chapter 9

Markets and the macroeconomy

Achieving more equal access to markets is fundamental to greater equity within societies as well as to moving countries onto dynamic growth paths, thus enhancing global equity. And both equity and growth are best served by prudent macropolicy (allowing for its countercyclical role). This chapter is organized around the three markets for capital, labor, and goods (land was covered in chapter 8) and the macroeconomy, exploring in each domain the potential and options for leveling the economic playing field and strengthening voice and accountability.

How markets relate to equity

Issues of design of market-related reforms and macroeconomic policy are often allocated to ministries of finance, macro- and trade economists, financial specialists, and the like. By contrast, policies for equity, including those for managing the consequences of market conditions and macroconditions, are typically considered the domain of the providers of schools, health centers, rural roads, safety nets, and justice systems. This division of labor is profoundly incorrect. The first set of policy domains is as important for equity as the second.

The main issue is access. The playing field is typically far from level in the workings of markets. Barriers are intrinsically inequitable when they privilege insiders' access to capital, good jobs, and favored product markets. But they are also bad for the innovation and investment that lie at the heart of modern economic growth. That is why leveling the playing field has the potential to be both more equitable and more efficient. It is also why broadening access typically requires more economic competition and more political accountability.

There are two broad categories of pathology that make the playing field uneven (see table 9.1). The first pathology arises when the influence of powerful political and economic elites is bad for equity and typically bad for growth—whether this takes the form of outright predation by political elites or excessive influence of economic elites in the shaping of policies and institutions, as under "oligarchic capitalism." As we read in chapter 6, Mexico's financial system through much of the country's history provides an example of elite capture—a protected, relational, incumbent-oriented financial system.

The second pathology arises when policy efforts to control or manage markets are directed, at least notionally, to improve equity, but with high costs for efficiency, and are often captured by middle groups (or indeed elites) in ways that harm the poor. This had its extreme manifestation in communist economic policy, but it is also prevalent in societies in which markets play a large role. Another example is when protection for formal sector workers, while bringing valued benefits to some, slows processes of restructuring and job creation for other workers. Both pathologies, but especially the first, reflect Adam Smith's concern that the influential may shape markets to serve the interests of incumbents. As he said, "People of the same trade seldom meet together, even for merriment and diversion, but the conversation ends in a conspiracy against the public, or in some contrivance to raise prices."[1]

The main purpose of this chapter is not to diagnose from where such pathologies came but to explore possibilities for change that are feasible within the prevailing political, sociocultural, and economic context. Casual observation suggests that change is

Table 9.1 Two pathologies in the interaction between equity and growth

Domain	Policy capture by powerful elites	Ill-designed attempts at equity with large inefficiencies
Financial markets	Protected, relational, incumbent-oriented financial system in Mexico for much of its history	Directed subsidized credit in India and elsewhere, with dismal repayment largely from better-off farmers
Labor markets	Repressive labor market conditions in the predemocratic Republic of Korea	Excessive protection of formal sector insiders in the middle of the distribution—India, South Africa
Product markets	Clove and timber monopolies in Indonesia	Protection for inefficient agricultural food production (Philippines) and industry (Morocco) before trade liberalization
Macroeconomic management	Regressive resolution of macroeconomic crises in Latin America and Indonesia	Populist macroeconomic policies (Peru under García) that fuel future (regressive) crises

possible. The Mexican financial system has been reformed after the 1995 Tequila Crisis. Moroccan industry was (partially) disprotected. And many countries no longer pursue populist macropolicy, especially after they experienced its ill effects.

Reducing barriers to market access will often bring initial benefits, or redistributions, not to the poorest but to middle groups. There may even be temporary rises in inequalities in parts of the income distribution, for example when there are increases in returns to skills. This is desirable for efficiency and consistent with equity if institutions allow households and individuals to respond to the new incentives, and there are safety nets to manage those who are hurt. It is undesirable, however, if it creates new possibilities for middle groups to "hoard opportunities" at the cost of future growth and gains for the poor.[2]

Design choices will depend on the market and local context, including the political context, but two cross-cutting issues are worth highlighting. First, there is often an apparent paradox: when systems are shaped to favor those with influence and connection, economic liberalization should be good for equity; however, that is not always the case. Liberalization can also be captured by the powerful, perpetuating inequitable and inefficient economic structures—and risking political and social backlash to market-oriented reforms. This is why liberalization needs to be designed in ways that promote genuine competition and effective accountability structures, whether in the form of regulation, transparency, or other forms of societal control, and sequenced properly.

Second, while greater equity can be complementary to long-run prosperity, the second pathology vividly shows the potential for inefficient choices in the name of equity. Tradeoffs between equity and efficiency exist. And even when there are aggregate gains, protected incumbents will be losers, at least in the short to medium term (in economists' jargon, changes will often not be Pareto-improving). Whether societies choose to compensate losers is a matter of social welfare (especially if they are poor) and political economy (especially if they are not poor).

We now turn to the three markets for capital, labor, and goods and the macroeconomy, exploring in each domain the potential and options for broadening access and strengthening accountability. Box 9.1 illustrates some of the interactions among equity, inequality, and growth in China.

Achieving equity and efficiency in financial markets

The performance of enterprises drives economic growth. An innovative and dynamic enterprise sector requires low barriers to entry, effective guarantees for property rights, and access to finance. We focus on the latter here. Unequal access to finance is associated with reduced productive opportunities and reflects unequal influence. Financial market liberalization can increase access, but it can also be captured. Sound technical design and strengthened accountability can help expand access while reducing both the risk of capture and disincentives to broader lending, thus enhancing opportunities.

BOX 9.1 *Markets and development: policy, equity, and social welfare in China*

China looms large in any attempt to interpret development, especially the role of equity in development processes. Hasn't it moved from a highly equitable form of communism to extensive use of domestic and international markets? And didn't this lead to both rising income inequality and the most extraordinary pace and scale of reduction in poverty and expansion in social welfare in history? This looks, at first glance, like a brute fact refutation of a central message of this report: that equity can lay the basis for prosperous development.

An account along these lines misreads change in China in important ways: many of the changes were equity-enhancing in the sense of leading to expansion of opportunities of the bulk of the population (chapter 6 discussed the institutional underpinnings of these changes). Consider some of the major shifts in Chinese policy that the literature interprets as having driven growth and income poverty: the institutional shift to the household responsibility system allowing peasants to produce for themselves (1979 and early 1980s), the expansion of township and village enterprises (TVEs) and the massive indirect effects of opening to international trade (whole period), the opening to inward foreign direct investment (especially in the 1990s), and the huge internal migration flows. All these led to major expansions in opportunity (and were major sources of growth) for large segments of the population. Rural reform quickly expanded opportunities for most peasants. TVEs were broadly dispersed. While the effects of international opening were concentrated initially in coastal areas, they have broadened in scope, both through the indirect effects of migration and the relocation of industries inland.

By contrast, where investment has been linked to connections and corruption, it is clearly inequitable, in the sense of lacking fair process and equality of opportunity to all potential investors. In the long term, introducing fairer and more transparent process will be important to sustained growth.

There were periods in which policy-related shifts (such as selective opening, the pricing of foodgrains, tighter controls on internal migration, and access to urban jobs) were associated with biases either against inner provinces of China or against rural areas. These were factors behind the rise in inequality in outcomes and stagnating income poverty between the late 1980s and early 1990s. This was probably inequitable in terms of rising inequality of opportunity. For these cases there may have been some tradeoff, but few observers argue that such policy-induced biases were essential to Chinese growth, in contrast to the overall institutional change and opening.

Moreover, even using the much narrower lens of income inequality, the periods when inequality fell (notably the early 1980s and the mid-1990s) actually had the highest growth rates, not the lowest. And the provinces where rural inequality rose the least had the highest growth rates.

There are rising concerns in China over the adverse consequences for development of growing inequality, including in some areas of social provisioning (in health, for example), and concentrations of wealth through connections. But there is no evidence that these brought benefits in income growth, the issue of concern here, and most observers (and the Chinese government) would see this as an area in which policy could be improved.

Sources: Ravallion and Chen (2004), World Bank (1997b).

Unequal access to finance is associated with unequal productive opportunities and reflects unequal influence

As discussed in chapter 5, the access to financial services and their cost are unequally distributed, especially in developing countries. Many firms and households complain that the right financial services are not provided, that procedures for opening an account or getting a loan are too cumbersome and costly (with high rejection rates), and that financial institutions demand collateral, which (poorer) borrowers typically lack.

Financial institutions respond that they cannot provide services profitably for technical and economic reasons. Poorer groups have small savings, and seek small loans and insurance (life, health, crop), which are hard to provide. Smaller clients borrow frequently and repay in small installments, making serving their needs very costly. And the underserved are new and not experienced in business, making them poor credit risks. But such reasons form only part of the story. The microcredit movement and large banks, such as Bank Rakyat Indonesia and ICICI Bank in India, show that it is possible to provide financial services profitably to poorer customers and small firms. Access is also unequal in areas of finance in which enforcement is not as much of a concern—such as deposit-taking.

Inequalities in access are also, in part, a product of unequal influence. Incumbents who benefit from restricted patterns of finance may lobby to limit access to finance, or erect other barriers to protect the rents of established firms. Barriers to entrepreneurial activity are indeed generally more onerous in poorer, more corrupt, and more unequal countries.[3] Weak property rights are part of the problem. But weak property rights can be the outcome of political economy forces—economic elites have an interest in the selective protection of property rights, because they stand to gain more when security of contracts and property depends on their position, connections, and wealth.[4]

We are primarily concerned here with the first pathology mentioned earlier, namely the influence of economic elites on the shaping of financial systems. In many countries, a small number of wealthy families or groups exert extensive control over the corporate sector, notably through control pyramids in which cross-shareholdings lead to dominant control rights in extensive parts of the corporate sector, often substantially in excess of the share of capital owned. These wealthy families are typically linked to political elites through economic deals, family connections, and shared social and

Table 9.2 Financial policy and institutions are often captured by the few: case study evidence

Country	Evidence
Brazil	Public financial institutions in Brazil appear to have served larger firms more than private banks have (Kumar 2005).
Chile	Following liberalization in the late 1970s, many privatizations of state-owned banks went to groups of insiders (Larrain 1989).
Czech Republic	Mass privatization in the Czech Republic delayed the establishment of a securities and exchange commission, facilitating tunneling (stealing assets by channeling to another firm owned by insiders) (Cull, Matesova, and Shirley 2002).
Indonesia	Market attributes large financial value for political connections, suggesting politics rather than economics determined access or rents (Fisman 2001b).
France, pre-1985	Banks, protected and dependent on government support, lend to less productive firms (Bertrand, Schoar, and Thesmar 2004).
Korea, Rep. of	The opening up of new segments of financial services provision was dominated by insiders. Increasing openness primarily expanded and strengthened the politically most connected firms (Haggard, Lim, and Kim 2003, Siegel 2003).
Malaysia	The imposition of capital controls in September 1998 primarily benefited firms with ties to Prime Minister Mahathir (Johnson and Mitton 2003).
Mexico late 1800s	There was capture of the financial sector in Mexico in the late 1800s blocking entry in emerging industries (Haber, Noel, and Razo 2003).
Mexico early 1990s	Lending to connected interests in the early 1990s was prevalent (20 percent of commercial loans) and took place on better terms than arms' length lending (annual interest rates were 4 percentage points lower). Related loans were 33 percent more likely to default and had lower recovery rates (30 percent less) than unrelated ones (La Porta, López-de-Silanes, and Zamarripa 2002).
Pakistan	Insider activities have significant economic costs. Politically connected firms borrowed twice as much from government banks and had 50 percent higher default rates between 1996 and 2002, with economywide costs of rent-seeking estimated to be 0.3 percent to 1.9 percent of GDP per year. Brokers trading on their own behalf earned annual rates of return 50–90 percentage points higher than those earned by outside investors. Hence, price manipulation by intermediaries helps keep equity markets marginal with few outsiders investing and little capital raised (Khwaja and Mian 2004, 2004b).
Russian Federation	Russia's free-for-all banking entry, combined with its choice of a universal banking system, gave great discretion to insiders to conduct asset stripping through the loan-for-shares scheme. The weak political accountability could not stop the capture of state resources or protected rents (Perotti 2002, Black, Kraakman, and Tassarova 2000).
Thailand	Connected lending was large before the 1997 crisis and firms with connections to banks and politicians had greater access to long-term debt (Wiwattanakantang, Kali, and Charumilind forthcoming).
United States, early 1800s	New bank licenses went largely to insiders in New York state (Haber 2004).
Ghana, Kenya, Tanzania, Zambia, and Zimbabwe	Firms that have an owner of Asian or European descent have a 0.34 higher probability of obtaining credit from suppliers (Fisman 2003).

cultural capital. Examples include the Mexican banking system, until the reforms of the second half of the 1990s, and the concentrated wealth and close connections between economic and political elites in East Asia (figure 2.8).[5]

Concentrated corporate control and wealth should be a concern if it leads to biases in access toward the influential and, even more, if it is associated with reduced innovation and dynamism. Reduced innovation can occur through direct restrictions on opportunity and the indirect effects of weaker property rights. Cross-country evidence suggests that there is a relationship. Countries with more self-made billionaires tend to grow faster, whereas those with more hereditary billionaires grow more slowly, suggesting costs of dynastic family control over economies. Societies with greater family control over the corporate sector also grow more slowly.[6]

More compelling evidence on the links between unequal power and financial sector distortions comes from case study material, from the historical experience of now-developed societies, and from contemporary developing countries.[7] Table 9.2 provides a selective list of results from recent studies of developing and transition countries. These case studies illustrate that unequal wealth and influence and low political accountability can be bad for entry and bad for the broad protection of property rights—and so can hurt the efficiency, growth, and the health of the financial system.

