. These data were taken from Barro and Lee (1995).

Degree of Trade Distortions. This index was taken from Sachs and Warner (1995) and measures the extent to which policy keeps a country isolated from the rest of the world. By and large, this index is a good summary indicator of the overall extent of economic reforms. (When alternative indexes, such as the one developed by the Heritage Foundation, were used, similar results were obtained.)

Institutions. As pointed out in the text of this chapter, North (1990), among others, has argued that institutions are important determinants of entrepreneurship and growth. Institutions that lower transaction costs allow individuals to devote more time to productive pursuits instead of protecting their interests from the rapacity of others. Property rights protection is, perhaps, the most important among these institutions. I explored its role by including a comparative index of property rights protection calculated from the data provided by Johnson and Sheehy (1995) in the regressions. This index (PROPERTY) captures the extent to which the legislation and the judiciary guarantee and protect property rights; the index can take values from 0 to 10, with lower numbers reflecting a more tenuous degree of protection.

Political Instability. Societies subject to a greater degree of political upheaval are more volatile and tend to discourage investment in innovation and productivity enhancements (Barro 1996). I used a series of proxies to investigate the extent to which the political system affects TFP growth. The results reported in this section were obtained when the average number of politically motivated attacks during the 1980s was included. This variable was called POLINST.

Macroeconomic Instability. A number of authors have argued that greater macroeconomic instability—and in particular, higher inflation rates—tends to affect economic performance negatively (Fischer 1993). The theoretical work on the subject, however, has not specifically focused on TFP growth. This means that, in a way,

[7]These new TFP growth estimates can provide some additional light on the recent debate on the role of productivity improvements in the East Asian "miracle" countries. See Harberger (1996), Krugman (1994) and Young (1995). The new estimates suggest that while the TFP growth of Taiwan (China) has been very high, that of the Republic of Korea and Singapore has been more mediocre.

the question of how inflation affects productivity growth is still somewhat open. In this chapter I investigated this issue by introducing an estimate of inflation tax revenues as a percentage of GDP into the regression analysis.

The following equation is representative of the results obtained when these additional variables were introduced into the regression analysis.[8]

$$\text{TFP GROWTH} = \underset{(1.9)}{0.05} - \underset{(-1.9)}{0.007}\ \text{GDP65} + \underset{(1.7)}{0.002}\ \text{HUMAN65} + \underset{(2.4)}{0.08}\ \text{OPEN} \qquad \textbf{(2.2)}$$

$$- \underset{(-2.0)}{0.006}\ \text{PROPERTY} - \underset{(-1.5)}{0.012}\ \text{POLINST} - \underset{(-0.4)}{0.001}\ \text{INFTAX}$$

$$N=39;\ R^2 = 0.56.$$

These results are quite interesting. First, the coefficients of the basic and standard variables—initial GDP, human capital and trade distortions—are significant at conventional levels and have the expected signs. It is particularly important to note that the idea of a positive relationship between openness and productivity growth is supported by this regression. Second, the strength of institutions, summarized by the index on the protection of property rights, plays an important role in explaining cross-country differences in TFP growth. The standardized beta for PROPERTY is 0.4, higher than that for the openness variables. Third, the inflation tax does not appear to have affected TFP growth significantly.

[8] The complete set of regressions is not reported because of space considerations. Overall, however, they continued to support the idea that more open economies experience a faster rate of productivity growth. The complete set is available on request.

APPENDIX 2B: RECENT ECONOMIC PERFORMANCE IN THE ANDEAN PACT COUNTRIES

This appendix contains a series of tables summarizing the recent behavior of some key macroeconomic variables in the five Andean Pact countries – Bolivia, Colombia, Ecuador, Peru and Venezuela. In also lists data for a small group of other Latin American nations. Also diagrams on real exchange rate behavior are presented.

