Review of
ECONOMICS
and
INSTITUTIONS

Review of Economics and Institutions
ISSN 2038-1379 DOI 10.5202/rei.v2i2.29

Vol. 2 – No. 2, Spring 2011 – Article 2

www.rei.unipg.it

Economic Integration, Inequality and Growth: Latin America Versus the European Economies in Transition

Giovanni Andrea Cornia✉
University of Florence

Abstract: The paper first summarizes the theoretical and empirical literature on the growth and inequality impact of the liberalization of trade, FDI, portfolio flows, and migration. It then compares the inequality and growth performance of Latin America over 2000-2008 with that recorded during the same period in the fast liberalizing European economies in transition. The paper argues that the latter recorded growth rates of GDP slightly higher than those of Latin America, but that they experienced also greater instability and a rise in income inequality which instead declined in most of Latin America. The paper suggests that such divergent performance is mostly explained by differences in policies.

JEL classification: D31, E24, E62, F20, F41, I20, O54, P27
Keywords: policy reforms, neo-liberal policies, international economic integration, income inequality, growth, Latin America, transition economies of Europe

The author would like to thank José Antonio Ocampo, Nazrul Islam, Milica Uvalic and participants to a seminar given at Nuffield College, Oxford on 2 December 2010 for comments on an earlier version of this paper. The author would also like to acknowledge the unfailing research assistance provided by Bruno Martorano. The usual caveats apply.

✉ Address: Department of Economics, University of Florence - Building D6, Room 2.55 - Via delle Pandette 9, 50127 Florence, Italy. (Phone +39 055 4374599, Fax: +39 055 4374905, Email: giovanniandrea.cornia@unifi.it).

Recommended Citation
Cornia, G.A. (2011). Economic Integration, Inequality and Growth: Latin America Versus the European Economies in Transition. *Review of Economics and Institutions*, *2*(2), Article 2. doi: 10.5202/rei.v2i2.29. Retrieved from http://www.rei.unipg.it/rei/article/view/29

1 Introduction

The world economy is far more integrated today than in 1980, the year that conventionally marks the beginning of the current phase of globalization. This growing economic, social, and cultural integration is to a large extent the result of endogenous changes in transportation, information and telecommunication technologies, and in demographic trends. Yet, the policies that have dominated the world scene until the onset of the recent financial crisis (and which are referred to for simplicity as 'neo liberal policies') contributed to the acceleration of global economic integration. While China, Vietnam and a few other economies followed a home-made approach to external liberalization, it is fair to say that the 1980s and 1990s saw a dominance of the neo-liberal policy approach in the majority of the developing and transition countries. However, during the last decade economic policy evolved in an important way in Latin America (LA) due to increasing dissatisfaction with the results of this approach and to the ensuing election of progressive regimes sensitive to distributive issues. In contrast, in most economies in transition of Eastern Europe and the Former Soviet Union (EE-FSU), the last decade witnessed a deepening of neo-liberal reforms. This difference in approaches permits to compare the growth and distributive impact of alternative policy packages within the context of a rapidly integrating world economy.

2 Economic Integration, Inequality and Growth: What Does the Literature Show?

What factors inspired policy making during the decade of 2000s? A tentative list of such factors includes political economy factors, political shifts, the pressure of international agencies like the IMF and the EBRD, a rapidly integrating world economy, the lessons learned about the impact of policy approaches implemented during the prior decades,[1] and – possibly –

[1] A framework which helps explaining changes over time in the factorial and personal distributions of income, decomposes the total income of household i as the sum of the products of its endowments of unskilled labor (LF), human capital (HC), physical capital (K), and land and other natural assets (L) by their respective returns, namely uw (unskilled wage), sw (skilled wage), rk (return on capital), and r (the rent of the land and mines). In symbols: $y_i = uwLF_i + swHK_i + rL_i + rkK_i$. Assuming the state taxes these incomes at different rates and that it redistributes some of the revenue in the form of household transfers, the post-tax and post-transfer income of person i can be expressed as: $y_i = uw\ LF_i\ (1 - t_{uw}) + sw\ HK_i\ (1 - t_{sw}) + r\ L_i\ (1 - t_r) + rk\ K_i\ (1 - t_{rc}) + TR_i$.
Changes over time of the income share of household i (y_i/Y) thus depends on: changes in distribution of production factors (LF, HK, L, K) among households; changes in the remuneration of the production factors (uw, sw, r, rc); and changes in transfers (TR) received and taxes paid (t) by each household. This framework is particularly useful for the analysis of the distributive changes observed during the last three decades, during which the distribution of LF, HC, K and L, as well as the factors returns (sw, uw, rk, and r) and of taxes and transfers (t and Tr) have changed in an important way.

the overall evidence of the international literature on the growth and distributive effects of neo-liberal policies. In this regard, we summarize hereafter the main findings of the empirical literature about the distributive and growth impact of such policies.

2.1 Distributive and Growth Impact of Trade Liberalization

The neoclassical trade theory embodied in Heckscher-Ohlin-Stolper-Samuelson (HOSS) theorem predicts that trade liberalization leads to an increase in national income in participating countries following an allocation of production based on comparative advantages. In addition, in labor-abundant countries, trade liberalization switches production from capital-intensive and inefficient import-substitutes towards labor-intensive exports, with favorable inequality effects. The empirical findings about the growth impact of trade liberalization, however, are very heterogeneous and do not allow to come to clear-cut conclusions. The mainstream literature[2] argues that trade openness enhances physical capital investment and economic growth. However, Rodriguez and Rodrik (1999) and Rodriguez (2007) show that more open economies did not fare better than less open ones and that standard measures of trade policy are basically uncorrelated with growth. It is only by adding additional variables that they found a tenuous link between trade policies and growth. Even recent attempts at disentangling the complex links of causality and endogeneity among geography, trade shares and institutions do not point to a strong effect of greater trade integration on economic growth. For instance, some of the fastest growing economies since 1990, such as Lebanon and Lesotho, have applied restrictive trade policies, whereas some of the most open ones, such as Moldova and Mongolia, experienced considerable growth collapses (Rodriguez, 2007). One is therefore tempted to conclude that the impact of trade liberalization on growth varies according to the size of the economy, sector of specialization, stage of development, and other factors. While in the early stages it is difficult to industrialize and grow without some trade protection, in more developed economies the international division of labor, economies of scale and foreign competition may be needed to improve growth and – under certain conditions – reduce income inequality.

In contrast, the evidence on the distributive impact of trade liberalization on inequality tends to highlight more frequently than not its negative impact. Bourguignon and Morisson (1989) found that in 35 small developing countries trade liberalization reduced the income of the richest 20 percent of the population and raised that of the bottom 60 percent. Similar conclusions were arrived at by Wood (1995) for the East Asian exporters of labor-intensive manufactured goods with reference to the 1960s and 1970s. Yet, a growing body of literature points to opposite conclusions for a broad range

[2] See for instance the studies of Dollar, Ben-David, Sachs and Warner, and Edwards cited in Rodriguez (2007), as well as Wacziarg and Welch (2003).

of countries. For instance, wage inequality was found to have increased in six of seven Latin American countries that liberalized trade, as well as in the Philippines and Eastern Europe (Lindert and Williamson, 2001). In turn, a study of 38 developing countries found that trade liberalization benefited the top 40 percent of the population while affecting negatively the bottom 40 percent (Lundberg and Squire, 1999). Similarly, Savvides (1998) shows that the most open developing countries experienced a rise in inequality between the 1980s and early 1990s and that there is a positive correlation between the income share of the poorest quintile and trade protection. Finally, a review of the evidence for Mexico, Colombia, Chile, Brazil, Argentina, Hong-Kong and India during the 1980s and 1990s (Koujanou-Goldberg and Pavcnik, 2007) identifies a parallel increase in international trade integration and income inequality and confirms there is no evidence that trade openness favours the less fortunate.