Such adverse long-term effects can be magnified through crises, further dampening growth and reducing equity. Connected lending lowers asset quality and makes financial systems more vulnerable. And well-connected interests do disproportionately well in crises, through looting or securing greater protection and bailouts, as

discussed in the section on macroeconomic management.[8]

The liberalization paradox: Rapid and premature liberalization can also be captured

A seemingly obvious implication of the pathology sketched above is that a more open and liberalized financial system should be good for access, innovation, and growth. Yet overly rapid liberalization can bring new perils. Table 9.2 includes examples of liberalization and privatization of financial systems leading to highly concentrated benefits. Rapid privatizations of state-owned banks often meant that banks went to powerful insiders or corporate groups, as in Chile in the 1970s, Mexico in the 1980s, and the Russian Federation in the 1990s.[9] In Chile and Mexico, the largest banks were sold to a small number of wealthy families in dubious auctions, with foreigners stopped from bidding. The buyers were allowed to fund the purchases with loans from the banks themselves, leading to extremely poor incentives for solvency. In both countries, the owners used the banks to grant themselves large loans, aimed in part at accumulating control over other firms. In Mexico, this was associated with a major consumer credit boom.

In the Republic of Korea, *chaebols* (family-run conglomerates) came to dominate nonbank financial institutions. This caused serious conflicts of interest and "produced numerous incidents of illegal and unfair activities, where funds from affiliated financial institutions were exploited for the benefit of *chaebol's* ailing subsidiaries."[10] And in the particularly dramatic case of Russia, the free-for-all liberalization was a source of both rapid concentration of assets and increased financial vulnerabilities (box 9.2).

Rapid or premature liberalization in a context of low political accountability can increase financial fragility, and the risk of opportunistic default.[11] Reckless lending strategies in Chile and Mexico created extreme vulnerability for the financial system, which collapsed when there were shocks to interest and exchange rates. A greater percentage of large loans defaulted and subsequent losses on large loans were larger than losses on smaller loans; losses were particularly large on loans to parties connected with the owners, who escaped significant sanctions. In both countries, the banking system had to be bailed out at enormous public cost, while much of the lent capital probably disappeared in capital flight, as in Russia. These cases suggest that rash liberalization with limited scrutiny can result in concentrated control of the banking system, with owners putting up limited amounts of their own capital, and weak or corrupt supervision and public guarantees to depositors. In all these cases the rise in low-quality liabilities (and the associated moral hazard) became a major factor in the subsequent financial crises.

In countries with greater accountability, financial liberalizations went a different way. In France, before the 1985 financial reforms, government subsidies and limits on competition led banks to support less productive firms and provide poor-quality loans. After 1985, the loan allocations improved and employment increased.[12] Although the reforms exposed some problematic lending patterns, there was no

BOX 9.2 *Too much and too little regulation: Russia before and after the transition*

Within a couple of years of liberalization, the number of banks in Russia had risen from four to around 3,000. One could argue that this was prime evidence that no elite was blocking entry. But such rapid entry in a regulatory power vacuum precluded any chance of regulatory oversight. It compromised the public perception of what a bank is and how it operates, undermining the very foundation required for the development of the domestic banking sector. In practice, many of these "banks" were not banks but private fund management entities used to channel capital flight. Those raising deposits from the general public lent the cash to insiders, gambled it irresponsibly, or simply shipped it abroad, leaving the banks as empty shells full of liabilities.

Banks could get away with such behavior not just because rapid entry overwhelmed the (rather unprepared) regulators, but also because the banking lobby further promoted laws that granted banks an extraordinary freedom to operate and dispose of other people's money. Russia endorsed the "universal bank" model, for example, hardly a structure suited to a legal and regulatory vacuum (although there is debate as to whether this was a key factor in itself). Bank lobbyists also ensured that banks were exonerated from the new commercial bankruptcy code (the bankruptcy code established before the 1998 crisis vaguely stated that banks would be subject to a specific bankruptcy legislation, which was not even tabled before 1998).

The universal banking structure and lack of bankruptcy system contributed to the severity of the financial crisis of August 1998, resulting in massive losses to depositors, foreign investors, and cost to the state budget (as many liabilities were transferred to the state-owned Sberbank).

Source: Claessens and Perotti (2005).

financial crisis or capture by the few. The system was less concentrated to begin with, and the reform process received more public scrutiny.

Premature or ill-designed liberalization can also lead to reform backlash, if the benefits are perceived to be concentrated in a few powerful groups while the losses are broadly socialized. There is less specific evidence on this for the financial system, but it forms part of a broader pattern of reaction against liberalizing processes. Witness the dramatic fall in support for privatization in Latin America between the mid-1990s and early 2000s (as documented by the Latinobarómetro surveys). Such a backlash is likely to be particularly sharp when associated with gains for particular groups—"economically dominant minorities" in the interpretation of a series of case studies by Chua (2004)—that can heighten the sense of horizontal inequities for other groups. It can undercut support for the very reforms that are critical for equity and growth. This is why policy designs need to consider both technical and political economy concerns.

Increasing access to financial services: Technical design, accountability, and competition

If both financial systems and financial liberalizations are often captured, what does this imply for the design of reform? The answer is complex and to some degree specific to the initial financial and legal institutions and political context of a country. But we can outline some general principles. Options to expand access entail moving financial institutions closer to the country's "access possibilities frontier." This will not necessarily imply finance for all: for all the success of microcredit for the poor, the major beneficiaries of greater access will be small and medium entrepreneurs from the middle class. But this is good for the broad-based growth that will benefit all groups. This involves both issues of technical design and developing the political and social accountabilities that will support and sustain change.

Technical design issues. For financial institutions, expanding the client base has much to do with scale, which is often too small. Recent experiences like those of ICICI bank in India show that the high transaction costs for small volumes and the large cost of expanding reach can be overcome. One option is the innovative use of existing networks. Postal systems, with their broad coverage, can be used to deliver new services by many private financial services providers. Many technological solutions now exist for small-scale banking, from mobile banking to broadening the range of delivery points—through kiosks, small branches, and joint ventures with nonbanks. Simpler banking products, like the "Mzansi" account in South Africa, and prepaid cards for small transactions can lower costs. Handheld computers have been used for quick approval of microfinance loans. Reverse factoring (lending on the basis of receivables from a creditworthy institution) using an Internet platform has allowed Nacional Financiera (NAFIN) in Mexico to extend trade finance. There has also been much innovation in the market for international remittances, which many banks have entered.

Some of these innovations need regulatory changes—for example, customer identification, anti-money-laundering rules and other rules can hinder access to a bank account, as when individuals do not have a fixed address or formal job. Better regulatory approaches for consumers can involve adopting "truth in lending" requirements for small borrowers and educating people on the risks of (new) financial services. However, a general lesson is to be wary of regulation in weak environments: all too often regulation ostensibly designed to protect savers and borrowers is ineffective in protection but still hinders access.

Are there shortcuts to enhancing access, especially when overall institutional improvements will take time? Too often there is emphasis on the more complicated and sophisticated aspects of financial systems, while, some of the basics—broadening access to financial services, including deposit-taking institutions—can be more important from an equity viewpoint. Information sharing can help improve competition in banking systems and can be encouraged more quickly in

some segments, including allowing nonbank financial institutions access to existing networks (such as payments systems). There can also be some scope for specific government interventions. But government interventions to broaden access through directed credit have typically been unsuccessful, causing inefficient distortions with few access benefits—the second type of pathology discussed in this chapter. Many governments, especially in the 1960s and 1970s, used various forms of subsidized directed credit, typically through state banks, to try to channel finance to poor farmers and small enterprises. Directed credit undermines institutional development because banks have no reason to develop credit analysis skills, as plentiful examples of defunct development banks show. By one account, default rates ranged from 40 to 95 percent throughout the developing world.[13]

Moreover, subsidies for housing, lending for small and medium enterprises, and agricultural finance are often captured by the well connected. Some schemes do reach the poor: India's social banking program did so, but at a high cost.[14] Such schemes then become, at best, an inefficient means of support for the poor, fostering unsustainable models of financial sector development. For example, India's Integrated Rural Development Program provided loans to socially excluded groups (certain castes and tribes, and women) with high levels of subsidy (25 to 50 percent of the loan volume to such weak sectors). By 2000, loan recovery was only 31 percent, and there was little evidence of repeat borrowing.

Microfinance clearly has a role in expanding access. It is best viewed as a complement, not a substitute, for more equitable financial reform and core financial system development. In most countries, microcredit and similar microfinance institutions reach less than 2 percent of the population. Only in a few countries is access really extensive—Bangladesh, Indonesia, and Sri Lanka stand out with coverage ratios in the order of 8 percent or more.[15] Subsidies are often used to encourage the setup of microfinance institutions, but they need to be designed carefully because they can increase final costs, by encouraging the formation of institutions that are too small and that are forced to raise prices to recover fixed costs. Co-sharing costs and risks with the private sector is a key market test. Start-up subsidies and other support can foster exploration of alternative business models, phasing out support over time. Maintaining a segmented system makes sense until the microfinance sector matures, with stronger microfinance institutions coming into the core financial system as they evolve.

Accountability and competition. Technical design is important, but the core of a reliable reform is building political and regulatory accountability. Public scrutiny has a key role, given the risks of capturing reform process and institutions. Potential actors to help oversee the process include associations of small firms, consumer groups, NGOs, media, and labor unions. But given the technical and complex nature of financial sector functioning, societal accountability is likely to be most effective if groups with an interest in a more open financial system are empowered, engaging independent nongovernmental technical bodies with the capacity to analyze financial sector conditions. The shadow regulatory commissions established in almost all regions, and such research centers as the recently formed Center for Financial Stability in Argentina, can be sources of education and avenues for interest groups to express their voice. It will remain important to design these mechanisms with care to avoid the creation of veto powers to reform (which can lead to counter-reform capture!)

It is possible to promote reforms that build more reliable and inclusive financial systems in a context of unequal influence. Formal regulatory structures can complement societal accountability. The development of the stock markets in Poland and the Czech Republic show what regulation and disclosure can do. At the transition from communism in 1989, these two countries were quite similar in economic structure and history. But the design of financial reforms was very different, driven primarily by differences in philosophy toward markets.[16]

The Czech Republic went for a radical voucher-based privatization of state-owned assets, convinced of the power of the market to organize itself: with property rights transferred to the private sector, it was expected that private actors would efficiently contract with one another. Poland pursued a more gradual approach, based on case-by-case privatization and a measured institutional development effort to build regulatory and supervisory capacity. Company and securities laws in the two countries reflected these differences in approach, with much greater requirements in Poland than in the Czech Republic for disclosure to the public, more protection of minority shareholders, and more power for the independent regulator.