TABLE 2B.1. REAL GDP GROWTH RATE (percent)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	0.4	5.1	4.4	6.0
Bolivia	2.3	3.9	4.0	4.5
Brazil	2.0	2.8	2.9	4.0
Chile	6.5	7.4	7.2	7.0
Colombia	4.6	4.1	2.1	3.5
Costa Rica	4.6	3.9	0.0	2.0
Ecuador	2.1	3.2	2.0	2.6
Mexico	1.5	1.8	5.1	4.4
Peru	-0.8	5.1	2.8	4.0
Venezuela	2.8	2.5	-0.5	3.5

Source: World Bank.

TABLE 2B.2. INFLATION RATE (percent)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	1192.7	35.8	0.2	2.5
Bolivia	68.0	11.7	10.2	6.5
Brazil	1056.9	1061.0	18.2	8.5
Chile	19.4	12.8	7.4	7.0
Colombia	25.0	24.0	20.8	20.0
Costa Rica	17.0	19.1	17.5	12.5
Ecuador	47.0	37.1	24.4	31.0
Mexico	75.7	21.6	39.0	21.0
Peru	2341.4	96.3	11.6	7.1
Venezuela	38.9	54.1	99.9	40.0

Source: World Bank.

TABLE 2B.3. NONFINANCIAL PUBLIC SECTOR BALANCE (percent of GDP)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	-6.4	-1.8	-3.2	-2.9
Bolivia	-6.3	-3.8	-2.0	-1.9
Brazil	-3.9	-1.5	-4.8	-3.9
Chile	1.9	2.2	3.4	0.7
Colombia	-1.1	-1.0	-1.2	-2.6
Costa Rica	-1.6	-3.3	-3.8	-5.5
Ecuador	-4.6	-1.5	-1.3	-3.0
Mexico	-10.6	0.1	0.0	-0.7
Peru	-7.7	-2.2	-2.7	-1.2
Venezuela	-3.9	-4.2	-8.2	7.6

Source: World Bank.

Table 2B.4. Current Account Balance (PERCENT OF GDP)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	-1.6	-2.5	-2.0	-2.5
Bolivia	-7.5	-6.5	-6.6	-9.9
Brazil	-0.4	-0.8	-3.2	-3.8
Chile	-3.1	-1.8	-3.7	-4.0
Colombia	0.5	-2.0	-5.5	-5.3
Costa Rica	-7.3	-3.7	-1.6	-1.6
Ecuador	-6.8	-3.9	-1.9	-2.4
Mexico	-1.0	-4.4	-0.5	-1.4
Peru	-6.0	-5.2	-5.8	-5.3
Venezuela	1.1	1.4	7.2	5.7

Source: World Bank.

TABLE 2B.5. GROSS NATIONAL SAVINGS (percent of GDP)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	15.4	15.2	16.9	16.5
Bolivia	3.8	8.3	10.9	8.4
Brazil	21.7	19.5	19.2	16.3
Chile	20.0	25.2	27.6	24.0
Colombia	20.2	19.0	18.1	17.9
Costa Rica	18.8	22.9	23.2	21.9
Ecuador	13.8	15.9	14.6	15.0
Mexico	19.6	17.5	19.1	20.4
Peru	14.2	15.1	17.0	17.7
Venezuela	20.4	19.4	18.9	25.2