How can we explain these conflicting findings and the discrepancy between empirical results and theoretical predictions? To start with, it must be underscored that the HOSS theorem holds under restrictive assumptions, i.e., trade between two countries producing two goods with two factors (capital and labor) using a technology that remains constant over time. The model also assumes no economies of scale, efficient factors markets (characterized by no restrictions to factors mobility and their full employment), balanced trade and symmetric trade liberalization by all partners. Yet, in the real world, trade takes place in a multi-country, multi-factor and multi-goods context in which most of the above assumptions do not hold. As a result, the predictions about the inequality and growth impact of trade liberalization change when some of these hypotheses are relaxed, i.e.,: (a) on occasion of changes in comparative advantages among countries participating in multi-country, multi-factor and multi-goods trade. Such shift was observed most vividly in the 1990s, when the entry on the world market for labor-intensive manufactures by the low-wage East Asian economies affected the comparative advantage of middle-income countries of Latin America, Eastern Europe and South East Asia vis-à-vis the OECD countries; (b) when trade liberalization happens in countries with an unequal distribution of the abundant factor (i.e., in the case of land- or mineral–intensive exports in countries dominated by *latifundia* and a few large mining corporations); (c) when trade liberalization leads to the import of skill-enhancing investment goods which cause an increase in the demand for and wage of skilled workers and a fall in the demand for and wage of the unskilled ones; (d) in case of unilateral trade liberalization combined with restrictive practices by the trading partners, as in the case of agricultural imports in OECD countries; (e) in case of trade reorientation following capital account liberalization, the appreciation of the real exchange rate and shift in demand towards cheap imports and away from domestic products (Taylor, 2000) which provoke a reduction in formal employment and wages, and greater reliance on out-

sourcing that further reduces absorption of unskilled labor.

2.2 *Distributive and Growth Impact of the Liberalization of FDI*

The theories of the distributive impact of FDI implicitly or explicitly refer to the case of greenfield investments in labor-intensive manufacturing in new sectors. They argue that the FDIs reduce income inequality and accelerate growth in low-wage, labour-abundant countries by raising the demand for unskilled workers and offering higher wages than those prevailing in the informal and rural sectors. FDI is also assumed to generate dynamic gains by contributing to technological and human capital upgrading, and to growth. Empirical evaluations of wage changes in Trans National Corporations-controlled firms provide results consistent with such theory in four East Asian countries (Te Velde and Morrissey, 2002) but opposite results in several other countries (Alarcon and McKinley, 1996; Benassy-Queré and Salins, 2005; Cornia and Martorano, 2009). Also in this case the failure of theory to predict actual changes in inequality and growth is explained by the relaxation of some of the hypotheses on which such theoretical models are based, as in the case of : (a) increased FDIs in capital-intensive mining, manufacturing (chemicals, metallurgy and machinery), and capital and/or skills intensive services such as utilities, finance, telecommunications, and business services which now account for some two thirds of all new FDI (UNCTAD, 2009 Table A.I.9); (b) mergers and acquisitions. Most often, foreign firms acquiring domestic firms impose cuts in employment, increases in tariffs, and consolidations among firms leading to, *ceteris paribus*, adverse distributive effects and uncertain growth effects (Baldwin, 1995; Morley, 2000); (c) the entry of capital-intensive FDI in markets which are already supplied by labor-intensive domestic firms, causing in this way a net loss of employment; (d) the shift by multinational firms of parts of its semi-skilled intensive production to developing countries (as in the case of the outsourcing of production from the US to the *maquiladoras* in Mexico) which generated an increase in the demand of skilled labour (Feenstra and Hanson, 1997); (e) the *'race to the bottom'* among developing countries trying to attract FDI by making concessions in the fields of taxation, subsidies, labor and social security legislation, and so forth, which, in the end, affect the distribution of private and public consumption.

2.3 *Distributive and Growth Impact of the Liberalization of Portfolio Flows*

Mainstream theory has until recently maintained that the liberalization of portfolio investments – i.e., purchases of bonds, shares and securities by non-residents in local stock markets, lending by foreign to domestic banks, and borrowing abroad by domestic firms, families and the state - raise investment, growth, employment, productivity and equity in countries with

low savings but high rates of return on capital and an abundant supply of cheap labor. Other supposedly positive effects include a decline in domestic interest rates, a faster accumulation of currency reserves, and a 'disciplining effect' on domestic macro policy. However, contrary to the above predictions, the evidence points to a consistent deterioration of income inequality and growth prospects associated with the liberalization of portfolio inflows and outflow, particularly in countries with weak labour institutions and social safety nets (Galbraith and Jiaqing, 1999; Diwan, 1999; Behrman et al., 2000). Explanations of the discrepancy between mainstream theory and evidence suggest that: (a) large portfolio inflows can cause an appreciation of the real exchange rate, reduce employment and growth in the export sector, shift resources from the tradable to the non-tradable sector, and encourage subcontracting and wage cuts in the tradable sector to preserve profit margins (Taylor, 2000); (b) portfolio investment are often directed not to agriculture and labor intensive manufacturing but to capital- and skill-intensive companies in the finance, insurance, and real estate sectors (*ibid*) which have higher short-term rates of return and a perceived low risk profile; (c) portfolio flows cause growing financial instability which leads to destabilizing financial crises with real growth effects (Caprio and Klingebiel, 2003). Left to themselves, deregulated financial systems do not perform well owing to problems of incomplete information, markets and contracts, herd behavior, panics, weak supervision and assets price speculation (Prasad et al., 2003). Indeed, much of the recent instability and recession (including that observed during 2008-2010) derives from the deregulation of domestic and external financial transactions carried out during the last thirty years; (d) the bailouts of banks which implied a transfer from (poor) non-participants to (middle and upper class) participants in the financial sector, including depositors, borrowers, and financial institutions caused negative shifts in income distribution (Honohan, 2005; Halac and Smuckler, 2003).

2.4 Distributive and Growth Impact of Migration

During the globalization of the 1870-1914 period, when 60 million of mostly unskilled workers migrated from the European periphery to the New World, migration reduced income inequality in the European countries, as the ratio of unskilled wages to farm rents rose following a drop in labor supply due to migration (Lindert and Williamson, 2001). The growth effects were also favorable. However, the recent migration tends to increase inequality in the countries of origin as the unskilled poor are less likely to migrate than middle class people whose families are better able to finance the high costs (between 3000 and 20,000 US$ per person) of informal migration. Remittances are therefore generally received by households in the 40^{th} to 80^{th} percentile of the income distribution, bypassing the people of the lowest rung. At the same time, outmigration of skilled workers may raise their wage in the countries of origin, leading to a rise in the wage premium

and overall inequality. Here, too, there are some discrepancies between theoretical predictions, and a review of the empirical literature (Docquier and Rapoport, 2003) does not offer conclusive evidence as to whether international migration increased or decreased economic inequality in the countries of origin. Such literature suggests that migration may be less un-equalizing in source countries when it is state-sponsored or when large migrant networks emerge in the countries of destination. As for the long term growth effects, remittances may stimulate overall long term growth in source countries[3] by lessening the balance of payments constraint, allowing the import of capital goods, facilitating the formation of human capital (as children staying behind have a greater chance to graduate from schools), and allowing poorer households to acquire and access productive assets and complementary inputs (see McCormick and Wahba, 2001 for Turkey and Egypt). But migration might retard growth because of the brain drain and Dutch Disease it causes, and because of a contraction of domestic labor supply due to growing reliance on remittances as a source of livelihood. The overall evidence in this regard shows that remittances have a favorable effect on poverty, volatility and current consumption but have no effect on the investment rate, school enrolment rates and the long term growth rate of GDP (IMF, 2005).