The results were quite different. The stock market in the Czech Republic started bigger but was quickly dominated by corporate insiders, who captured "58 percent of the values of companies over and above their legitimate shareholding, compared with an insignificant 1 percent in the United States."[17] There was widespread "tunneling," a form of asset stripping by insiders through transfers to other institutions they controlled. The Polish stock market, by contrast, started more slowly, but then overtook the Czech market (figure 9.1) Public scandals led to the regulator effectively pursuing violations, using the greater legal protections, and laying the basis for more broad-based property rights, greater confidence, and openness. By the late 1990s, there were already several initial public offerings in the market.

Segmentation provides another example of the need for appropriate accountability mechanisms. Financial sector regulation in many countries, including developed ones, enforced segmentation for long periods—both on a geographic basis and by type of financial services, as among commercial banking, investment banking, and insurance. The Italian experience with dispersed local banking suggests that mutual and cooperative banks performed an important function in supporting local activities, which was much better than state-owned banks or banks dominated by politicians.[18] But regulatory capacity has been eroded by technological change. Given that segmentation often resulted in capture by local elites, the erosion of barriers has likely improved access as often as not. Yet there is room for smaller, locally managed intermediaries to promote access. Such locally focused intermediaries need explicit disclosure and accountability requirements to local users (as opposed to local politicians), which has been the tradition in cooperative or mutual banks, to limit the undue political influence of the few.

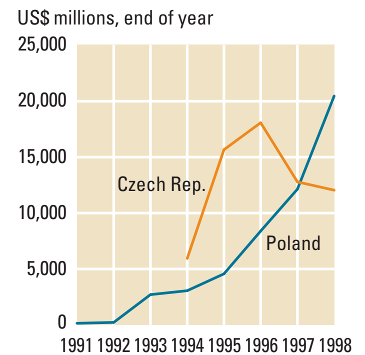
Opening the financial sector to competition from foreign financial institutions can also spur financial broadening. Foreign bank entry can help by improving efficiency and stability, reducing protected profits, and forcing (local) financial institutions to focus more on providing financial services to all. Financing obstacles are perceived to be much lower by borrowers in countries with high levels of foreign bank penetration, with evidence that even small enterprises benefit. But note that allowing the entry of foreign banks is not synonymous with capital account liberalization. Rapidly opening the capital account before adequate domestic regulatory and supervisory structures are in place can be dangerous, especially in a world of large, and often herdlike, international capital flows, coupled with politically connected lending of poor quality. This increased the vulnerability of Indonesia, the Republic of Korea, and Thailand in the East Asian crisis.

Finally there is the potential for external commitment. The relative success of Central European countries in strengthening accountability has been attributed to the constraint on abuse induced by the need to prepare for accession to the European Union. In Slovakia, after a decade of influence-peddling and slow reform in the financial sector, the pendulum swung toward reform only as the date of possible EU accession approached.[19]

Achieving equity and efficiency in labor markets

For most of the world's people, economic opportunities are primarily determined, or

Figure 9.1 Poland's stock market started slowly but then surpassed the Czech Republic's



Source: Glaeser, Johnson, and Shleifer (2001).

at least mediated, by the labor market—in formal and informal work. The wages and employment conditions in the labor market affect the quality of life of workers and their families, sometimes in ways that may seem harsh or unfair. The functioning of the labor market has a profound effect on equity—across workers, in patterns of access to work, and between workers and employers. Government intervention to achieve greater equity is frequent in labor markets, but often with costs in terms of efficiency—exemplifying the second pathology. While this is an area in which genuine trade-offs exist between protection of weaker workers (which is good for equity) and flexibility (which is good for growth), elite capture and gross inefficiencies can be addressed through better design and broader accountability.

Equity and efficiency reasons to intervene in the labor market

Labor markets are different from other markets. Unlike the markets for many commodities, labor markets generally are not competitive. They may be characterized by uneven market power (between employers and workers), by imperfect mobility of workers, by insufficient information, or by discrimination. These imperfections generate rents in the employment relationship, which both sides can try to capture. This can lead to unfair and inefficient outcomes when the bargaining position of the workers is weak. For example, employers may underpay workers who are not mobile, force workers to work in hazardous conditions, or discriminate against vulnerable groups. Private markets, left to themselves, also do a poor job of protecting workers against the risk of unemployment. In the absence of perfect access to financial markets, or complete insurance markets, workers may not be able to smooth consumption in response to labor income shocks. If they cannot gain access to financial markets, they may also be prevented from moving from bad jobs to good.

All governments, irrespective of income, intervene heavily in the labor market. Governments typically intervene to correct these failures: to protect workers and endow them with rights and "voice" in the employment relationship, to empower unions to represent workers in negotiations with employers, to ensure compliance with labor laws and regulations, and to provide insurance against income shocks. Public intervention can improve market outcomes and lead to significant equity gains: more equal opportunities for workers, better working conditions, and less discrimination. It can also lead to large gains in efficiency: for example, by allowing full use of the labor of discriminated groups, by increasing labor mobility, or by better managing income risk.[20]

The problem is that poorly designed or inappropriate government intervention can also make things worse, with results that are bad for equity and efficiency. For example, excessive protection of formal sector insiders can lead to "rationing" jobs in the formal sector, pushing surplus labor into either informal employment (as in India) [21] or unemployment (as in South Africa). [22]

The problem is particularly acute in developing countries, because labor market regulations and standards typically apply only to formal sector workers, leaving the majority of the workforce uncovered.[23] Protecting workers through legislation and regulation that is enforced only in the formal sector, without other measures to improve working conditions in informal employment, can reinforce the segmentation between formal and informal employment in ways that are inherently unfair. In Colombia, workers are legally entitled to severance payments for dismissals deemed unjust, but these entitlements are not enforced in the informal sector, which employs more than half the workforce. Not only do Colombian informal sector workers not benefit from the legislation, but arguably they are harmed by it, because the resulting higher cost of labor in the formal sector limits formal employment opportunities for "outsiders" (mainly women and youth).[24]

In reality, the distinction between formal and informal employment is often blurred. Some authors argue that the informal economy functions partly as an unregulated entrepreneurial sector, often voluntarily

entered even at the expense of lower income.[25] It is clear that the informal sector is heterogeneous, and includes both those who choose to work there and those who work there out of necessity. Those in the top strata—microentrepreneurs who hire others and many of the self-employed—do relatively well in average earnings. Those at the bottom—intermittent casual laborers and industrial outworkers—do not. Women tend to be underrepresented in the top strata and overrepresented in the bottom.[26] They also often earn less than men within each strata—although some of these differences may reflect voluntary choices for more flexible, part-time work. In a recent study, the International Labour Office (ILO) argued that the formal and informal sectors are part of a continuum of working conditions, earnings, and rights.[27] A significant share of formal sector employees had some of the (poor) working conditions associated with informality, while a fraction of informal sector workers enjoyed conditions more typically associated with formal sector jobs. The challenge for governments is to shift more jobs along this continuum toward better working conditions and higher wages, and to do so in ways that do not come at the expense of efficiency.

Indeed, poorly designed or inappropriate government intervention can also be inefficient and bad for long-term growth. Recent research on India, for example, suggests that starting from a common legal framework (the Industries Disputes Act of 1947), the states that amended the legislation in the direction of reinforcing security rights of workers and other prolabor measures had lower output and productivity growth in formal manufacturing than those that did not change it or that made labor regulations more flexible.[28] Relatively protective legislation may have reduced opportunities for workers—especially the majority without a formal sector job.

A look at some African labor markets illustrates the impact of government policies (figure 9.2). Many countries—including Ghana, Uganda, and Tanzania—have large self-employment sectors, which absorb increases in the labor supply and help keep unemployment low. South Africa stands in sharp contrast, with a small informal sector—absorbing only about 19 percent of the total workforce in 2002, much lower than the share of nonagricultural employment in other African countries—and high unemployment (42 percent in 2003).[29] Part of the story lies in much larger wage differences between formal and informal sector work in South Africa than in the other cases. But it also appears to be caused by the unusually small size of the informal sector (compared with Latin America, for example). Some suggest that the legacy of apartheid that inhibited the development of traditions of small-scale entrepreneurial activity, and labor regulations that are enforced for firms of all sizes (depending on the industry and region), may explain the lack of entrepreneurs and small firms in South Africa.

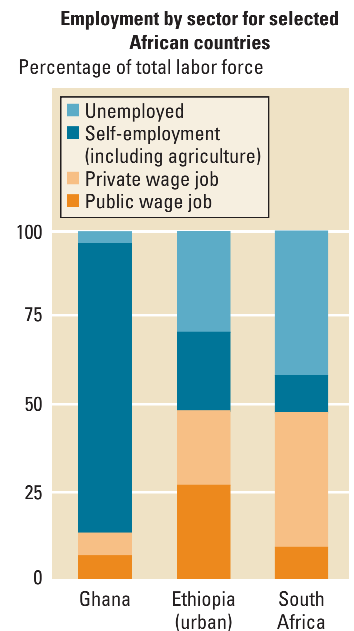
In Ethiopia, on the other hand, the majority of the urban unemployed are well educated and from middle-class households.[30] They also tend to be young, have never held paid work, and have a median duration of unemployment of nearly four years. Indeed, about half of young unemployed males are searching for public sector jobs, which pay on average a 125 percent premium over self-employed work.

Addressing links with unequal power

Government intervention in the labor market is often a reflection of the underlying distribution of political agency. Governments may (and often do) intervene in the labor market in pursuit of goals other than addressing market failure. They may intervene to buy off the support of certain groups (for example, urban formal sector workers) or to suppress social dissent under an authoritarian regime or to serve the interests of those with greater political influence. Oligarchic capitalist societies can be associated either with labor repression or with unionized and (relatively) advantaged formal sector workers who share in the rents.

Interventions aimed at shifting aggregate welfare toward politically powerful middle groups, often in the name of equity, at the expense of others (an illustration of our

Figure 9.2 Patterns of employment and unemployment vary widely across African countries

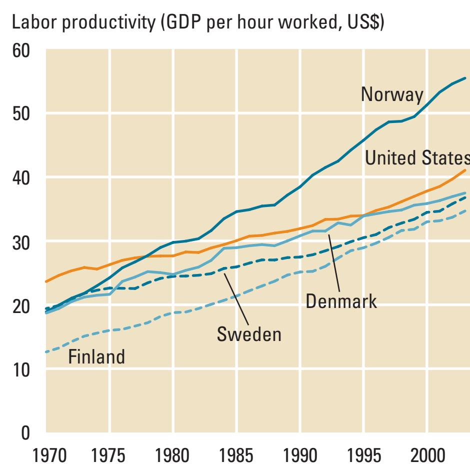


Source: Kingdon, Sandefur, and Teal (2005).
Note: Ghanaian data are for 1998/99 and public wage employment includes government and state enterprise workers. South African data are for 2003 (Labor Force Survey). Ethiopian data are for urban areas in 1997 (Labour Force Survey) and because of definitional issues may not be fully comparable.

second pathology) are inherently bad for equity and usually bad for efficiency. Politically influential energy sector and teacher unions in Mexico, for example, have protected their employment and wage entitlements by blocking reforms that would lead to, respectively, energy sector reform and higher-quality and more equitable schooling. Public sector workers in France have used their political force, with the aid of massive strikes, to curtail attempts to bring their nonwage benefits and other entitlements in line with those of the private sector.

Stronger civil and political rights and broader mechanisms for voice can reduce the likelihood that the government's labor policy agenda will be hijacked by politically powerful groups. There is a strong association between democracy and the level of wages, both across countries and within societies that have experienced a political transition, such as the Republic of Korea, and Taiwan, China.[31] Stronger respect for civic rights in Latin America has also been associated with greater formalization of employment and a higher wage share.[32] In Spain, the transition to democracy in the mid-1970s led to demands for greater equity that were associated with the legalization of free trade unions,[33] the rapid introduction of extensive social transfers (including pensions and unemployment insurance), and the implementation of progressive income taxation. The result was a shift from a regulated state, in which protection for workers came mainly through permanent jobs and controlled housing rentals, to a liberal economy with flexible markets, and more extensive public provisioning of services (see focus 3 on Spain).

Figure 9.3 Different labor market institutional setups can yield equally good productivity growth paths: Scandinavia versus the United States



Source: Underlying series for OECD (2005).
Note: Measures used are GDP volumes, in U.S. dollars, at constant prices, constant purchasing power parity (PPPs) prices with a base year of 2000 and total hours worked for total employment.

Better design: Can labor market institutions be designed to be pro-growth and pro-equity?

