“Comments on Dani Rodrik’s ‘Why is There So Much Economic Insecurity in Latin America?’”
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In these comments, we make essentially the following four points:

1. The concept of “economic insecurity” (hereafter EI) is not clearly defined and the empirical evidence supporting the author’s conceptualization of EI is flimsy.

2. Oftentimes trade-offs are not taken into consideration.

3. Second moments (variances, distributions) of macroeconomic variables are emphasized without due consideration of the first moments (such as average growth rates of per-capita income).

4. The treatment of the role of institutions is superficial.

Section 1 of this commentary summarizes and criticizes the evidence provided to support the point that there is much economic insecurity in Latin America. Section 2 summarizes the author’s diagnostic and implicit remedies. The remaining sections address the areas in which we think the analysis of the paper is incomplete.

1. THE PREMISE OF THE PAPER IS NOT WELL ESTABLISHED.

The question posed in the paper –why there is so much EI in Latin America- calls for clarification. Does it entail a comparison of levels of EI with respect to other regions or to an increase in EI in Latin America? The author provides no evidence showing that Latin America suffers from more EI than other regions. The discussion mainly focuses on the increase in EI that, according to the author, took place in the 1990’s. Furthermore, the concept of EI is poorly defined and (even if we could agree on a definition) the case for its increase is not convincing.

The evidence on “so much EI” consists of (1) two opinion surveys (2) decline of trade union membership, (3) increase of the proportion of employees not covered by “job security”, (4) unemployment rates, and (5) some per-capita income measures of aggregate EI (table 6B). We discuss each of these pieces of evidence in turn:

1. Tables 1 and 2 describe survey data from two Wall Street questionnaires. The first table shows responses to questions regarding current and expected living standards in a number of Latin American countries. It is quite difficult to give those answers any weight without a clear understanding of what “better” means. It is unclear how
answers vary across regions of the world - if the case is that EI is peculiarly high in Latin America, these surveys do not substantiate the claim. In table 2, it is not clear that people are faced with the trade-offs involved when asked whether the country should spend more on pensions. Not surprisingly, when there are no prices, people demand more goods (pensions) and less bads (military).

2. We argue below that a decline in union membership and power could actually increase the economic security of the average citizen.

3. Rodrik uses the decline in job protection as an indicator of EI. We argue in section 7 that standard measures of job security tend to be associated with higher EI.

4. According to the author’s own data (Table 4), unemployment decreased in eight countries, remained roughly unchanged in three, and increased in five. Of these five, the only case in which the increase has been really alarming is Argentina. Furthermore, the mean and median rates of unemployment have declined from 8.7% to 8.1% and from 8.7 to 7.4% respectively. (Excluding Argentina, the declines are from 8.7% to 7.6% and from 8.9 to 7.2% respectively.) So the evidence on unemployment, if anything, points the other way.

5. In Table 6B Rodrik shows that EI (measured as the probability that decade-average GDP growth rate is –5% or less) has gone up significantly from the 1980’s to the 1990’s for most Latin American countries. However, its level is still low when compared to the corresponding values from the 1960’s and 1970’s. As an alternative that concentrates on levels rather than on growth rates, we redo the exercise, asking instead, what is the probability that decade-average GNP falls below the value attained in 1981. The results are summarized in Table A.

<table>
<thead>
<tr>
<th>Country</th>
<th>Prob(x1&lt;1)</th>
<th>Prob (x2&lt;1)</th>
<th>Prob(x3&lt;1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Argentina</td>
<td>0.00</td>
<td>0.29</td>
<td>0.00</td>
</tr>
<tr>
<td>Brazil</td>
<td>0.42</td>
<td>0.30</td>
<td>0.00</td>
</tr>
<tr>
<td>Colombia</td>
<td>0.33</td>
<td>0.00</td>
<td>0.00</td>
</tr>
<tr>
<td>Chile</td>
<td>0.10</td>
<td>0.07</td>
<td>0.00</td>
</tr>
<tr>
<td>Mexico</td>
<td>0.76</td>
<td>0.23</td>
<td>0.12</td>
</tr>
<tr>
<td>Uruguay</td>
<td>0.58</td>
<td>0.43</td>
<td>0.00</td>
</tr>
<tr>
<td>Venezuela</td>
<td>0.00</td>
<td>0.36</td>
<td>0.39</td>
</tr>
</tbody>
</table>

*Source: Authors' calculations from World Bank Indicators. Assumption: Average ratio of GNP/GNP81 normally distributed

When we look at levels of per capita GNP as opposed to growth rates, the improvement from the 1980’s to the 1990’s found in Rodrik is confirmed. However, it is not at all evident that the 1990’s represent a worse scenario when compared to the 1970’s. Except for Venezuela, growth in the remaining countries during the 1990’s has been high enough to compensate for high frequency movements in GNP, ensuring a minimum level of GNP.
per capita over the decade. That is, insecurity has decreased in Latin America according to this measure.