3 Liberalization, Distribution and Growth: Comparing the Experiences of Latin America and Eastern Europe and the Former Soviet Union During the Last Decade

3.1 Comparative Performance in the Fields of Growth, Inequality and Instability

Between 2000 and 2007 the countries of EE-FSU recorded a GDP growth that was faster than in LA (this difference is reduced if the comparison is done over 2003-2007, i.e., after the 2001-2 recession which affected all LA). Large inflows of FDI and foreign loans in EE-FSU were a welcome addition to domestic savings and helped to enhance growth performance (Table 1). In addition, the EE-FSU, particularly the countries of Central Europe and the Baltics, became much more integrated into the global economy than any other region. For instance, in 2008 the exports of goods and services amounted to some 50 per cent of GDP in EE-FSU, compared with 23 percent of GDP in LA.

[3] The evidence in this regard is contradictory: Faini (2002) finds a positive but weak relation between migration and growth, Chami et al. (2003) find a negative relation, while the IMF (2005, Table 2.1) finds no relation and shows that the investment rate does not increase in countries with high remittances/GDP ratios.

Table 1 - GDP Growth in Eastern Europe-Former Soviet Union (EE-FSU), Latin America (LA) and Selected Countries Severely Affected by the 2009

	2000-6	2007	2008	2009	2010
			EE-FSU		
Central Europe & Baltics *(of which)*	**5.6**	**7.0**	**1.7**	**-8.3**	**-0.4**
- Estonia	*8.5*	*7.2*	*-3.6*	*-14.0*	*-2.6*
- Hungary	*4.3*	*1.2*	*0.6*	*-6.7*	*-0.9*
- Latvia	*8.6*	*10.0*	*-4.6*	*-18.0*	*-4.0*
- Lithuania	*7.3*	*8.9*	*3.0*	*-18.5*	*-4.0*
South Eastern Europe *(of which)*	**5.1**	**7.2**	**6.6**	**-3.6**	**0.5**
- Bulgaria	*5.4*	*6.2*	*6.0*	*-6.5*	*-2.5*
- Romania	*5.6*	*6.2*	*7.1*	*-8.4*	*0.5*
East. Europe &Caucasus *(of which)*	**9.1**	**12.1**	**5.9**	**-7.0**	**2.6**
- Moldova	*6.0*	*3.0*	*7.2*	*9.0*	*0.0*
- Ukraine	*7.4*	*7.9*	*2.1*	*-14.0*	*2.7*
Russian Federation	**6.9**	**8.1**	**5.6**	**-7.5**	**1.5**
Central Asia	**8.9**	**9.3**	**7.6**	**2.5**	**6.0**
Total EE-FSU	**7.1**	**8.7**	**5.5**	**-4.8**	**2.1**
			Latin America and the Caribbean		
C. America + Caribbean *(of which)*	**3.9**	**6.5**	**4.2**	**-1.4**	**3.0**
- Mexico	*3.0*	*3.4*	*1.3*	*-6.7*	*3.5*
South America *(of which)*	**3.5**	**6.5**	**5.9**	**-0.1**	**4.7**
- Chile	*4.3*	*4.7*	*3.2*	*-1.8*	*4.5*
- Paraguay	*2.0*	*6.8*	*5.8*	*-3.5*	*3.0*
- Venezuela	*4.1*	*8.2*	*4.8*	*-2.3*	*2.0*
Total L. America & Caribbean	**3.7**	**6.5**	**5.2**	**-0.7**	**4.3**

Source: author's compilation on the IMF's World Economic Outlook Database and CEPALSTAT database.

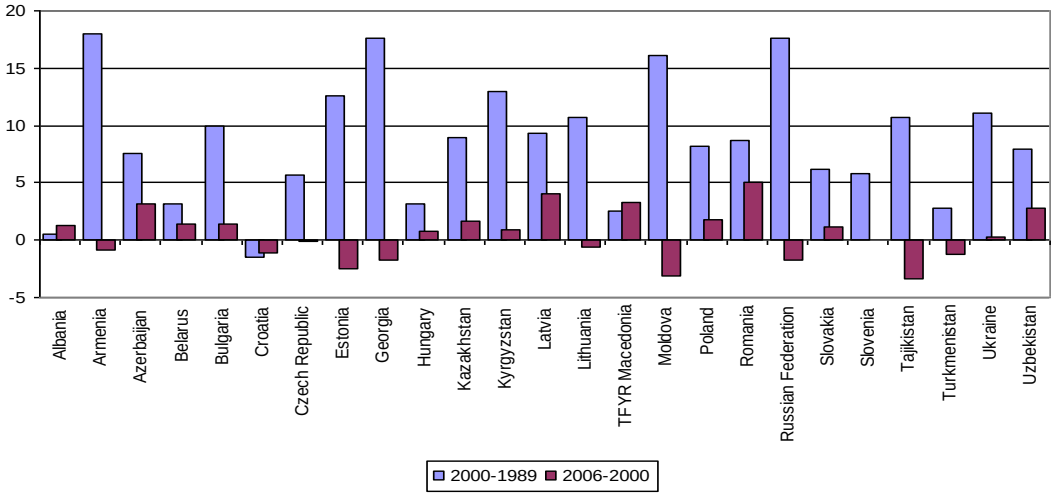
Yet, this policy model has run into four main problems. First, while the external integration of the region increased, its diversification remained limited. In fact, growing integration with Western Europe, which accounts for 60-90 percent of the trade and financial transactions (Nuti, 2009), increased the vulnerability of EE-FSU countries to shocks originating from this region. In contrast, the destination of LA exports became more diversified, thanks to growing trade with the Asia-Pacific region. Second, EE-FSU was the only emerging region to run collectively a persistent and large current account deficit while, by contrast, LA consistently ran a surplus between 2003 and 2008. Persistent deficits and rising indebtedness increased EE-FSU's susceptibility to capital flow reversals.[4] As a result of these two factors, though EE-FSU grew as a whole by 7.1 percent over 2000-2006, as opposed to 3.7 percent of Latin America over the same period (5.4 over 2003-6), this superior growth performance disappeared in 2008 and was reversed in 2009-2010 (Table 1). This was particularly true for the Baltic countries, Hungary, Ukraine, and Russia. In LA, only Mexico (which diversified little its exports destination) recorded in 2009 a large GDP drop (*ibid*). In several respects, the recent EE-FSU crisis is a repeat of the Latin American debt-led growth

[4] Auer and Wehrmuller (quoted in Nuti, 2009) estimate in 250 $ billion the foreign debt of the region, much of which became sub-primes as many local currencies were devalued.

and debt accumulation of the 1970s that ended with the crisis of the 1980s.