The challenge for governments is to design interventions that balance equity and efficiency goals in ways that are within a country's institutional capacity. History suggests that this is a complex task, and there are real tradeoffs that need to be assessed. Different societies are likely to make different choices.

Scandinavia and the United States have very different sets of labor market institutions, yet they share a good track record of solid growth and high employment-to-population ratios (figure 9.3). The Nordic countries have mandated generous benefits and protection for workers, financed by a high tax effort. But they also have a highly coordinated and centralized approach to wage-setting and policymaking, which allowed all parties to internalize the consequences of their actions, with the union movement historically an advocate for openness and competition. The United States leaves the setting of wages and work conditions, including benefits, much more to discretion and employer-worker negotiation. This fits well within its tradition of decentralized bargaining, which gives freedom to individual firms to bargain with their workers in response to their varying economic and financial conditions. It leads to greater wage inequality and more workers without health and other forms of insurance. But it is consistent with lower taxes and high levels of flexibility.[34] The Nordic countries and the United States opted for different labor market models (in line with their history, legal tradition, and societal preferences), but all succeeded in delivering to their workforces a large pool

of job opportunities, productivity growth, and rising incomes over the long term.

What doesn't work? There are also many ways of getting labor market institutions "wrong." And when countries get it wrong, one segment of the labor market (typically public and formal sector workers who represent the middle and high end of the usage distribution) benefits from extra protection at the expense of others. Outcomes are highly unequal, and the costs to efficiency and growth are usually severe. The experiences of India, South Africa, and Colombia cited earlier are vivid examples.

Governments also get it wrong if they intervene extensively in the labor market when product markets are not competitive. A typical example is the unionization of public sector workers. In Mexico, before the reforms of the 1990s, workers in public utilities and in the public oil sector secured high wages by capturing a share of the rents generated in these monopolistic sectors. But their gain came at a cost for employment and competitiveness in Mexico's private sector. Mexico's experience is not unique: it applied equally to state enterprise workers in Turkey until the 1990s and to public sector workers in India and many other countries.

Things can also go greatly wrong when governments mandate protection with no attention to incentives. In much of Europe, governments implemented generous unemployment benefits with little connection to workers' actual job search behavior. The result was an increase in the duration of unemployment and the emergence of long-term unemployment, with its destructive impact on human capital, loss of employability, weakened ties to economic and social life, and for many, high degrees of poverty and social exclusion.[35]

What works? The key to avoiding these pitfalls is achieving a balance between protection and flexibility. Design specifics matter a lot, as does the underlying structural context. Collective organization of workers is one of the main channels for securing better and more equitable working conditions. Free trade unions are the cornerstone of any effective system of industrial relations. Unions act as agents for labor, coordinating the demands of workers and organizing them into a single entity whose collective bargaining power matches that of the employer. Trade unions can help provide a positive work environment by reducing labor turnover and by promoting worker training and higher productivity. Unions have also been found to reduce inequality and wage discrimination in countries as diverse as Ghana, the Republic of Korea, Mexico, and Spain.[36] Unions also can have an important noneconomic role. They have been a force for progressive political and social change in many countries (Poland, the Republic of Korea, and South Africa).

But the involvement of unions in wage-setting can also have significant negative economic effects. Evidence from industrial societies suggests that union involvement reduces the employment of young and older workers ("outsiders") and benefits prime-age males and females.[37] Unions often act as monopolists, improving wages and work conditions for their members at the expense of consumers and nonunion labor. For example, recent studies of manufacturing wages in Africa show substantial union wage premiums (30 to 40 percent in some countries).[38]

Formal trade unions are most effective at improving conditions for workers without huge efficiency costs when product markets are competitive, so that unions cannot raise wages for their members by capturing rents at the expense of other parts of society; when collective bargaining arrangements and institutions have enough flexibility to accommodate different demand and supply conditions for different types of workers; and when unions operate in a context that allows them to internalize and absorb the cost of their actions. On the other hand, when unions are co-opted by political elites or by the state, their actions can have significant costs for efficiency.

An illustration of the potentially highly positive role of unions in improving working conditions while supporting productivity growth comes from a study of worker-firm relationships in high-value export crops in

BOX 9.3 *Organizing in the informal economy*

Developing countries have trade unions and large informal economies, two phenomena commonly thought to be incompatible. But recent work by Women in Informal Employment: Globalizing and Organizing (WIEGO) has uncovered a surprising amount of organizing in the informal economy. Formal trade unions that extend their coverage to informal workers and trade unions of informal workers are two organizational forms that have emerged. Organizing can also be done by cooperatives, savings-and-credit groups, producer groups, and neighborhood and trade associations.

Organizing in the informal economy differs from organizing in the formal economy along several dimensions. Collective bargaining can take many forms. Bargaining partners are not just employers but can also include municipal authorities, police, wholesalers, and other interest groups. Activities of informal workers' trade unions can also extend beyond collective bargaining and include a range of services, such as savings, credit, social security, and advocacy. Because members do not work in a standard workplace or for a single employer, membership in trade unions can take unusual forms.

- Registered as a trade union, the Self-Employed Women's Association (SEWA) in India is both an organization of poor self-employed women workers and a movement combining elements of the labor, cooperative, and women's movements. It offers a broad range of services to its nearly 700,000 members, including banking, health care, child care, insurance, legal aid, housing assistance, and capacity building (www.sewa.org).
- StreetNet International, launched in 2002 in South Africa, has 15 affiliates (unions, cooperatives, or associations) in Asia, Africa, and Latin America that organize street vendors, informal market vendors, and hawkers. As of early 2004, these affiliates represented 128,000 members (UNRISD Gender Policy Report).
- HomeNet Thailand is a network that helps organize informal home-based subcontracted and own-account workers (mainly women). It drew attention to the plight of these workers following the financial crisis in 1998.

Sources: United Nations Research Institute for Social Development (UNRISD) (2005); Women in Informal Employment Globalizing and Organizing (2005).

northeastern Brazil. Union activity among landless agricultural laborers in this case was an important factor behind improvements in work practices that led to higher quality (critical for export crops), higher productivity, and better working conditions for landless workers. To effect this change, however, the union had to shift from defending the interests of its traditional base of support (small farmers) to representing the interests of a larger group of landless laborers. Success was also facilitated by the fact that, on the employer side, the union was negotiating with large firms from southeastern Brazil. These southeastern firms had experience in collective bargaining, in contrast to the more traditional large farmers of the northeast, which were accustomed to more repressive and conflictive labor relations.[39]

Collective organization of workers can also secure greater bargaining power and thus better working conditions for informal economy workers. Studies of informal worker associations in India, South Africa, and Thailand suggest that organizing informal workers decreases the workers' invisibility to policymakers and legislators, helps them gain access to information, gives them voice and self-identity, and in some cases helps to provide them with a range of social protection services (box 9.3).

Providing income security is another area in which the structural context and design specifics, which pay attention to incentives and reward desirable behaviors, are critical to policy outcomes (box 9.4). This is also true of minimum wage policies for which the key to avoiding large efficiency costs is to get the level right and to allow for enough flexibility across types of workers to accommodate different demand and supply elasticities for their labor.[40]

Design specifics and the broader structural context are equally critical to the success of legislation on other work standards (health and safety) or protection for specific vulnerable groups (such as child laborers, ethnic minorities, or the disabled). There is an international consensus that core labor standards—freedom from forced and child labor, freedom from discrimination at work, freedom of association, and the right to collective bargaining—have such intrinsic value that they should always be pursued. But even for these core standards there are questions about how to achieve them most effectively and with minimum cost.[41]

An example of government intervention to protect workers from abuse comes from Cambodia's successful experience with implementing core labor standards in the garment industry. Starting in 1999 Cambodia could earn a higher quota for exports to the United States by demonstrating improvements in working conditions. A monitoring system—developed and implemented by the ILO, with support from the U.S. Department of Labor, the Government of Cambodia, and the Garment Manufacturers Association of Cambodia—has virtually eliminated the worst labor abuses, such as child labor and sexual harassment. A recent survey showed enforcement of core labor standards in the garment sector has boosted Cambodian exports to Europe and North America.[42] But

BOX 9.4 *Employment protection legislation*

Left to itself, the labor market does a poor job of protecting workers against a sharp loss in income associated with unemployment. As a result, most societies have developed ways to cope with the threat of job loss. Often this involves some combination of informal support mechanisms, private savings, and obligations on employers. When these mechanisms break down—as they do when the shocks are large, sudden, protracted, or affect an entire community—the government needs to step in. Government intervention typically involves one or several of the following instruments: job security regulations, mandated severance pay, unemployment insurance, or mandatory self-insurance mechanisms.

Job security legislation is typically aimed at protecting jobs and preventing job destruction. Most evidence suggests that it is quite effective at doing so. Across countries, more stringent employment protection legislation (EPL) appears strongly associated with more stable employment. But EPL reduces job destruction at a significant cost, as the expectation of high separation costs makes firms more reluctant to expand employment, and makes it less profitable to start new ventures or create new firms. So, employment protection also reduces job creation. For example, researchers found that strict new job-security laws enacted in the 1980s reduced employment in many industries in Zimbabwe (Fallon and Lucas 1993). Overall, the net effect of job security legislation on employment is ambiguous (Bertola 1990; OECD 1999; Bertola, Blau, and Kahn 2001; Kugler 2004).

What is clear is that EPL changes the nature of unemployment. Lower job destruction reduces the *incidence* of unemployment. But lower job creation increases the *duration* of unemployment and can lead to the emergence of long-term unemployment.

Not surprisingly, EPL appears to have a different impact on different groups of workers. In both Colombia and Spain the reduction of dismissal costs and job security provisions was associated with moderate increases in the employment of young men and women (Kugler 2004; Kugler, Jimeno, and Hernanz 2003). For Chile, Montenegro and Pagés 2004 find that job security regulations reduce the employment rate of youth and the unskilled to the benefit of older and more skilled workers. A study across the countries of the Organisation for Economic Co-operation and Development arrives at a similar conclusion: consistent with the story that EPL protects "insiders," stricter EPL increases the employment of adult men and reduces that of young workers and women (OECD 1999).

Given the complex effects of EPL, how can governments best intervene to help protect workers against temporary drops in income associated with unemployment? Some EPL may be efficient, reducing excessive volatility in turnover. But too strong EPL—as is typical of many formal sectors in the developing world—slows the pace of creative destruction central to innovation and growth, with disproportionate adverse effects on those without "good" jobs. Yet reducing EPL needs to be complemented by greater worker security that is not linked to specific jobs, both on social welfare and political economy grounds.

The design of the optimal solution depends on the institutional and administrative capacity of government and on the structural characteristics of the labor market (Blanchard 2004). Countries with significant administrative capacity and medium to high incomes can implement unemployment insurance systems with incentives for job search (declining benefits with duration and provision of benefits conditional on acceptance of acceptable job offer). Middle-income countries reluctant to implement a full-blown unemployment insurance system can support self-insurance mechanisms, such as mandatory savings accounts (but because of the limits to self-insurance, these are not as effective). Low-income countries can opt for public works schemes, which if effectively designed are self-targeting and can be implemented even when levels of informality are high (chapter 7).

whether the system will survive the end of the U.S. quota incentives remains to be seen (see chapter 10).

How to reform a "bad" set of labor market institutions

Reforming labor market institutions is technically and politically difficult. It is technically difficult because reforms need to be coordinated across a variety of labor market institutions, and often also with reforms outside the labor market. It is politically difficult because there usually are vested interests in maintaining the status quo. Moreover, the short-term costs of reform can be large and unevenly distributed. Take reforms to reduce employment protection: those currently protected see themselves as having much more to lose from reform than to gain from such a reduction. And if they are also politically influential—represented by unions and with political voice—their power to block reforms may be an insurmountable barrier.

Several countries have implemented substantial labor market reforms more or less successfully: Ireland, the Republic of Korea, the Netherlands, New Zealand, and the Slovak Republic among OECD countries; Chile and Colombia among developing countries (see box 9.5 for Colombia and the Slovak Republic). China is in the midst of a large labor market transition, and the Balkans are struggling through dramatic labor market reforms.