The author does not mention inflation as a source of EI. It seems a dangerous omission for the Latin American case. It is hard to imagine worst economic insecurity than that suffered during high inflation. And, of course, the most vulnerable are those who do not have access to financial instruments or information. In the extreme case, hyperinflations have been more devastating for the economic security of the poor than any other economic disaster in history.¹

Summing up: we believe that providing a clear definition of what the author means by EI and measuring it more accurately are necessary steps to be able to ascertain its causes and to be able to give policy recommendations.

2. CAUSES (AND IMPLICIT REMEDIES)

Rodrik identifies three main causes of EI in Latin America:

(1) Debt Crisis and Policy Response
The author compares the trauma of the 1980’s in Latin America to the Great Depression in the U.S. He points out that, differently from the New Deal program in the U.S., which helped to provide social insurance and build safety nets, the market oriented reforms that followed the crises in Latin America have weakened institutions of social insurance, leading to more EI.

(2) Macro Volatility
Rodrik argues that high macroeconomic volatility, particularly driven by erratic capital flows, has had a disproportionate incidence on immobile factors, contributing to higher levels of EI among workers. Adding to this, he states that two key instruments such as fiscal policy and the exchange rate had to be abandoned in order to manage capital flows. He argues that fixed exchange rate regimes (or more generally, exchange rate policies not targeted on real variables) limit the ability to counter real shocks, and this has negative consequences both in the aggregate and in terms of insurance/distribution.

The main channel from (1) and (2) to EI is the labor market, through the decline of job security (one measure of which is the decline in unionization).

(3) Weakness of Institutions of Voice

¹ See Weyland (1996) and references there for evidence. “While income can be jeopardized in many ways, runaway inflation is the single biggest threat that can thrust large numbers of people suddenly in the domain of losses…Numerous opinion polls confirm that common people are concerned primarily about accelerating inflation.” (pp. 190) “...an often large majority of citizens (up to 77% percent in Peru) reported a decline in their economic well-being, specially due to inflation.” (pp. 192). Ahumada et al (2000) find that the poorest quintile pays twice as much inflation tax than the richest (three times as much during hyperinflation.)
As a third cause, the author blames the political systems in Latin America, which have failed to create viable mechanisms of voice. As manifestations of this failure, he mentions the fragmented and unrepresentative nature of national legislatures, the weakness of political parties and the decline in unionization.

3. THE IMPACT OF THE REFORMS

Rodrik’s critique of the reforms implemented in Latin America is controversial. Figure A shows the aggregate performance of the Argentine economy before and after the reforms.

It is undeniable that the scenario after the reforms is a far more attractive one.

Unfortunately, some people are not enjoying all the fruits of the improved economic performance. That is due to as poverty, unemployment and other problems in the labor market, underdeveloped financial markets that do not allow consumption smoothing, inadequate provision of social services, etc. All these problems call for special attention, but we are not sure that grouping them under the name of EI helps us understand their roots or helps us in thinking about possible solutions.²

4. DETERMINANTS OF VOLATILITY

² Furthermore, these issues have not necessarily followed a common trend in all Latin American countries and they should probably be addressed in distinct ways in the different countries.
Rodrik emphasizes the incidence of capital mobility as a source of volatility in LA. Even though its importance cannot be neglected, empirical evidence directs attention to other sources of volatility that have been as much or even more harmful for this region. Hausman and Gavin (1996) document the sources of volatility in Latin America (from 1970-1992), that they classify as either policy-induced volatility or external-shocks volatility. The main point in their analysis is that even though both sources of volatility have been important, policy volatility (in particular, monetary policy) has been tremendously higher in LA when compared to other countries/groups of countries.

5. EXCHANGE-RATE REGIMES

We have to confess that at least one of the authors of these comments feels quite uneasy entering the fray of the discussion about exchange rate regimes, which at times resembles chanting between fans of rival soccer teams more than a civilized academic exchange. Having said that, we believe that the treatment given to the issue in the paper is notably one sided; an illustration of the point we made in the introduction that the paper often ignores trade-offs, and that it forgets first moments (with their possible impact on second moments!) In this case we are referring mainly to the credibility effects of alternative exchange-rate regimes.3

Also, in the model of section VIII, it is not clear how one would map the experiments performed to real-world exchange-rate regimes. What the author calls flexible exchange rates, looks more like a fixed but adjustable exchange-rate regime under full information.