Third, the rigid neoliberal policies adopted in much of the EE-FSU region reduced the policy space (in the fiscal, monetary and exchange rate areas) required to respond effectively to the external shocks that hit the region since late 2008. Finally, the neoliberal policies of EE-FSU have given rise to a pattern of growth that was often anti-poor, not only during the transformational recession of 1989-2000 but also during the roaring years of 2000-7 (Figure 1). Yet, the worsening of inequality in the region during the recent period was moderate so that – taking the combined effect of rapid growth and moderately rising inequality – the real incomes of the bottom deciles nevertheless increased.

Figure 1 - Changes in the Gini Coefficient of the Distribution of Income over 1990-2000 versus 2000-2006 in EE-FSU

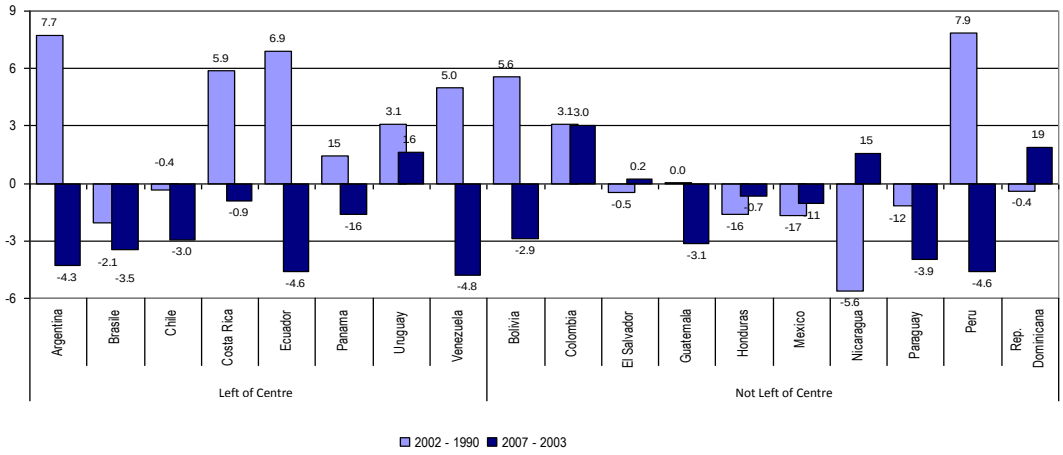


Summary of Gini changes: 1989-00: 23 up, 1 down, 1 no change; 2000-06: 12 up, 7 down, 6 no change.
Source: author's compilation on the basis of SWIID2, July 2009 version.

The rise in inequality witnessed since 2000 in 14 countries of the EE-FSU region are owed to the factors discussed in section 3 and in particular to controversial macro and tax policies, the distorting effects of a lopsided external integration, the hands-off policy approach in the field of labour and educational policies, and (with the major exception of the Central European countries) limited social transfers. Other factors not discussed in this paper that are often cited as having contributed to the inequality increase concern privatization and introduction of user fees in formerly free public services. The rise in inequality in EE-FSU in the last decade, however, needs to be seen in relative terms, because, despite this rise, inequality in this region still remains well below LA levels, largely due to a still much larger redistributive impact of direct taxes and public transfers (Zaidi, 2009). At the same time, income inequality fell – often drastically – in most countries of LA (Figure 2) for the reasons discussed below.

Since 2002-3 LA introduced reforms broadly inspired by a model of 'open economy redistribution with growth' committed to reducing the social debt

Figure 2 - Changes in the Gini Coefficient of Income Inequality over 1990-2002 versus 2003-2007 in Latin America



Summary of Gini changes: 1990-02: 9 up, 5 down, 4 no change; 2002-07: 4 up, 11 down, 3 no change.

inherited from the colonial past and exacerbated by the neo-liberal policies of the 1980s and 1990s. With few exceptions, the new policy model did not introduce a radical redistribution. Rather, it emphasized orthodox objectives such as macro-stability, fiscal prudence, and the preservation of free trade and capital movements. Yet, in a clear departure from the 1990s, most LA governments opted for managed exchange rates, a prudent fiscal policy, reduced dependence on foreign capital, rapid accumulation of currency reserves, and a more active role of the state in the fields of taxation, labor market, and social policies.

It could be argued that the differences documented above in the field of growth volatility and inequality are mainly explained by differences in economic and political structures between the two regions. In this regard, it must be noted that EE-FSU and LA are both middle income regions (though average incomes are higher in the former regions),[5] except for a few Central American, Caribbean, Balkan and Central Asian countries which belong to the group of countries with a low-middle income per capita. Both regions are highly heterogeneous in terms of economic structures. LA includes a group of semi-industrialized countries (the Southern Cone and Mexico), a group of commodity exporters (the Andean countries), another group depending on migrant remittances (most Central American and Caribbean countries), and a group of mixed economies depending on services (Table 2). Likewise, EE-FSU comprises a cluster of industrialized countries (Central Europe, Belarus and Ukraine), another of commodity exporters (Russia, Azerbaijan, Turkmenistan, Kazakhstan, Uzbekistan), a third group where high- and low-tech services (transit fees, tourism, and others) play a key economic role, and a fourth group of countries (Tajikistan, Kyrgyzstan,

[5] In 2008 EE-FSU had an average PPP-GDP per capita of 18.000 US$, as opposed to an average GDP per capita of 12000 for LA as a whole.

Moldova, Albania, Bosnia, Armenia) which are dependent on remittances and foreign aid (*ibid*). Since the two regions are 'similarly heterogeneous,' structural differences are unlikely to explain the observed differences with regard to growth, inequality and volatility during the last decade. Indeed, till mid 2008, both of them benefited from favourable trends in commodity prices, access to global finance and remittances, and both regions suffered from major reversals in these respects in 2008-2009.

Table 2 - GDP per capita (US$, at Market Exchange Rates) of Different Groups of EE-FSU and LA Countries, 2005

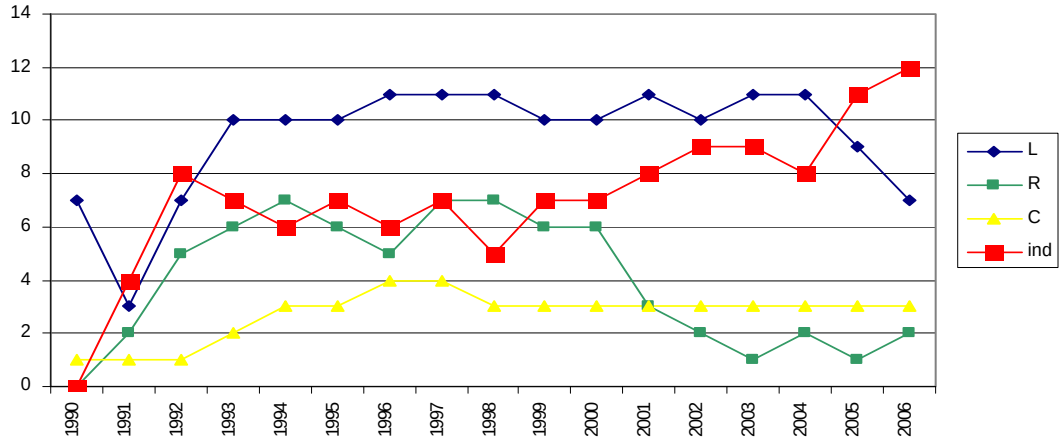
	Group I (remittances dependent)	**Group II** (commodities exporters)	**Group III** (industrial economies)	**Group IV** (mixed economies)
EE-FSU	**US $ 1266** (Albania, Armenia, Kyrgyzstan, Moldova, Tajikistan, Uzbekistan)	**US$ 3175** (Azerbaijan, Kazakhstan, Russia, Turkmenistan)	**US$ 8889** (Belarus, Cz. Repub, Hungary, Poland, Slovakia, Slovenia, Ukraine)	**US$ 5576** (Georgia, Macedonia, Bulgaria, Croatia, Estonia, Latvia, Lithuania, Romania)
LA	**US$ 999** (Nicaragua, Honduras, El Salvador)	**US$ 3733** (Bolivia, Chile, Colombia, Ecuador, Peru, Venezuela)	**US$ 5500** (Argentina, Brazil, Mexico, Uruguay)	**US$ 3189** (C.Rica, Dom. Republic, Guatemala, Panama, Paraguay)