Experience suggests that effective change involves a combination of factors: designing and implementing a consistent and comprehensive policy package; tackling vested interests; broadening societal accountability, including increasing the voice of poorer groups; and, in some cases, compensating losers. Macroeconomic and financial shocks can facilitate change, although not always a positive one. Reforming institutions in the

BOX 9.5 *Two cases of labor market reform: one comprehensive, one partial*

Comprehensive reform in the Slovak Republic

In 2000 unemployment in the Slovak Republic reached 19 percent of the labor force—the highest in the OECD at that time. The main factor was the substantial job reallocation generated by the transition to a market economy, compounded by low labor mobility because of skill and regional mismatches. But the impact of the transition shock on the labor market was worsened by an inadequate set of institutions: high rates of taxation of labor and overly generous unemployment benefit and social assistance systems, which discouraged job search and encouraged informality.

Reforming these institutions in the midst of high unemployment was extremely difficult, particularly for a reformist government with a small majority in parliament. But in early 2003, bolstered by its reelection, the reformist Slovak government undertook a comprehensive and ambitious reform of social and labor market policy. The government's multipronged strategy combined measures to reduce the taxation of labor, increase the incentives to work through reform of unemployment insurance and social assistance, invest in the skills of labor and employability, improve the matching of workers and jobs through higher labor flexibility and mobility, and strengthen state administration in labor and social policy.

The new strategy represented a marked change in philosophy in labor and social policy in the Slovak Republic: from a system that mixed ingredients of insurance and redistribution toward one that separates social insurance from equity objectives; and from a tradition of entitlements based on subjective or "moral" norms to one that guarantees a certain living standard to all citizens irrespective of the reason they may have for being poor, but that rewards individual initiative and motivation.

The key ingredients in pushing the reform through were a reformist government with a strong popular mandate; strong leadership and technical competency from the Ministry of Labor and Social Affairs; accession into the European Union as a disciplining device; and widespread public perception, built on analysis and dissemination of this analysis, that institutional reforms were needed. Moreover, labor market reform was carried out not in isolation but as part of a broader policy package to make the Slovak economy more competitive in light of EU accession. This package included a substantial overhaul of personal income taxes, as well as reform of the education system.

Partial labor market reform in Colombia

In 1990 Colombia introduced a labor market reform that substantially reduced the costs of dismissing workers. The reform reduced severance payments, widened the definition of "just" dismissals, extended the use of temporary contracts, and speeded up the process of mass dismissals. The joint effects of these reforms were to reduce the costs associated with firing workers in firms covered by the legislation. But the reforms did not affect informal sector firms, which did not comply with the legislation.

An analysis of the effects of the reforms suggests that they did increase the dynamism of the Colombian labor market by increasing exit rates into and out of unemployment (greater churning). There was an increase in worker turnover for formal sector worker, greatest among young workers, more educated workers, and workers employed in larger firms. The reforms may have also contributed to increasing compliance with labor legislation by reducing the costs of formality.

Source: Kugler (2004).

midst of widespread job loss and high unemployment (as in the Republic of Korea following the 1998 financial crisis) is particularly difficult, even though it may be easier at such times to achieve societal consensus for reform.

Designing a consistent and coherent policy package. One of the strongest lessons from country experience is that piecemeal reform does not work (tinkering at the margin usually has perverse distributional effects). Moreover, reforms need to cover a range of labor market policies and to be linked with reforms in social protection systems. Reform is more effective and more equitable when different labor market instruments are coordinated: measures to reduce insider power and increase flexibility by lowering the restrictions and costs of firing can be linked to setting up of unemployment insurance mechanisms and eliminating dual status contracts. Reforms in other markets and the public sector are often key to the success of labor market reform. The depth and competitiveness of other markets (including product and financial markets) are critical.

Tackling vested interests. Reforms are often held hostage by politically more powerful groups. For example, policies to reduce employment protection, allow for subminimum wages, or streamline and improve public sector employment typically encounter sharp resistance from unions. Building broad societal consensus for reform is often the only way to tackle these vested interests. As a first step, this may require documenting the high costs of bad labor market policies through good data collection, analysis, and dissemination (as in the Slovak Republic).

Broadening social accountability. Building societal consensus in support of labor market reform may require specific measures to empower the groups of so-called outsiders or disenfranchised workers who bear the costs of nonreform. It helps to have political parties and societal organizations with broad bases

of representation and support. When this is not the case, it may be necessary to look for ways to open up institutions and give greater voice in bargaining (at all levels) to representatives of disenfranchised groups. This is easier when there are democratic local governments and strong autonomous associations—independent private business associations, worker associations that represent the interests of specific groups, and so on. The independent private sector is also a natural ally when it comes to reforming public sector employment and wage practices.

Compensating losers. The short-term costs of reforms can be high for certain groups of workers: unemployment insurance and social assistance reform in the Slovak Republic disproportionately hurt Roma workers and those living in high unemployment regions. So it may be necessary to compensate the losers. It is best to do this in ways that address the obstacles that losers face in reentering the labor market (support for education or training) or that facilitate labor mobility and reward work incentives (transport vouchers for workers moving from social assistance to work). Such compensatory measures have been introduced as part of the Slovak Republic's labor market reform package.

Product markets and trade reform

Product markets are intimately related to equity, with two-way patterns of causation: product markets shape the distribution of economic opportunities, and inequalities in influence shape the functioning of product markets. Both the design of external trade policy and the workings of internal product markets reflect patterns of influence. Removing barriers and excessive regulation needs to be complemented by measures to expand skills, infrastructure, and safety nets to achieve genuine access and help losers.

Market broadening and deepening are central to the expansion of opportunity: directly for firms and the self-employed, indirectly for workers. How equitable this expansion of opportunity is depends on interactions among external trade opening, domestic markets, patterns of infrastructure, labor markets, safety nets, and other measures to improve the business climate. Product market and trade reforms have great potential to bring expansion in opportunity, but there can be costs in the short to medium term, and these can hit particular groups, from relatively powerful protected incumbents to middle and poorer groups. The costs are associated with how markets and investment processes work: labor is typically not fully mobile, new skills take time to acquire, and new investments are often lumpy and can take time, especially when firms face imperfect credit markets (see earlier section) and an uncertain investment environment.

The functioning of product markets is embedded in political and social structures. Elite capture ranges from the apparent and egregious—as in the granting of the Indonesian clove monopoly to a son of President Suharto (a monopoly since disbanded)—to the less transparent shaping of trade policy to protect the profits of the influential. It is also true that policies with (genuine or rhetorical) equitable purpose can lead to outcomes that are bad for growth and mixed for equity. This is evident in the characteristically high levels of protection for relatively labor-intensive manufacturing and for food production (such as maize in Mexico, rice in the Republic of Korea, and the infamous agricultural subsidies in the European Union, Japan, and the United States). While poorer groups sometimes gain, it is more common that middle and elite groups are the main beneficiaries, while food consumers lose out.

While policies that reduce the power of incumbents in product markets will typically be good for efficiency and equity, a version of the "liberalization paradox" discussed earlier may often apply. Groups and individuals with economic capacity and political influence are best positioned to take advantage of market opening. Under some conditions this can lead to market backlash. Chua (2004) documents cases of "market-dominant minorities" who benefit from free market reforms, including trade liberalization. Traditionally dominant ethnic minorities, such as the Chinese in Southeast Asia, the Lebanese in West

Africa, and whites in Latin America and South Africa, seem to be the primary beneficiaries of the marketization of their economies. Such outcomes can fuel deep-seated resentments and lead to violence. These political economy and reform backlash considerations are additional reasons for integrating attention to equity into the design of product market reforms and trade liberalization.

Trade liberalization

Trade liberalization changes relative prices in an economy, causing shifts in output, wages, and employment. Analyses of trade liberalization are primarily about outcomes, providing only indirect evidence on opportunities. They show that trade openness is positively associated with growth and, on average, there are no strong correlations with income distribution. Morley (2001), using data from Latin America, found slightly negative effects of trade liberalization on income distribution, while Behrman, Birdsall, and Székely (2003) found positive influences of trade liberalization on wage inequality. Another study using panel data for 41 countries found that trade openness is associated with increases in inequality, after controlling for a set of other structural and policy influences.[43]

These average effects mask a great deal of diversity in impacts across groups, especially over the short to medium term. The impact of trade-induced price changes depends not only on average pass-through but also on exactly which prices change and how producers and consumers respond.[44] For example, the effects of removing protection for agriculture will depend on whether agricultural prices subsequently rise or fall and whether the poor are net producers or consumers of disprotected products. Normally, it is assumed that trade liberalization in agriculture will benefit poor small-scale farmers and be good for equity. After all, "developing countries have traditionally taxed the agricultural sector while developed countries have protected it."[45] But the impacts must be analyzed case by case at the microlevel.

Cereal protection in Morocco offers an illustration. In a simulation analysis of removal of wheat tariffs, Ravallion (2004b) finds that, contrary to expectations, rural families would tend to lose while urban ones would gain. Although the results predict that there would be more gainers than losers among the rural poor, aggregate losses outweigh aggregate gains. Furthermore, expected effects would be enormously varied, with significant horizontal inequalities: households with the same incomes were predicted to experience widely differing outcomes, depending on their specific structure of production and consumption. Using a similar simulation analysis, China's accession to the World Trade Organization (WTO) was found to have a small aggregate poverty-reducing effect, but this masked considerable variation in impacts across households in rural versus urban areas and across different regions.[46]

While aggregate effects of trade reform on poverty and equity are not always clear—whether diverse impacts translate into inequalities in opportunities depends on how new activities open up, and whether labor can move into them—we do know that there will be winners and losers. Outcomes depend on the ability and willingness of governments to mitigate losses to particularly hard-hit sectors, possibly by redistributing some of the gains accruing to winners.

Domestic product markets and equity

Lack of competition among traders, remote geography, poor infrastructure, and high transport costs can all prevent the transmission of border price changes to intended reform beneficiaries. Addressing such problems can improve the impact of trade reforms on equity.

The case of public or private marketing agencies for export crops is a typical example. Small farmers in many countries traditionally have had no option but to sell to a marketing agency at prices substantially lower than the free on board (f.o.b.) export price. Legitimate transport and marketing costs account for some of the price differ-

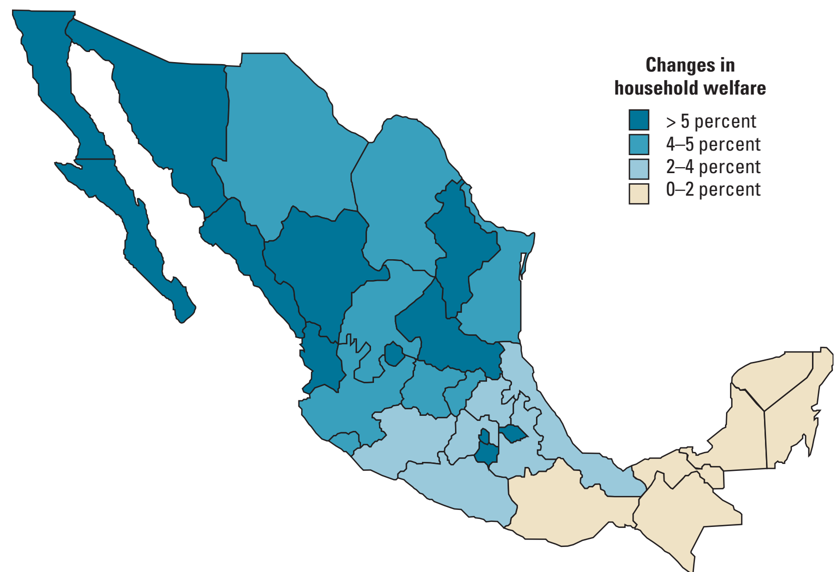
ence, but monopsonistic profits often do as well. Marketing agencies can thus prevent trade-induced price changes from reaching farmers at all.[47] A 1998 study found that the Vietnamese rice marketing system was controlled by a small number of state enterprises. These enterprises limited the transmission of border price changes to farmers and pushed up transaction costs.[48] A more extreme example was when marketing boards became instruments for extraction of surplus from agricultural exporters, such as for cocoa farmers in the post-independence period in Ghana. Malawi has faced similar issues: cartels by companies buying tea, sugar, and tobacco have forced down the returns to farmers.[49]

Abolishing marketing boards does not guarantee efficient marketing, however, they may play a useful role when markets are thin, or a tradition of trading has not developed, as in the raw cashew export market in Mozambique. Although the state trading company was privatized in the late 1980s, there was insufficient competition among private marketers when raw cashew export restrictions were lifted in the early 1990s. Indeed, raw cashews had to move through three tiers of intermediaries with near monopsony power before reaching world markets. As a result, the trading margin from the farm to the factory was 50 percent and the expected liberalization price increases never reached farmers.[50]

Trade reforms in Mexico show how infrastructure and transportation costs can shape opportunities through their impact on price transmission. Mexico's trade liberalization in the 1980s and entry into North American Free Trade Agreement (NAFTA) in 1994 appear to have led to wage increases in states bordering the United States relative to the rest of the country.[51] A different study on Mexico found that tariff reductions translate into domestic price reductions less and less as distance from the main port of entry increases. This effect can be substantial (figure 9.4). Studies of Rwanda and Indonesia have also documented the isolation of remote households from border price changes.[52]

Even when trade liberalization is intended to be pro-poor, incomplete transmission of border price changes for both exports and imports means that benefits are not evenly distributed. In other words, ease of access to international markets matters. Unfortunately, those who could benefit most from favorable price changes—the poor in remote rural areas—are those least likely to be affected by them.