We are somewhat surprised by some assumptions made in the paper and in a large part of the literature, which in a pre – “Lucas critique” way assumes many parameters to be invariant across policy experiments. In particular, the implicit assumption that the degree of nominal rigidity is invariant to the policy regime (and its credibility) is quite difficult to swallow from a theoretical point of view. Even the shocks themselves, as Calvo (1999) notes, can be a function of the foreign exchange regime, its transparency and credibility.

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3 For the mechanisms through which fixed-exchange rate regimes provide more credibility, see Canavan and Tommasi (1997) and (1998), and Atkeson and Kehoe (2000).
An additional point is that exchange rate regimes should be considered in the context of a wider discussion about alternative international structures of macroeconomic governance. The “dream world” of one of these discussants would be a world of one currency (of course, fixed), no barriers to mobility of anything including labor, and sophisticated fiscal cooperation. A little closer to reality than such utopia, even in the non-cooperative current world, countries could achieve some of the magic in Rodrik’s exchange rate model by some contingent fiscal rules (which might also be feasible under the informational and governance assumptions of section VIII). The next section discusses some more realistic improvements on fiscal institutions.

6. IMPROVING FISCAL INSTITUTIONS

A series of important recent papers have shown that, contrary to the recommendations of most macroeconomic theory, fiscal policy in Latin America is procyclical. (See for instance Gavin et al 1996, Gavin and Perotti 1997, Talvi and Vegh 2000.) Furthermore, there is some indication that spending on primary education, health care, water and sanitation, and poverty-targeted programs are not protected during budget cuts in recessions (Inter American Development Bank, 2000), and even that spending on some social items may be more procyclical than aggregate spending (Ravaillon, 2000).

There seems to be a consensus that the channel that induces this “insane” fiscal behavior is that creditworthiness declines when bad shocks hit. The markets perceive Latin American countries as more likely to default after a negative shock. Often, governments are forced to further sacrifices, signaling to appease the gods with even further fiscal adjustments.4

If that is the case, then this might be one area where there is potential for improvement in both first and second moments. We know of two channels to improve reputations: one is sustained good behavior, the other is improving institutions. We recommend both. What improving institutions exactly means, will vary from case to case, depending on many factors such as which is the macroeconomic stance in other dimensions of policy. But, for many countries, there seems to be room for improvements in budget processes, tax administration, federal tax-sharing agreements,5 and –perhaps- some fiscal rules.

7. LABOR MARKETS: “JOB SECURITY”

Rodrik identifies the decline of job security as one of the main indicators and channels of increased EI in Latin America. As the author correctly points out, it is hard to come up

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4 There is some evidence that countries with worst inflation histories (a proxy for worst reputations) behave even more procyclically (Braun 1998).

5 This could be the crucial factor in the Argentine case, where the perverse incentives provide by the tax-sharing regime induce procyclical spending by the provinces – with provincial spending constituting 2/3 of consolidated spending excluding pensions.
with direct evidence on job security. But if we focus on the type of indicators used in the paper (things such as union density, and proportion of workers “protected” by formal written contracts to which labor protection regulation applies), one might argue that “job security” increases EI for the majority of the population. In the next section we focus on unions. Let us review here some recent results which seem to suggest that standard measures of job protection tend to be associated with worst labor market outcomes in terms of both first and second moments.

1. Heckman and Pages (2000) find that job security has decreased employment and increased inequality.

2. Caballero and Hammour (2000) argue that job protection leads, in the long run, to substitution of labor by capital, reducing wages and increasing unemployment.

3. Di Tella and McCulloch (1999) find that less flexible labor markets lead to lower employment, lower participation, higher and more persistent unemployment, and to jobless recoveries.

8. UNIONS

There is an undercurrent in the paper that seems to be saying that unions are a helpful institution to reduce EI. We do not have the time, the space, or even the knowledge to provide a full discussion of trade unions, in theory and in worldwide practice. We will restraint ourselves to a few points, some of which might be general, while others are specific to the actual workings of unions in some Latin American countries. The general goal of the points below is to argue that (actual) unions have, at best, dubious effects on economic security.

1. There is evidence that suggests that unions reduce employment. See for instance Allen et al (2000) for the case of Uruguay.