Source: author's compilation on the basis of Cornia (2010).

In contrast, the political history of the two regions differs markedly. The EE-FSU countries emerged in 1989 from decades of communist rule, state dominance over the economy and every sphere of life, and an overly compressed income distribution. Though important institutional transformations were achieved between 1989 and 2000, it is possible that the policy approach followed in the 2000s was influenced by the desire to further diversify away economic policies from the socialist approach inherited from the past and by the perceived need of further reducing the role of the state in the economy, of introducing more market incentives and of eradicating the path dependent spirit of egalitarianism inherited from the past. One may see a reflection of such perceived needs in the decline of the number of left of centre (L) and nationalist right-of centre (R) regimes, a stagnation at low level of centrist (C) regimes, and the parallel rise of pragmatic 'independent' regimes (Ind) focussing on liberal policies, fulfilling the criteria for joining the EU, domestic liberalization and global integration (Figure 3). As for the distributive agenda, there was a major shift from the principle of 'equalizing outcomes' to that of 'equalizing opportunities' (Central Europe was, again, an exception).

The political trajectory of Latin America has been very different. For long, the region has been a symbol of authoritarianism, unequal distribution of assets and income, and limited or no redistribution by the state. However, during the last twenty years, the political landscape has been dominated by

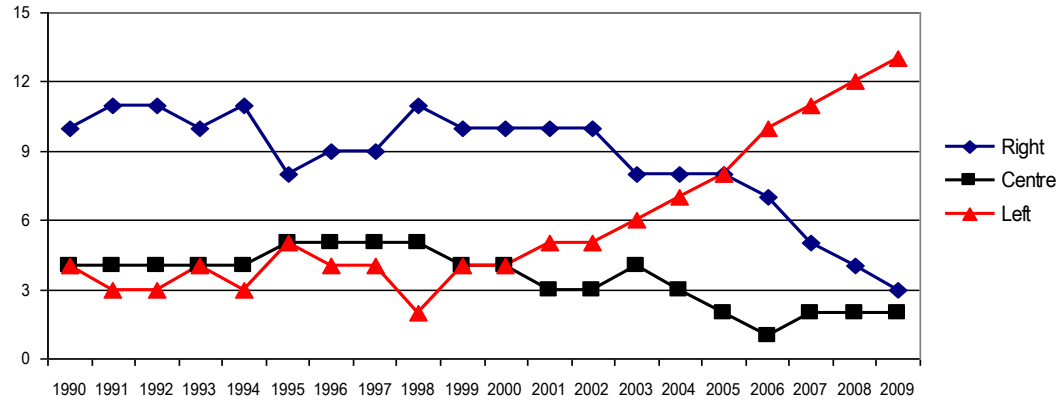
Figure 3 - Changes in Political Orientation in 24 EE-FSU Countries, 1990 - 2006



Source: author's compilation on Keefer (2007) and national data reported by Wikipedia for 2006.

a steady drive towards democratization and, starting from the late 1990s, by a steady shift in political orientation towards left-of-centre (LOC) regimes, either social-democratic or national-populist (Figure 4). Matters of social justice and economic development are at the core of the new LOC parties' identity. However, in the pursuit of such objectives, such parties avoided the ill-conceived approach to budget deficits and inflation typical of the populist regimes of the 1980s. In fact, the LOC economic model incorporates neo-liberal elements such as a prudent fiscal policy and low inflation, awareness of the inefficiencies associated with some types of state intervention, the primacy of the market in price formation, regional trade integration and openness to foreign investment. At the same time, LOC economic model's concern for poverty and inequality, recognition of market failures and attachment of importance to strengthening of state institutions are in stark contrast with the neo-liberal emphasis on shrinking the state and the self-sustained role of markets (Panizza, 2005).

Figure 4 - Changes in Political Orientation in 18 Latin American Countries, 1990 - 2009



Source: Cornia and Martorano (2009).

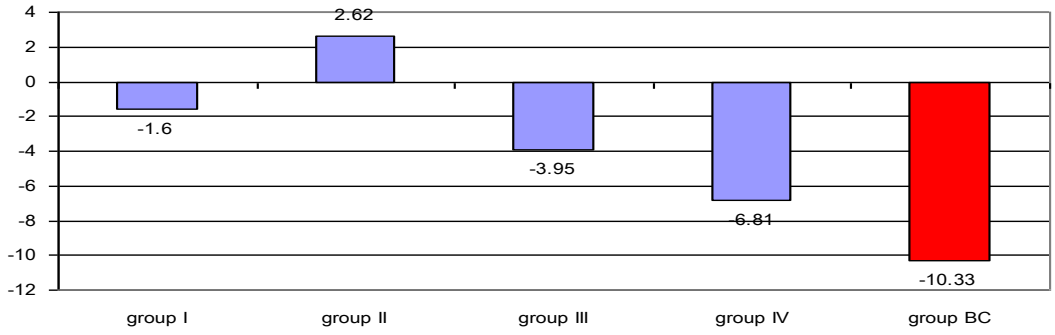
3.2 *Policy Differences*

The differences in overall political orientation mentioned above, as well as the lessons learned during the recent past (i.e., the lessons learned from the crisis of the neo-liberal policies implemented in the 1980s and 1990s in Latin America, and the lingering desire to remove the inheritance of the communist past in EE-FSU) likely affected the policy regimes adopted in the two regions during the last decade. While the policy approaches followed in the two regions coincided in some areas, they sharply differed in others.

3.2.1 Budget Deficit, Public Debt, Inflation and Current Account Balance

During the last decade, LA abandoned to a considerable extent its traditional pro-cyclical fiscal and monetary policies.[6] In all countries of the region there was a sharp decline in budget deficit which typically fell below one percent of GDP. In many cases deficits were turned into surpluses. Governments also attempted to reduce their dependence on foreign borrowing. Brazil and Argentina repaid their outstanding debt to the IMF, and a few others restructured their foreign debt securing considerable discount in the process, and yet others benefitted from the Highly Indebted Poor Countries (HIPC) program. As a result, the regional public debt/GDP ratio fell from 47 to 25 percent, while the gross public foreign debt net of fast growing currency reserves fell from 33 to 8 percent of GDP. Meanwhile, between 2002 and 2007, inflation fell to between 4 and 9 percent except in Venezuela.