Figure 9.4 It's better for household welfare to be close to economic opportunities



Source: Nicita (2004).
Note: Welfare changes were calculated from the effects of trade liberalization–related price changes that affected both the purchasing power and incomes of households.

Many of the factors responsible for transmitting trade-related price changes are also important to the functioning of domestic product markets. For instance, competition among traders, infrastructure quality, and transportation costs all influence how profits are allocated across a product's life cycle or value chain. And the percentage of a good's final price that goes to the primary producer, intermediary producer, distributor, and retailer can vary tremendously.

The cashmere sector in Mongolia shows how product market reforms could be both equity- and efficiency-enhancing. If properly developed, cashmere could be a pillar of Mongolia's successful transition from a command to a market economy. It is the country's single largest employer and a principal source of livelihood for the poor. It provided jobs for more than 16 percent of the workforce and accounted for more than 6.3 percent of GDP

during 1993–2002. But unsatisfactory public sector policies have meant that the industry has not lived up to its potential.

One significant bottleneck is in marketing and distribution. Mongolia's major cashmere market is in Ulaanbataar, 600–1,000 km from most regional production centers. Herders generally have to sell to traders at the farmgate or at informal provincial marketplaces at discounts of 10 to 45 percent from prices in Ulaanbataar. With little knowledge of market demand, individual herders can incur costs traveling to markets with no certainty of a sale. Policies that encourage regional market centers and herder cooperatives, as well as infrastructure improvements, could reduce marketing costs and increase herder's margins.[53]

Soybean farming in India offers another illustration of how product marketing channels can improve equity. Ninety percent of the soybean crop is sold by small farmers to traders, who act as purchasing agents for buyers at a local, government-mandated marketplace, called a *mandi.* Farmers have only general information about price trends and no choice but to accept prices offered to them by traders or the auction price on the day they bring their goods to the *mandi.* As a result, traders can exploit farmers and buyers using practices that create systemwide inefficiencies.

Under the e-Choupal Initiative, ITC, one of India's leading private companies, placed computers with Internet access in rural farming villages. Each computer—placed in a farmer's home and serving about 10 villages—becomes a social gathering place for the exchange of information and an e-commerce hub. Farmers can use the computers to check prices, learn about farming techniques, purchase inputs, and sell their soybean crops at the previous day's market price. Farmers then have to transport their crop to an ITC processing center, where it is electronically weighed and the farmer is immediately paid. Farmers selling to ITC through an e-Choupal receive, on average, 2.5 percent more for their crops, and ITC saves an additional 2.5 percent on procurement costs by cutting traders out of the loop. Farmers also benefit from accurate weighing, prompt payment, and information about prices and price trends that allows them to optimize their sales decisions. The e-Choupal system continues to grow rapidly, reaching more than 3.1 million farmers by late 2004.[54] The initiative illustrates how improvements in technology and communications infrastructure can be good for both equity and efficiency in product markets.

In addition to better marketing channels and new technology, there are other ways to improve product market competition that can be good for equity. Measures that facilitate the entry of new firms often mean that small and medium enterprises benefit at the expense of large, politically connected incumbents. Product market competition can also drive consumer prices down and make goods more affordable for the poor. Of course, measures to improve competition benefit efficiency and growth as well, improving the welfare of the poor.

Licensing restrictions—even when designed in the name of equity—are one way to hamper competition. India reserves the production of more than 600 manufactured products, including apparel and textiles, to small companies. This licensing regime could cost the country jobs by preventing small producers from growing and competing with larger manufacturers in, for example, China. High regulatory, administrative, and fiscal burdens can also harm product markets by keeping firms in the informal sector. Informal firms face a number of constraints, including limited access to financing, which tend to leave them significantly less productive than their formal sector counterparts. For example, informal Turkish brake manufacturers achieve only 22 percent of U.S. productivity, while their formal sector competitors achieve 89 percent. Affordable access to titled land and reliable infrastructure (chapter 8) can also enhance firm and product market competitiveness.[55]

As discussed, improving transportation and logistical infrastructure can reduce the cost of moving goods. Better transportation links with other regions can also provide insurance against regional price fluctuations. For example, if there is a drought or food shortage in one area, efficient regional con-

nections would allow consumers to import reasonably priced food from other parts of the country. Finally, better transport and logistics systems reduce inventory costs by making the timing of delivery more reliable, again benefiting producers and consumers.[56]

Interactions between product and labor markets

Changes in product markets, whether induced by internal developments or external trade-related changes, can have powerful influences on the opportunities facing workers. Standard trade theory predicts that countries should export products that use relatively abundant factors intensively. Labor-abundant countries that open up should see relative gains in unskilled wages, as indeed occurred among the East Asian tigers in the 1960s and 1970s.[57]

The Latin American experience stands in sharp contrast. Many countries, including Argentina, Chile, Colombia, Costa Rica, Mexico, and Uruguay, saw wider wage differentials with increasing trade openness during the late 1980s and 1990s. Some argue that this was due to the massive insertion of low-income Asian countries into global markets. Others interpret the evidence as supporting generalized skill-biased technical change, in which trade opening facilitated processes of restructuring, including the destruction of jobs in inefficient industries, and rising demand and relative wages for skilled workers.[58] Whatever the reason, the question is whether this was a source of rising inequality in opportunity. Over the short to medium term, this was almost certainly the case, because unskilled workers cannot increase skills quickly. Over the longer term, rising wage differentials provide incentives for investment in education, if education systems provide equal opportunities (chapter 7).

Effects of economic restructuring on workers also depend on the extent of labor mobility. One study from India shows that the effects of trade liberalization in the early 1990s on poverty varied by state, depending on the flexibility of labor laws. In states with less flexible laws, where liberalization did not produce any measurable effect on the allocation of labor across sectors, the adverse impact of trade opening on poverty was felt the most. In states with more flexible labor laws, movements of labor across sectors eased the shock of relative price changes.[59] While greater mobility is desirable, the design of measures that increase flexibility needs to be balanced with the levels of worker protection that are appropriate for the institutional setting (see the earlier discussion on labor markets).

Safety nets and opportunity

Safety nets complement product market deepening and are often an essential element of a strategy to ensure that market expansion leads to more equal opportunities. General questions of the design of safety nets were discussed in chapter 7; here we highlight the links with product market change. As discussed above, trade opening creates winners and losers. How this affects equity depends partly on how governments can offer support to the losers.

Rodrik (1998) finds that openness is associated with higher government spending. The argument is that open economies are more subject to external shocks and spend more on social insurance to mitigate external risk. In more advanced economies with the capacity to manage social welfare systems, exposure to external risk is strongly correlated with spending on social security and welfare. In less-developed economies, governments rely on a broader set of tools, such as public employment, to reduce risk.

The specific design of safety nets can expand opportunities to those who suffer adverse effects. For instance, trade adjustment assistance programs in the United States extended unemployment benefits, training, and relocation subsidies to displaced workers. While the United States was offering the programs in response to the NAFTA, the Mexican government established *Procampo,* a cash transfer program for grain farmers to ease the pain of NAFTA-induced competition from the United States. It was designed to provide consumption support to compensate for price declines and to allow farmers to diversify into other activities. While the size of the transfers was hurt by the 1995 Tequila Crisis, there is evidence of gains to farmers

and of the use of proceeds for investment purposes.[60]

While the ideal policy mix may be one that combines reduced barriers and extensive safety nets, in practice, this is not always feasible. Many countries phase liberalization to seek to ensure that processes of job creation precede or accompany job destruction—this has been a central feature of the East Asian experience (see discussion of China in chapter 6). This carries risks of slowing restructuring and extending protection beyond periods justified by equity concerns because of capture by influential beneficiaries.

Credibility, political supportability, and the design of product market reform

While technocrats can design trade and other product market reforms that appear to be good for growth and equity, the expected gains will never materialize if there is not enough political support. Because of the nature of trade policy—a concentrated set of winners from trade barriers versus a diffuse set of winners from liberalization (consumers in general)—it is easy for vested interests to capture policy. Steel tariffs in the United States and agricultural subsidies in the United States, Japan, and Europe are obvious examples.

Even after trade liberalization laws have been passed, they are still not immune to capture. If economic actors do not believe that reforms are credible—that is, that politicians will recant at the behest of vested interests—the anticipated adjustments will never take place. Cashews in Mozambique again provide an apt example. In the early 1990s, the Mozambican government (working with the World Bank) implemented a new pricing regime that liberalized the export of raw cashews. But there was no credible political commitment to the new pricing regime, so neither cashew farmers nor cashew processors adjusted to the new price signals. Efficiency gains from the reallocation of resources never materialized.[61]

While this section has emphasized the heterogeneity of effects of product market changes, the policy message is not necessarily one of detailed fine-tuning of reforms. That brings risks of greater capture. The ideal balance is a combination of gradual but committed liberalization with extensive engagement in the complementary measures that broaden opportunities for all: education, infrastructure, competition, and safety nets. Societal debate and information can ensure that governments remain accountable to all groups, not just those with access and connections. Of particular importance for external opening is the role of external commitments. Entry into international agreements, such as the WTO, the European Union, or NAFTA, can effectively lock politicians into trade reforms. When trade regulations are bound by international agreements, reform commitments are more credible and less susceptible to capture by domestic special interests (asymmetries in power among the international parties to such agreements remain, as we will read in chapter 10).

Macroeconomic management and equity

Macroeconomic instability is both a cause and consequence of inequity

Macroeconomic stability is a public good and might be expected to equally affect all. There is a well-established association between macroeconomic stability and long-term growth, and growth typically brings expansion in opportunities to everyone. But the fact that stability is a public good does not mean that the incidence of benefits is equal. As discussed in chapter 4, the distribution of income gains from economic growth is typically as unequal as the initial income distributions. Moreover, macroeconomic instability, whether in the form of volatility or high inflation, can have differential and potentially inequitable effects, because the pattern of power and wealth can influence the distribution of losses—and different groups have differential capacities to manage the consequent shocks.

As in many other areas, there are two-way patterns of causation between macroeconomic conditions and equity. Unequal patterns of power and associated institutional structures are at the center of causative influences from inequity to insta-

bility and in regressive effects of crises. By emphasizing these links, we are not arguing against the large body of literature on economic causes of crises. Depending on the type of crisis, this literature sees the causes as fiscal imbalances, herdlike movements of investors behind exchange rate crises, and interactions among external liabilities, exchange rates, and financial-corporate conditions, especially under "crony capitalism."[62] Some of the processes in this literature complement the diagnosis here; others are manifestations of underlying distributional and institutional conditions.

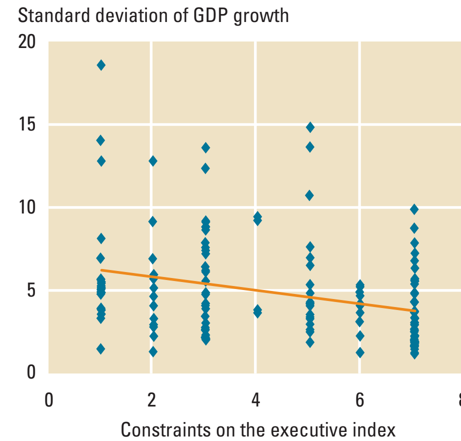
Figure 9.5 shows the bivariate correlation between macroeconomic volatility and a measure of "constraints on the executive" branch of government, which would be expected to be closely linked to restraints on elite power. Weaker constraints are associated with greater volatility (and a higher propensity for macroeconomic crises).