2. Some back of the envelope calculations (which should be carried more properly) indicate that, under some assumptions in the production function, a drop in unionization might decrease income volatility for most citizens.\

3. John Pencavel, in the very same article that Rodrik refers to, argues that “labor unions constitute a pressure group on government that, by imposing impediments on market

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6 The exercise assumes wages and employment of unionized workers to be fixed, and varies the fraction (less than $\frac{1}{2}$) of unionized workers in the population. Under some conditions, the exercise is similar to the one in Section VI of Rodrik’s paper, with unionized workers shielded against shocks and the rest of workers suffering a magnified impact.
processes, tends to increase the incomes of unionized workers at the expense, primarily, of nonunion workers, consumers, and future generations” (1997, p. 46)7

4. To Pencavel’s point one might add, with a particular eye to the workings of some Latin American polities, that unions as actors in larger political games (in what Spiller and Tommasi 2000 call political general equilibrium) oftentimes produce negative externalities on institutions beyond the labor market. In the Argentine case, we would include: the federal fiscal system (Saiegh and Tommasi 1998), the social security system (Brooks, 1998), the education sector (Savedoff, 1997), and the health sector (Montoya 2000). In the last three cases, union participation in Congressional policy making seems to have tilted the balance in favor of increasing trade union power, and against better provision of services crucial to economic security.

9. POLITICS AND INSTITUTIONS

The paper argues that the weaknesses of institutions of voice (unions, parties, legislatures) are among the causes of EI in Latin America. We will not deny the importance of “voice.” Let us just state that it is clear that neither us, nor the author, have a clear grasp on how exactly “voice” works and how exactly it matters.

But institutions are important not only for reasons of voice, but also because they are the rules of the game that structure outcomes. In our opinion, the first order effect of institutions is on outcomes. One of the weaknesses of the paper is that it does not pay sufficient attention to issues of political economy, specially institutional political economy.

The first eight sections of the paper do not include political economy considerations - quite surprising given that the author is one of the best known political economists of development. When the paper comes to issues of political economy and institutions, it does so with an overly light touch.

We believe that a much more micro-analytical approach to the institutional determinants of public policy is badly needed, not only in this paper, but also more generally.8 Further, even though we would not disagree with the view that some form of union representation might be a healthy component of a democratic polity, we wonder whether Rodrik believes that the actual unions in Latin American countries, “aging dinosaurs struggling to adapt as the climate changes” (Wallerstein and Western, 1999), will evolve into becoming sufficiently responsive to the needs of workers as a group.

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7 We might add that, given the characteristics of unionized and non-unionized workers in Latin America, the groups negatively affected by unions might include the elderly, the young, women, rural workers and, more generally, the poor.

8 Spiller and Tommasi (2000) suggest a possible framework for that endeavor.
Furthermore, the paper falls into rather unjustified broad generalizations about the workings of Latin American polities. The phrasing of the last part of section IX might leave the impression to the uninformed reader that, for instance, Argentina and Venezuela are in about the same trajectory in the evolution of their democracies. Nothing can be further from the truth. Hoping that we are not falling in the same mistake by dismissing the current state of Venezuelan politics with the stroke of a keyboard, let us provide an extremely summary (and rough) picture of recent years in the Argentine polity.

As experts on Latin American politics have clearly stated (Dominguez 1998, Jones 2000, Levitsky 2000) democracy in Argentina is alive and well. Argentina recovered democratic practices in 1983; underwent a profound process of market-oriented reforms in the 90’s, building upon a business-poor coalition; and it is, since December of 1999, governed by a center-left coalition with substantial appeal in the middle classes. The current political leaders and policymakers of Argentina are well aware of the type of issues emphasized in Rodrik’s paper, at the same time that (we hope!) they are also aware of the costs of macroeconomic (and microeconomic) mismanagement. It is not clear what additional message could this paper convey, which is not being processed already in the Argentine polity.

This takes us to another point that is not clear in the paper. At times we get the impression that the author is talking to an audience which is not aware of the problems -- perhaps the “Washington Consensus” straw man. Other times it seems that the author believes that these countries’ polities have chosen a particular point in the possibility frontier between “economic security” and other policy objectives, and that somehow they should move towards more security, sacrificing some other objectives.

If these countries are on one point along the frontier, there is nothing that we as analysts could (or should) tell them. We believe, though, that they might be in the inside of that possibility frontier. In the conclusion we suggest a couple of “win-win” strategies, both of which boil down to matters of institutional reform.