Figure 5 - Average Current Account Deficit/GDP over 2000-7



Notes: ***Group I****: Latin America;* ***Group II****: Kazakhstan, Kyrgyzstan, Russia, Tajikistan, Turkmenistan, and Uzbekistan.* ***Group III****: Armenia, Azerbaijan, Georgia, and Ukraine.* ***Group IV****: Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Slovak Republic, and Slovenia.* ***Group BC****: Estonia, Latvia, and Lithuania.*
Source: author's calculation based on official data.

EE-FSU followed a similarly prudent and cautious approach with regard to public finance, but not to the current account balance. Since the mid 1990s, convergence in fiscal and monetary policies within the region led to a reversal from a budget deficit (of about 3 percent) recorded in 2000 to a

[6] Ocampo (2009) argues however that the improvements in budget deficits recorded during this period do not fully reflect a shift to countercyclical fiscal policy, which would have required the realization of larger fiscal surpluses in good years.

balanced budget by 2007.[7] However, the current account deficit rose sharply to between 10 and 25 percent of GDP, particularly in the Baltics, Hungary, Bulgaria, Romania, Belarus, Ukraine and Moldova.[8] By comparison, current account deficits remained between 3 and 6 percent in Central Europe and at 1.6 per cent in Latin America (Figure 5).[9]

The huge current account deficits of the EE-FSU countries were not due to public profligacy but were caused by a surge in private foreign debt which was financed by a massive inflow of FDI and easy access to 'cheap money', i.e., hard-currency loans (both corporate loans and household mortgages) at low interest rates provided by local subsidiaries of foreign banks. In the Baltics, Bulgaria, Romania and Hungary, between 50 and 85 percent of bank loans were made in foreign currency, thus giving rise to a currency mismatch, strong dependence on decisions of global players, and high external indebtedness (Aslund, 2009). By 2008, five countries (Bulgaria, Estonia, Hungary, Latvia, and Slovenia) had private foreign debts in excess of 100 percent of GDP.

While it has been argued that current account deficit do not pose a problem as long as they are financed by FDI, in the case of EE-FSU a high reliance on FDI turned out to be not only a source of growth but also a cause of fragility. Indeed, a very high proportion of the output of the foreign investments was exported to Western Europe, i.e., the same region from which most FDI originated. This made the external accounts of EE-FSU excessively dependent on the business cycle of Western Europe. Table 3 confirms that over 2000-2008, EE-FSU received on average 6.5 percent of its GDP per year in foreign financing (with peaks of 14 percent in Bulgaria) as opposed to about 4 per cent in Latin America. During the boom years, the impact of foreign capital on inequality was positive in case of greenfield FDI in manufacturing, and negative in the case of mergers and acquisitions and bank-to-bank loans. In turn, excessive reliance on foreign loans caused a major deterioration in the net foreign asset position of EE-FSU (Figure 6). During the 2009-10 crisis, the excessive dependence on loans from foreign banks made EE-FSU vulnerable to a sudden stop in capital inflows which had a clear negative effect on growth and income inequality.

[7] Only Hungary incurred an average deficit/GDP ratio of over 7 percent over 2005-7.

[8] In Bulgaria the deficit of the current account balance exceeded 25% of GDP in 2007 and 2008

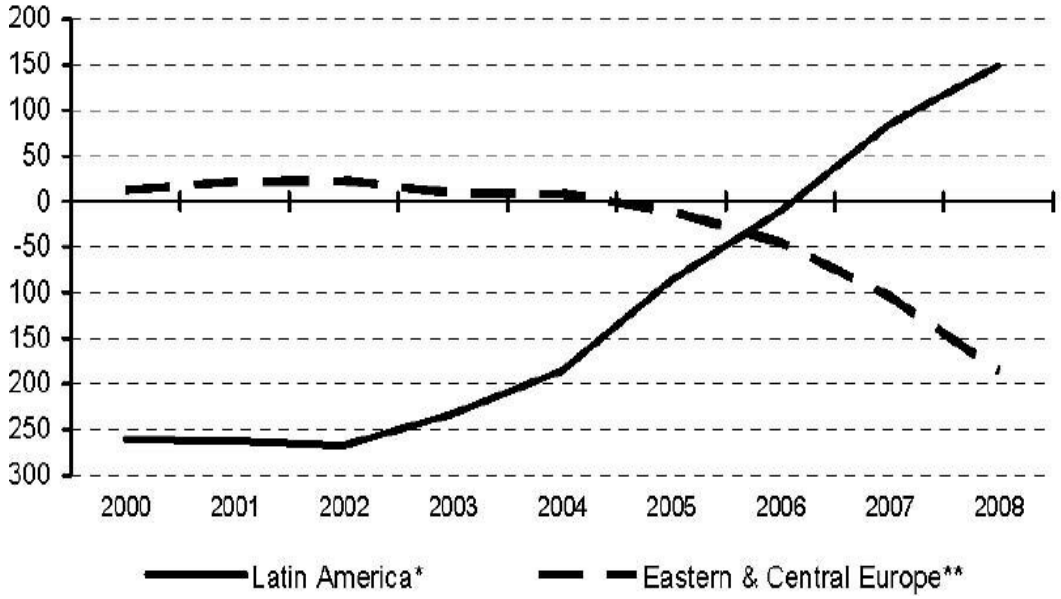
[9] Except for the crisis years of 2001-2 the current account balance has always been positive.

Table 3 - FDI/GDP Flows, 2000-2008 Economies in Transition

	2000-6	2007	2008
	Eastern Europe and the Former Soviet Union		
Central Europe & Baltics *(of which)*	**5.7**	**6.6**	**4.8**
- Estonia	9.8	12.9	8.3
- Latvia	4.2	8.3	4.5
South Eastern Europe	**5.4**	**11.6**	**8.1**
- Bulgaria	11.8	29.6	18.4
Eastern Europe & Caucasus *(of which)*	**7.9**	**5.4**	**7.9**
- Moldova	5.6	11.2	11.6
Russian Federation	**1.7**	**4.3**	**4.2**
Central Asia	**4.6**	**8.1**	**6.6**
EE-FSU Total	**5.7**	**7.7**	**6.5**
	Latin America		
C. America + Caribbean *(of which)*	**3.9**	**5.8**	**5.9**
- Panama	6.3	9.7	10.3
South America *(of which)*	**3.1**	**3.4**	**3.9**
- Chile	5.8	7.7	9.9
LA Total	**3.5**	**4.5**	**4.8**

Source: UNCTAD's investment database.

Figure 6 - Net Foreign Asset Position (Billions of US$) in Selected Countries of EE-FSU and LA, 2000-2008



*Note: * Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela; ** Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Litrhuania, Poland and Romania.*
Source: Porzekanski (2009).

3.2.2 Exchange Rate Policy

The crises of the fixed-peg regimes of the 1980s and 1990s epitomized by the collapse of the Argentinean currency board in 2001-2 encouraged the Latin American countries (with the exception of fixed-peg Venezuela and dollarized Ecuador, El Salvador and Panama) to opt for crawling pegs or managed floats aimed at preventing an appreciation of the real exchange rate. The goal was to shift economic activity towards the labor-intensive traded sector (e.g., manufacturing and agriculture) with favorable effects on income distribution, exports and growth. To support their exchange rates, Argentina, Chile, Colombia and Brazil introduced temporary capital controls, and allowed Central Banks to intervene in the currency markets, especially during the years of financial bonanza (2005-7) so to avoid an excessive real appreciation.