The correlation says nothing about causation. But there is evidence supporting the view that "weak and unequal" institutions have a causative influence on economic instability. A tradition of work interprets instability as a consequence of distributional struggles that are ineffectively managed by institutions.[63] As discussed in chapter 6, the seminal work by Bates (1981) on Ghana interprets exchange rate overvaluation and internal pricing policies as mechanisms for governments to severely tax cocoa farmers in the early postindependence period to provide resources to buy off urban groups. A combination of predatory governments and weak or absent balancing institutions created the preconditions for fights over rents and systematic political instability until the early 1980s. Analyses of hyperinflation, in settings as diverse as Bolivia and Israel, interpret macroeconomic instability as a consequence of failures to manage societal conflicts.[64]

Macroeconomic instability can interact with unequal influence in the fallout from crises

Crises, whatever the causes, are systematically bad for growth, more so in the presence of distributional struggles. Rodrik

Figure 9.5 Weaker institutions are associated with macroeconomic volatility and crises



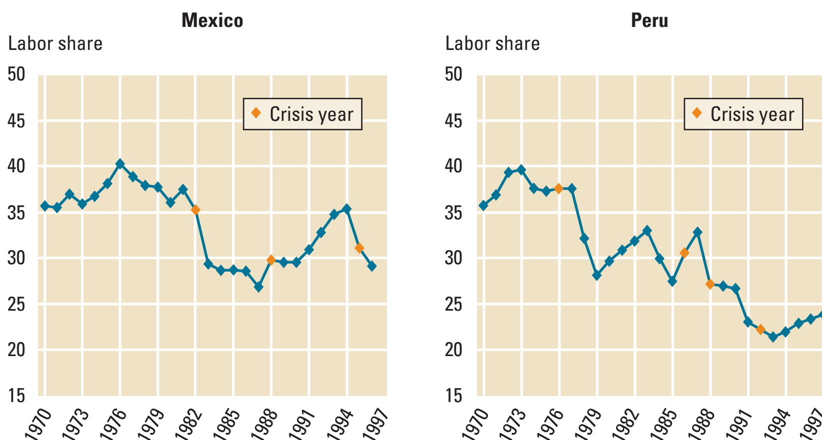
Source: Authors' calculations, using World Bank statistics and the Polity IV database for constraints on the executive index.
Note: A higher value for the constraints on the executive index denotes greater accountability.

(1999a) argues in a cross-country empirical analysis that the effects of external shocks in the 1970s were significantly worse for subsequent growth in societies in which latent distributional conflicts (proxied by income inequality or ethnolinguistic fragmentation) were more severe and conflict-management mechanisms (proxied by institutional strength and indicators of democracy) were weaker.

High inflation and macroeconomic crises can be particularly harmful to the poor, who are least equipped to manage adverse shocks. For the impacts on distributional outcomes, household survey evidence does not display systematic disequalizing or equalizing biases across countries: the Mexican 1994–95 crisis was slightly equalizing (although strongly poverty-increasing); the 2001 Argentine crisis was disequalizing. There is some evidence that high inflation is worse for poorer groups, for example, in the Philippines[65] and Brazil.[66]

Mechanisms for crisis resolution tend to be inequitable as a result of unequal influence. Many of the results are not fully reflected in household income and spending surveys. The reason is that the big action usually takes place elsewhere, notably in changes in capital income and fiscal positions that the surveys typically fail to capture.

Figure 9.6 Labor shares fall during crises and don't fully recover afterward



Source: Authors' calculations, based on national accounts.
Note: Crisis years are defined as years in which at least two out of three of the following occur: a 25 percent (or higher) nominal devaluation, negative growth, and 50 percent (or higher) rate of inflation.

There is evidence that crises lead to reductions in measured labor share (strongly influenced by formal sector earnings and employment). Diwan (2001) finds that labor shares systematically fall during crises and don't fully recover afterward, a cross-country result illustrated for Mexico and Peru in figure 9.6.[67] The flip side of this pattern is that the shares of corporate and financial sector capital income rise relative to wages. There are also significant interactions with structural variables. In particular, closed trade, capital controls, and fiscal deficits are associated with higher labor shares in normal times, but with larger falls in labor shares when crises occur. Crises are mechanisms for the resolution of distributional conflicts that are not tackled during good economic times. Labor is relatively immobile and so typically bears a higher proportion of the cost. Pre-crisis labor shares may, in some cases, have been too high for competitiveness and stability, but the point is that crises are a high-cost form of conflict resolution. And the interaction between shocks and weak conflict resolution mechanisms is associated with weaker long-run growth.[68]

In addition to any effects through the distribution of labor and capital income, important mechanisms work through the financial sector and associated fiscal action.

Table 9.3 Fiscal costs of selected banking crises

Country and episode	Fiscal cost (percent of GDP)
Argentina, 1980–82	55.1
Brazil, 1994–96	13.2
Chile, 1981–83	41.2
Ecuador 1996–	13.0
México, 1994–	19.3
Venezuela, 1994–97	22.0
Korea, Rep. of, 1997–	26.5
Indonesia, 1997–	50.0
United States, 1981–91	3.2

Source: Honohan and Klingebiel (2000).
Note: Costs refer to both fiscal and quasi-fiscal outlays and the present value of the future stream of costs. Banking crises in Ecuador, Mexico, the Republic of Korea, and Indonesia were ongoing at the time of the study.

Major crises lead to large financial losses, typically financed by both explicit and implicit fiscal outlays. Case study evidence indicates that these are highly regressive, through gainers and losers from capital flights, transfers from those outside to within the financial system, and the patterns of bailout among financial sector participants.

The fiscal costs of crises are large (table 9.3). For example, the post–Tequila Crisis Mexican bailout is estimated at $112 billion, with a large additional amount spent trying to prevent crises through liquidity support, sovereign bond swaps, and the financing of large investors who withdraw money from projects.[69] Halac and Schmukler (2003) use the $23 billion decline in the central bank's reserves between February and December 1994 as a proxy, calculating a total fiscal and quasi-fiscal cost of the crisis of $135 billion. This represents about one-quarter of Mexico's GDP in 2000 and some four times the $33 billion in capital receipts from privatization during the 1990s.

What is the pattern of gainers and losers? Some wealthy individuals undoubtedly lose their shirts. But there are strong tendencies for the poor to lose, sometimes to lose a lot. First, the wealthy with information and access to international banking systems get their money out first. And they may actually experience capital gains when domestic asset prices tumble and the exchange rate goes against the currency. In Argentina, the ratio of foreign assets to domestic GDP rose from about a quarter to more than 90 percent between 2001 and early 2002, because of a combination of capital flight and currency depreciation (figure 9.7).

Second, the recipients of fiscal bailouts are those within the financial system—depositors, creditors, and equity owners, who are systematically better off than those outside. (There are of course small middle-income depositors but, as noted below, it is possible to protect them without providing blanket protection for all.) Case study evidence finds biases toward wealthy and more influential individuals and groups within financial systems. Owners of large deposits enjoyed the greatest compensation (and

sometimes capital gains) in crises in Argentina, Ecuador, and Uruguay, often through getting their money out of the country, while small depositors suffered capital losses. In addition, there is evidence that large borrowers with close connections to banks were especially favored in crises in Chile, Ecuador, and Mexico.[70]

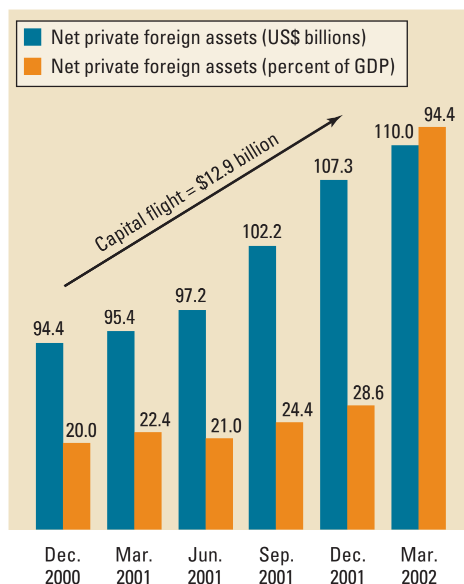
Crisis costs are paid for by some combination of higher taxes and lower spending. Who pays depends on the marginal pattern of taxation and spending. As a first approximation on the tax side, many developing-country tax systems are roughly proportional (everyone pays the same proportion of their income, primarily through indirect taxation). On the spending side, work on Latin America and Asia in the 1990s finds that marginal spending was generally progressive, as the expansion of social and infrastructure programs "crowded in" poorer groups.[71] Thus, the forgone spending hurt poorer groups the most. The net effect is a regressive workout financed largely by regressive fiscal adjustment.

While case study evidence indicates a strong pattern of regressive consequences of crises, this is contingent on initial structures, patterns of influence, and policy specifics. For example, the Russian crisis, while undoubtedly costly in social terms, may have led to a surprisingly positive shift to more equitable structures of resource management (box 9.6).

Policy directions need to take account of policy design and accountability structures

Macroeconomic instability is thus both product and cause of underlying inequalities and associated weak institutions. The costs are large to equity and growth. What can be done? As in other areas, it helps to answer this question in terms of the com-

Figure 9.7 In Argentina, the wealthy had a way out during the crisis



Source: Ministry of the Economy, Argentina.
Note: The sharp increase between December 2001 and March 2002 was because of the exchange rate devaluation.

BOX 9.6 *Did the Russian 1998 crisis have equitable consequences?*

The Russian crisis was at first glance typical of crises of the 1990s—driven by interactions between private capital movements and domestic institutional structures that encouraged moral hazard, and with large adverse effects for welfare. The social costs were severe, with a fall in GDP of 5 percent in 1998. Between 1996 and 1998 household per capita expenditures fell 25 percent, expenditure poverty rose from 22 to 33 percent and government transfers fell by 18 percent, albeit with better targeting (Lokshin and Ravallion 2000). There was also major capital flight, with many of the rich getting their assets out fast, leaving the rest of the society to share the costs. This fact alone is a sign of great inequity: the rich had more opportunity to protect their assets by shifting money out of the country. This (individually rational) behavior imposed costs on less wealthy groups.

But the transition appears to have had additional effects that were, at least to some degree, more equitable. Russia before the crisis was in a particularly inefficient and inequitable equilibrium, in which firms did not pay their energy or tax bills, and the energy sector didn't pay its taxes. Firms were not allowed to go under for fear of employment effects, but this was a highly ineffective safety net. Subsidies were estimated at 15 to 20 percent of GDP in the three years before the crisis, fueling corruption and delaying enterprise restructuring. There was extensive asset-stripping at the cost of the broader society.

The crisis triggered major changes in economic relationships. The strategy of "devalue and default" led to large relative price movements and cut Russia off from international capital markets. The cutoff, combined with the authorities' recognition of the unpopularity of hyperinflation, finally forced hard budget constraints on the system, which had powerful ripple effects in inducing the demise of the nonpayments system, making economic transactions more transparent and laying the basis for a recovery in taxes. Real exchange rate depreciation made many firms competitive again, and this fed through into employment. Furthermore, the big Moscow banks were allowed to fail (with total costs, largely incurred before the meltdown, a relatively low 2 percent of GDP). And the default meant that external holders of Russian paper took an immediate loss, effectively allowing a degree of international burden-sharing. While there were undoubtedly reputational costs, there may have been an advantage in taking this upfront, rather than after protracted negotiations. Overall, while a serious analysis of impacts on equality of opportunity is not feasible, the effective shift in regime from a system in which influence played a dominant role in resource allocation to one of hard budget constraints and greater transparency was probably good for efficiency and equity.

Source: Pinto and others (forthcoming).

plementary role of specific policy design and the deepening of accountability structures and societal mechanisms to manage conflict. The Israeli hyperinflation provides an illustration. Its resolution involved both a full set of financial and macroeconomic policies and an intensive process of societal interaction to manage underlying conflicts between organized labor, the corporate sector, and other interest groups.[72]

There is an extensive body of literature on design specifics. Thus, we conclude with some comments on the principles of macroeconomic management that emerge from a focus on equity. Some of the principles are fairly familiar, especially the need to build stronger regulatory and supervisory structures for the financial system and comprehensive insurance mechanisms while out of crisis. Once a crisis hits, it is particularly difficult to design and implement such measures and politically difficult to implement more equitable outcomes. By contrast ex ante insurance design—whether for depositors, bankruptcy, or unemployment—is more likely to be broad based and, if already in place, reduces the case for ex post deals tailored to the influential.