10. CONCLUSION

Latin American countries face many difficult problems, some of which are common to most of the countries, and others which affect with special virulence only some of them. These problems include unemployment, poverty, inequalities, imperfections in capital and insurance markets, malfunctioning education and health sectors, etc. More broadly, most of them lack some fundamental State capacities.

These problems need to be addressed, but we remain unconvinced that the notion of EI, as put forward in this paper, adds much to our understanding of the problems or to our search for possible solutions. At this point, we do not find the notion of “EI” as a particularly useful organizing concept.
Dani Rodrik seems particularly concerned about the “feelings” of the middle classes, and about what those feelings might imply for the sustainability of market-oriented reforms. That is indeed a formidable intellectual and political issue to which we need to pay more attention. As Dani puts it, we do not have any satisfactory answers; we would add that perhaps we are not even asking the right questions.

Recognizing the very limited state of our current knowledge, let us venture some tentative remarks. A few years ago, many of us were involved in trying to figure out the determinants of policies in developing countries, particularly puzzled by the wave of market-oriented reforms. That literature, which had Dani Rodrik as one of its intellectual leaders, did make some progress. But many important questions remain unanswered. We still do not have a good understanding of the formation of agendas at the elite level, or on the formation of mass opinion. Indeed the latter is an underdeveloped field even in the center stage of the social sciences.

Following the influential work of John Zaller (1992), we might conjecture that the way the general public transforms its own sense of well-being into political opinions and framing of viable options, is strongly influenced by political leadership and by the statements of expert communities. Indeed, that was one of the conjectures regarding the (forward) process of market-oriented reforms. The possibility of a backlash could probably be couched in the same logic. Whether the uneasiness of the middle classes transforms itself in mistaken attempts to undo some of the achievements of the last few years, or in more intelligent attempts at correcting many failures without threatening the core of the reforms, will depend largely on the way the options are framed by political leaders, and in turn on the way these options are framed to political leaders by expert policy communities.

Since we are all part of the last step, we should be particularly careful. In our opinion, the essential message should be:

A) Macroeconomically responsible macroeconomics is socially responsible macroeconomics. As the issue of procyclical fiscal behavior indicates, efforts to continue improving reputations for fiscal solvency, as well as efforts to improve the political and economic institutions affecting fiscal outcomes, will provide a payoff not only in terms of improving first moments, but also might enable Latin American governments to implement the policies necessary to mitigate the social costs of economic fluctuations.

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9 Some of that progress (at least from economics) is reported in Rodrik (1996), Tommasi and Velasco (1996), and Tommasi and Sturzenegger (1998). For a recent reassessment with more emphasis on the role of political institutions, see Bambaci et al (1999).

10 See Graham and Pettinato (1999) for some recent progress in using objective and subjective information to try to understand people’s attitude towards economic policies.
This indicates that responsible macroeconomics is a complement, not a substitute for concerns about EI and about the social effects of macroeconomic volatility, contrary to what some current literature (Rodrik and also Lustig in this issue) seems to suggest.

B) If we had to choose one entry point to the problems of Latin America, we would not choose “EI.” There is always “too much” of something bad in Latin America; that “something” keeps changing over time or across diagnoses: lack of democracy, inflation, income inequality, economic insecurity. In our opinion, the strategy should be to try to identify the reasons why Latin American countries by and large do not seem capable of providing effective fiscal, social, monetary, regulatory and many other policies. This points to some form of institutional weakness, what authors like Evans (1995) and Rodrik (1997) call lack of State capacity. In several recent papers, Rodrik emphasizes the (even economic) virtues of participatory policies. 11 We agree with that, but we believe that a more “nuts and bolts” approach is needed to understand the varieties of institutional malfunctionings in Latin America. 12 Each country needs to diagnose what type of institutional reform (if any) could improve the governance of macro, micro and social policies. Only if such reforms are implemented, will the concerns in Rodrik’s paper be addressed in the politico-economic equilibrium of each country.

Reference


12 As Naim (1999) puts it, “institutional weakness is not one specific illness, but, like cancer, includes a variety of maladies, each requiring different treatment.” On the need to stop searching for the institutional Holy Grail, see also Acuña and Tommasi (1999). Spiller and Tommasi (2000) develop an analytical framework that emphasizes the capacities of political actors to enforce intertemporal exchanges, and provide a specific diagnostic for the Argentine case.

Brooks, Sarah (1998) “Political Dynamics of Pension Reform in Argentina” Mimeo, Department of Political Science, Duke University, September.


Caballero, Ricardo and Mohamad Hammour (2000) “Institutions, Restructuring and Macroeconomic Performance” Mimeo, MIT.