In contrast, many EE-FSU countries anchored their currencies, instead of letting them float. For example, Slovenia and Slovakia formally adopted the Euro; Kosovo and Montenegro *de facto* adopted the Euro; the three Baltic countries and Bulgaria established a currency board; and Ukraine, Belarus, Moldova, Kazakhstan adopted a dollar peg (Aslund, 2009). In turn, three countries introduced a free float, and only four (Poland, Hungary, the Czech Republic and Serbia) adopted a managed float permitting an easier adjustment to external shocks. The literature suggests that countries with fixed pegs attract short-term capitals which expand domestic money supply and boost inflation, appreciate the real exchange rate and worsen income inequality by shifting resources towards the capital- and skilled-intensive non-traded finance, insurance, and real estate sector (Taylor, 2000). In addition, with a fixed peg, a balance of payments shock cannot be counteracted through devaluation, and requires instead large increases in interest rates and fiscal surpluses which cause marked and un-equalizing contractions of GDP while further attracting foreign capital.

3.2.3 Labor Market Policies

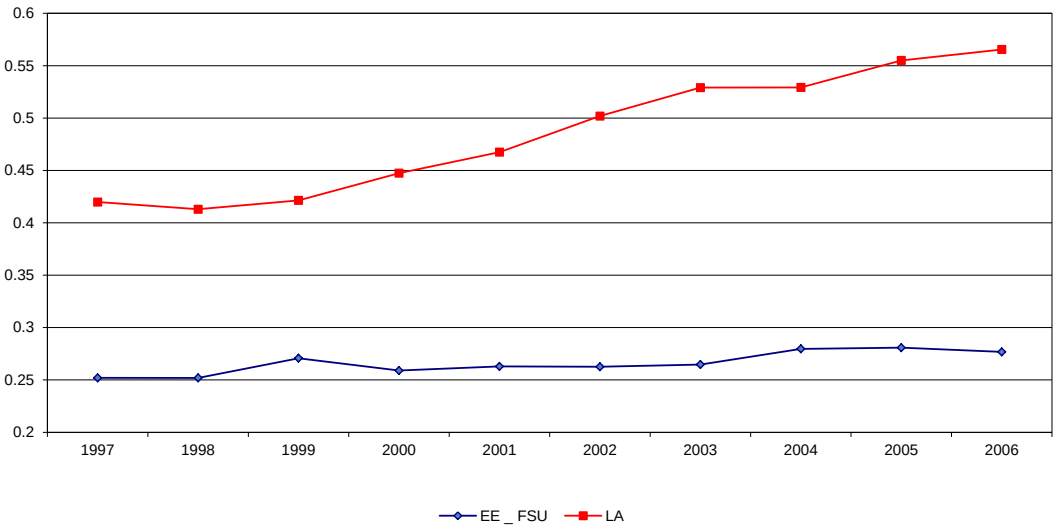
Most LA countries addressed explicitly the problems of unemployment, job informalization, falling unskilled wages, and weakening of institutions for wage negotiations. Many countries also introduced large-scale public work programs, attempted to extend the coverage of formal employment, and strengthened wage bargaining institutions. They also decreed minimum wage hikes (Figure 7), which were generally found to be associated with lower earnings dispersion in both formal and informal sectors (Cornia and Martorano, 2009 and references therein). Despite the revival of unions, average wages rose slowly (*ibid*), possibly signaling the greater concern of policy makers for creating jobs than for raising wages.

The introduction of these policies in LA and the growth recorded between 2003 and 2008 led to a drop in the unemployment rate by 5.5 percentage points in LOC and 2 points in NO-LOC countries, and a fall in informal

and self-employment, while the wage premium declined in most cases (Table 4) due to a growing supply of educated workers (see below) and a shift in production towards the unskilled labor-intensive sector, with positive effects on inequality.

In EE-FSU the rapid growth of 2000-7 cut sharply unemployment which declined by between 3 points (in the Czech Republic) and 10 in Poland – though Hungary, Romania, Georgia, Serbia and Macedonia exhibited a rise in joblessness (Unicef, 2009a). In almost half the countries, including the top-performer Poland, the decline in unemployment was facilitated by large-scale out-migration. In contrast, minimum/average wage ratio in EE-FSU countries stagnated at a low level (Figure 7), suggesting that the skill premium rose because of wage liberalization and the decline in human capital formation during the 1990s (see later). Finally, the liberal reforms adopted during the transition in EE-FSU countries did not aim at developing those institutions (such as collective bargaining, unemployment insurance, public works) and safety nets that can moderate earnings inequality, particularly in periods of crisis.[10]

Figure 7 - Trends in Minimum Wage/ Average Wage ratio, 1997-2006, LA and EE-FSU



Note: ***LA countries:*** *Argentina, Brazil, Chile, Colombia, Costa Rica, Honduras, Mexico , Panama, Paraguay, Peru, Uruguay and Venezuela.* ***EE-FSU countries:*** *Albania, Armenia, Azerbaijan, Belarus, Bulgaria, Croatia, Czech Rep., Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latvia, Lithuania, Poland, Romania, Russia, Slovakia, Tajikistan, Ukraine, Uzbekistan.*
Source: ILO database.

[10] Between 2000 and 2007 earnings inequality rose in one third of the countries, stagnated in another third and fell in the rest (Unicef, 2009b). Detailed research shows that returns to education rose following wage liberalization, technological modernisation and growing informalization (Mitra and Yemtsov, 2006).

Table 4 - Ratio of Hourly Wages of Workers with High versus Medium Levels of Education

	1992	*2002*	*2007*
Argentina	1.86	2.08	1.73
Bolivia	----	2.71	2.14
Brazil	1.74	2.78	2.37
Chile	1.72	----	2.54
Colombia	2.52	----	2.85
Costa Rica	1.93	2.16	2.44
El Salvador	2.03	2.22	2.13
Panama	2.14	2.44	2.41
Paraguay	----	2.03	1.79
Peru	----	2.16	2.00
Dominican Republic	----	1.96	1.89
Uruguay	1.65	2.20	2.09
Venezuela	1.84	1.82	1.57

Source: author's elaboration on the CEDLAS database.

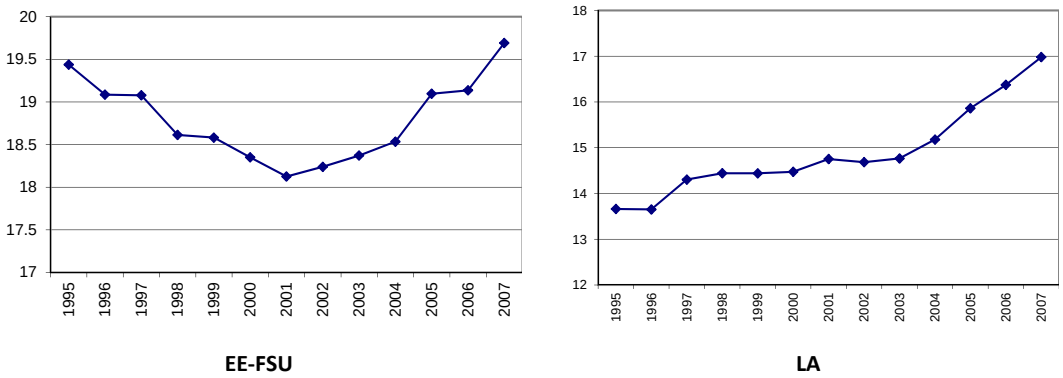
3.2.4 Tax Policy and Redistribution

Both regions improved revenue collection during the last decade. In Latin America, tax/GDP ratios started rising since 1995, accelerating further since 2003 (Figure 8, right panel).[11] Tax-GDP ratio increased by 6 to10 percentage points in Argentina, Brazil, Colombia, Bolivia and Venezuela, which reached a level of taxation similar to that of the US. This increase in tax-GDP ratio is structural and reflects improved tax administration and collection. Of the additional tax revenue collected since 2002 more than half came from direct taxes, a third from VAT, and the rest from other taxes. Overall, while tax reform still has a long way to go, these changes rendered the tax system a bit more equitable than before. In addition, countries benefiting from gains in terms of trade appropriated part of these windfall gains in the form of non-tax revenue (half a point of GDP on average, and 3-4 points in the key commodity exporters).