Less obvious is a heightened emphasis on fiscal prudence. In public debates, adopting a less stringent macroeconomic stance is often portrayed as a distributionally progressive approach, whether in good times or bad. While there will always be specific judgments about the distributional impacts of a range of fiscal and monetary policy options, the analysis here suggests that taking a "superprudent" position over the course of the cycle provides greater hope for supporting a more equal development pattern. On one level, this sharply reinforces the common prescription to break procyclical policy positions. Macroeconomic restraint in good times will facilitate automatic stabilizers and a sensible easing of policies to be applied in a disciplined fashion when adverse shocks occur. Thus, the priority is to build fiscal rules and institutions that help overcome the political pressures to deplete potential surpluses in good times, as well as informational asymmetry problems. These institutions should also improve the credibility of countercyclical fiscal policies during downturns.[73] This strategy would, in particular, provide the macroeconomic foundation for broad-based, self-expanding safety nets.

Finally, there is a case for different forms of accountability. Over the long term, the most effective approach is to move to new fiscal and social contracts built on deeper accountability structures—to a better political equilibrium.[74] There is then a need for an appropriate mix of stronger regulatory accountability shielded from short-run political pressures from all sides—more independent central banks and stronger financial sector supervision—and greater transparency and debate about the overall design of macropolicy and the incidence of workouts. There are important interactions with external actors and rules for crisis management that will be taken up in chapter 10.

In sum, we have explored policies that, by leveling the playing field in the markets for capital, labor, and goods and by managing the macroeconomy, can lead to greater equity and prosperity. Financial markets are typically biased toward incumbents, reflecting the historical political influence of the powerful. Yet rapid and ill-designed liberalizations can lead to further concentration of influence. Greater societal controls are needed as well as a more measured tackling of barriers—especially to small and medium firms—backed by regulatory structures and more information to reduce the power of connections.

Labor market outcomes may reflect the weak bargaining position of workers, but labor policies often lead to patterns of job protection that create economic rigidities and help those in good jobs, to the detriment of those in the informal economy. Support for unions and security for workers are important objectives, but designs need to be adapted to economic conditions in ways that reach poorer, informal workers and minimize impediments to economic restructuring.

Both the design of external trade policy and the workings of internal product mar-

kets reflect patterns of influence. Removing biases and ensuring access to all need to be complemented by measures to expand skills, infrastructure, and safety nets to achieve genuine access and to manage losses (especially horizontal inequities). Imprudent macroeconomic policy is typically inequitable: high inflation hurts those least capable of managing its consequences, and financial crises are particularly pernicious, because the powerful can benefit or be bailed out at the expense of the rest of society. Prudent macroeconomic management, backed by strong countercyclical policy and independence in policy design is an ally, not a foe, of greater equity. We now turn to policies that can help level the global playing field.

The role of public policy in addressing spatial inequalities

The persistence of regional disparities within countries is a major policy concern confronting many governments in rich and poor countries alike. Clarity on the causal factors of weak regional performance and careful consideration of potential tradeoffs are needed to guide policy choice over regional interventions.

The average income in Brazil's northeast is less than half the national average. Poverty rates are far higher than the national average in India's densely populated states of Bihar, Uttar Pradesh, and Orissa, and the regional income gap appears to be widening. In 1990, children in the northwest region of Nigeria were four times less likely to receive any immunizations and 50 percent more likely to die by age five than those near the capital in the southwest; by 1999 they were five times less likely to receive any immunizations and 85 percent more likely to die before age five. Chronic regional underperformance can give rise to many concerns and threaten national unity—lost economic potential, unfairness in regional opportunities, potential instability, loss of social cohesion, and adverse social consequences, including higher crime and disease.

The geographic and historical factors underlying interregional inequality are complex and overlapping. Weak resource endowments and distance from markets can constrain development in lagging regions. In many cases, economic differences are linked with long-standing, unequal relations of power between advantaged and lagging regions, and institutional weaknesses within the latter.[1] When actors in advantaged regions control the assets, decision-making and policy formation processes, and the terms of the policy debates on which lagging regions depend, regional "catch up" is much more difficult.[2]

When historically disadvantaged ethnic, racial, and social groups are concentrated in particular regions, group-based inequities become reflected in regional inequalities. This is the case in parts of Latin America, where indigenous groups are both poorer and concentrated in poorer regions,[3] and in Vietnam and in India where tribal groups (*adivasis*) are spatially concentrated.[4]

In the absence of redistributive fiscal transfers, recent reforms in many countries toward greater decentralization may aggravate regional disparities. The positive effects of decentralization may be lost in regions that have weaker fiscal capacity, such as in Argentina's experience with decentralizing reforms in education.[5] In poor regions where regional elites have particularly concentrated power, decentralization may also deepen both intra- and inter-regional inequalities.[6]

Trends in inter-regional inequality have varied considerably across countries. The United States has experienced convergence and lower interregional income disparities. Indonesia shows convergence of provincial incomes since the 1970s. Brazil has seen divergence over many decades, but recently has shown convergence. Evidence on India also suggests divergence. China's pattern of growth has reduced gaps in the 1970s and 1980s, which widened in the 1990s. And in Mexico a long-run trend of slow convergence in incomes shifted to one of slow divergence after an opening that started in the late 1980s.

Characteristics of lagging regions

The reasons for regions to lag varies, and we present a simple taxonomy.

Low poverty density, low market access. These regions are sparsely populated, remote, and face particular geographic challenges. Distance and poor resource endowment—often with weak social indicators, generally poor infrastructure, and weak regional voice—place these regions at the periphery of national economic activity and opportunity. Supporting development of these regions may be desirable on poverty grounds, but it is likely to be expensive.

Low poverty density, high market access. These regions typically have been booming at one point in history, and were well integrated with the national economy. But changing demand patterns or resource exhaustion became sources of decline, even though political influence may have persisted. For such "rustbelt" regions, there is a case for public support for movement of people and resources out of declining industries, backed by social safety nets for the affected workforce.

High poverty density, high or low market access. These regions are most often considered for targeted interventions: poverty is concentrated in them, population density is relatively high, and the lack of market integration is due to history rather than geography. Possible culprits include weak governance, poor institutional capacity and human capital, a history of sociocultural conflict and domination, a poor investment climate, and security problems. Such regions are often home to socially, racially, and ethnically disadvantaged groups. Where such groups are dispersed or patron-client relationships dominate, the challenge of fostering organization, agency, and political influence is especially great.[7]

Regional development policies and tradeoffs

Regional development policies involve interventions to facilitate inward investment, enhance income opportunities and well-being in lagging regions, help households move to opportunities elsewhere, and shift interregional power relations. Policies are context specific and involve tradeoffs. If lagging regional performance reflects geographic disadvantages or an absence of

Poverty density (poor or disadvantaged people per square kilometer)	Market access (population density, transport costs): Low	Market access (population density, transport costs): High
Low	• Chile's "zonas extremas" • Russian North (state-sponsored settlements) • Northern Canada	• N.E. China's "rustbelt" region • Developed country "coal towns" (France, U.K., U.S.)
High	• Thailand's northeast • Mexico's southern states	• India's "Hindu Belt" poor and populous states • Italy's southern Mezzogiorno

agglomeration and scale economies, public interventions may be particularly expensive. But when public policy is designed to correct market failures (such as underdeveloped insurance or credit markets), address specific social or historical factors handicapping regional performance, or capture externalities intrinsic to national welfare (cultural, environmental, security), there may be few or no efficiency tradeoffs.

Fiscal incentives

A popular approach involves fiscal incentives to induce industry to locate and invest in lagging regions: tax advantages, insurance or risk-sharing arrangements, direct subsidies, or indirect subsidies through provision of low-cost public services. But evaluations of fiscal incentives generally indicate that they can be costly and ineffective. Brazil's efforts to develop the manufacturing center of Manaus in the north have been a success by some measures, but costs per job created are high.[8] Interregional "fiscal wars" can also occur as regions compete to attract businesses. If uncoordinated or unconstrained, these can have adverse consequences for local tax bases and public services in competing jurisdictions. Compared to the alternatives listed below, this tends to be a high-distortion strategy.

Public investment

Targeted public investment, particularly in core infrastructure, is another policy response aimed at reducing geographic disincentives to firm location, whether for existing or new firms. China has followed this strategy, first in the coastal special economic zones, and now in western regions (see box below).

Investment in regional infrastructure links may enhance productivity of existing firms and attract new firms. But, it also allows more efficient firms in richer regions to sell to lagging regions. This is one factor that has slowed development of the relatively poor Mezzogiorno region of southern Italy, despite large investments in national north-south infrastructure that has reduced transport costs.[9]

Facilitating labor mobility

Facilitating voluntary labor movement to higher opportunity areas is another strategy. In contrast to fiscal incentives and public investments that focus on bringing jobs to poor areas, this strategy focuses on bringing poor people to areas with more potential. Relocation assistance can include transport, housing, training, resettlement allowances, and portable safety nets. Examples included incentives in Russia for families to relocate from their northern settlements—developed at huge state expense for resource extraction and security purposes during the Cold War—and incentives to support movement of labor out of declining industries, such as the moribund coal sectors in Western Europe and the former Soviet Union since the 1960s. While the programs have helped ease the impact of unemployment, there are questions about cost effectiveness and long-term impact.

There is also a long history of efforts to direct settlement of remote regions or encourage migration to frontier lands. Early settlers to the Americas, including the west and midwestern regions of the United States, were beneficiaries of legal land grants to clear and use new land. More recent programs include Indonesia's transmigration program that shifted Javanese to sparsely populated outer islands in the 1970s and 1980s, or early Ethiopian resettlement programs to fertile areas in the south and southwest regions of the country. However, these and other resettlement programs have been criticized for their coercive or ethnic dimensions, raising questions about the adverse impact on indigenous population groups and settlers.

Enhancing agency

Where intergroup inequalities in agency underlie regional disadvantage, national and regional policies addressing discrimination, racism, and citizenship deficits can be important instruments for dealing with spatial inequality. Enhancing voice and participation of excluded groups is also important for national peace and cohesion. While ethnic discrimination and regional disadvantage do not necessarily lead to conflict, researchers and truth and reconciliation commissions alike have identified them as contributing factors.[10] In Aceh, Indonesia, oil rents have been transferred back to the region since 1976, yet regional conflict and demands for autonomy have increased rather than abated.[11] This suggests that transfers alone are not sufficient to address regionally concentrated grievances—they must be accompanied by meaningful political participation and dialogue.

Conclusion

The specific nature of the constraints to regional growth and investment performance in lagging regions needs to be identified and prioritized. Policies that provide fiscal incentives to investors are likely to fail if the main factors that adversely influence regional investment climate—quality of local institutions, skilled labor availability, proximity to key markets, functioning capital and land markets, security risks—still pose binding constraints.

Public investment in infrastructure that reduces transport costs for both people and goods has often proved an effective strategy for integration. And, as with other policies, well designed technical solutions are more likely to be implemented if those living in poorer regions are empowered.

Development of lagging regions in China

Unprecedented economic growth and poverty reduction in China have been accompanied by significant increases in regional disparities since the economic reform in the late 1970s. The socioeconomic costs of a sustained divergence in income between leading and lagging regions has become a major concern of the government.

In 1999, the government initiated the "Go West" strategy to develop the lagging western region. Through targeted public investments and fiscal subsidies, the central government spent some 1,000 billion yuan (US$120 billion) in the past five years, focusing on infrastructure, education, health, and the environment. A variety of investment incentives and low interest loans aimed to attract domestic and foreign firms to areas in which the western region has some comparative advantage, such as energy, agriculture, and agroprocessing.

The relative decline of the historically advantaged northeastern region has also attracted concern. China's northeast currently suffers from slow growth and high unemployment in declining industries, along with many severely distressed towns and cities. The government started the "Revitalize Northeast" strategy in 2003. This involves new initiatives, including strengthening the investment climate, developing greater flexibility in factor markets, using public funds to support rather than postpone adjustment, and mitigating social costs through improved and portable safety nets.