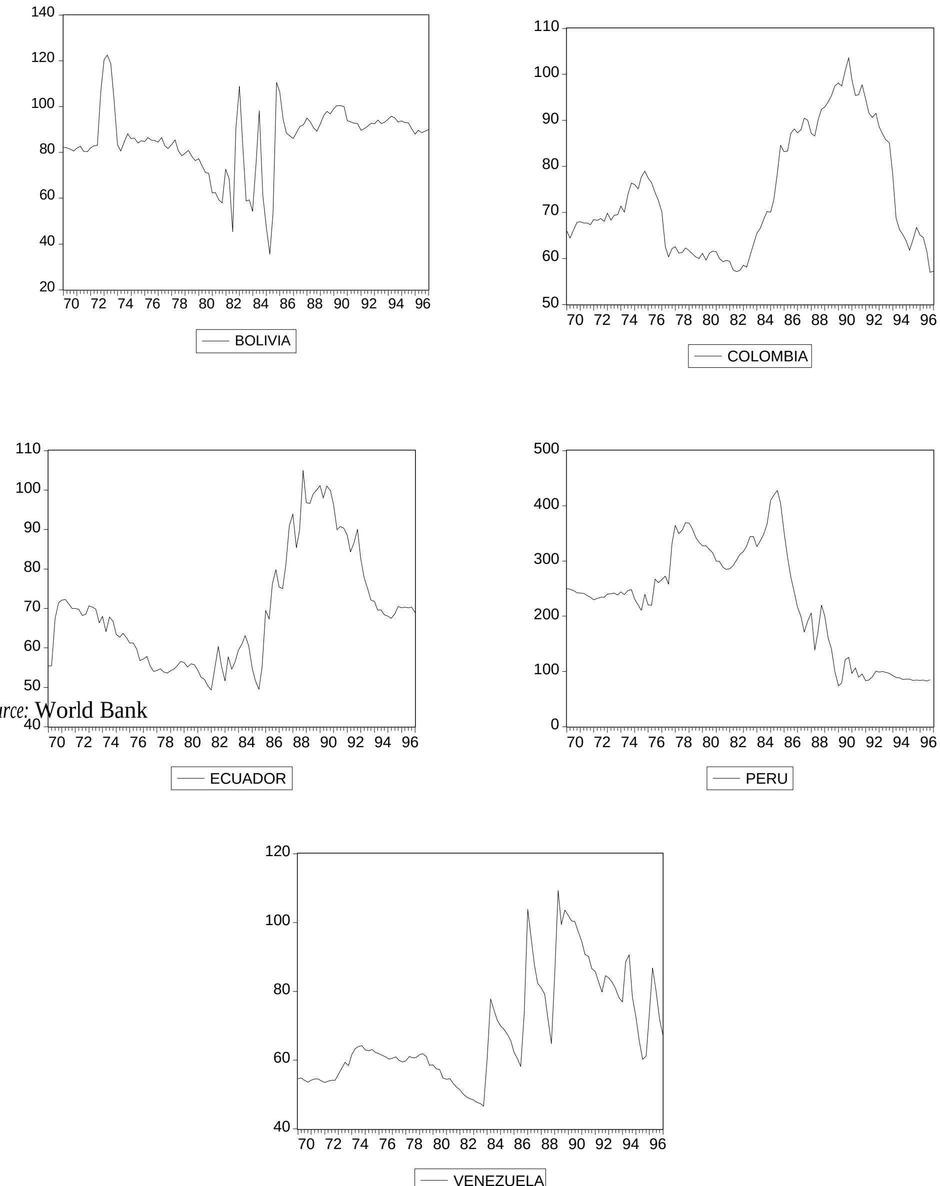
Source: World Bank.

TABLE 2B.6. RATE OF UNEMPLOYMENT (percent)

	Average			
	1986–90	**1991–96**	**1996**	**1997**
Argentina	6.5	11.6	17.5	17.2
Bolivia	8.3	4.5	3.6	3.5
Brazil	3.8	5.2	4.6	5.4
Chile	9.8	7.2	7.4	6.5
Colombia	11.5	9.7	8.8	11.3
Costa Rica	5.5	4.9	5.7	NA
Ecuador	9.1	8.2	7.7	NA
Mexico	3.5	4.1	6.3	5.6
Peru	6.7	8.3	7.1	8.7
Venezuela	9.8	9.2	10.9	11.9

Source: World Bank.

FIGURE 2B.1: REAL EXCHANGE RATES IN THE ANDEAN COMMUNITY COUNTRIES



Source: World Bank

Source: World Bank

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