In EE-FSU, tax/GDP ratio fell during the transformational recession of the 1990s. In their effort to raise tax revenue (which rose by 1.5 GDP point during the 2000s, against 2.5 for Latin America), these countries relied on administrative simplifications, a lowering of tax rates, and the introduction of VAT and a personal and corporate income flat tax. While the three Baltic countries retained the highest pre-reform tax rate and generally increased the no-tax area (thus making the tax schedule relatively more progressive), the remaining countries adopted very low rates (e.g., 10-15 percent for the personal income tax, and 9-25 percent for the corporate income tax) equal to the lowest pre-reform tax rates (Table 5). In the latter case, the *ex-ante* effect of the tax reform was un-equalizing, even though there is no evidence that

[11] Regression analysis (Cornia and Martorano, 2009) confirms that the tax/GDP ratio rose on average by 0.20-0.22 GDP points a year due to greater tax effort, a formalization of the economy, and tax buoyancy.

Figure 8 - Tax/GDP Ratios in EE-FSU (left panel) and LA (right panel), 1995-2007



***EE - FSU countries**: Armenia, Azerbaijan, Bulgaria, Czech Republic, Estonia, Georgia, Hungary, Kazakhstan, Kyrgyzstan, Latria, Poland, Romania, Slovakia, Slovenia, Tajikistan, Uzbekistan (Lithuania is exluded for lack of data) **LA countries**: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Dom. Rep., Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Uruguay, Venezuela.*
Source: author's elaboration on the CEDLAS database.

Laffer-type responses have generated revenue increases (Keen et al., 2008). While it is important to avoid generalizations, and while the effects of flat taxes are not necessarily regressive (as in the case of the Baltic countries), it appears that tax changes introduced in EE-FSU during the last decade are likely to have reduced tax progressivity.

In LA, the last decade has seen improvements in the field of social transfers, with favorable redistributive effects. During the 2000s, public expenditure on social security and social assistance rose, and there is evidence that its incidence became more progressive, thanks to a shift away from less progressive social insurance for the relatively few employed in the formal sector and towards a better financed social assistance (ECLAC, 2005 and Barrientos and Santibanez, 2009). This new emphasis entailed the development of large scale poverty reduction programs pivoting around non-conditional cash transfers, conditional cash transfers, and integrated anti-poverty programs which absorbed between 0.5 to 1 percent of GDP and covered a high share of the population at risk. Several studies document the favorable impact of these programs on human capital formation, while a study by Istituto de Pesquisa Economica Aplicada (IPEA) (cited in ECLAC, 2006) found that non-contributory pensions and *Bolsa Família* explained one third of the inequality decline observed in Brazil during 2000-2006.

In EE-FSU, social protection systems are highly heterogeneous and the related outlays range between 4 and 20 percent of GDP. Except in Central Europe, which can count on a very generous system, social protection remained heavily biased towards modestly progressive pension systems. Other benefits, such as unemployment benefit, sick pay and child allowances, all of which are much better targeted than pensions, have remained underfunded. Progress in the field of social assistance was less marked than in LA. As a result, these countries initially lacked the admin-

Table 5 - Countries Adopting the Flat Tax in EE- FSU

Country	Year of of adoption	Personal Income Tax Rates		Corporate Income Tax Rate		Changes in basic allowance
		Before	*After*	*Before*	*After*	
Estonia	1994	16 – 33	26	35	26	Increase
Lithuania	1994	18 – 33	33	29	29	Increase
Latvia	1997	25 and 10	25	25	25	Reduction
Russia	2001	12- 30	13	30	35	Increase
Ukraine	2004	10 -40	13	30	25	Increase
Slovak Rep.	2004	10 -38	19	25	19	Increase
Georgia	2005	12 -20	12	20	20	Eliminated
Romania	2005	18 -40	16	25	16	Increase
Kyrgyzstan	2006	10 – 20	10	20	10	Unchanged
Macedonia	2007	15- 24	12	15	12	Unchanged
Kazakhistan	2007	5- 20	10	30	30	Increase
Albania	2007	1 -20	10	20	20	Increase
Montenegro	2007	15- 23	15	15- 20	9	Increase
Czech Rep.	2008	12 -25	15	24	22	Increase
Bulgaria	2008	10-24	10	10	10	Eliminated

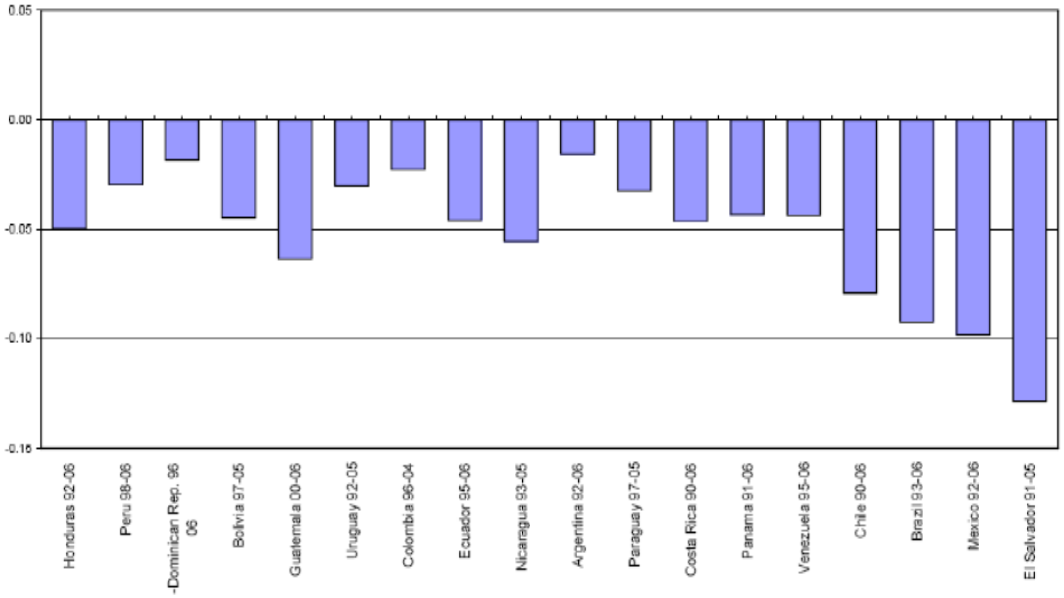
Source: Keen et al. (2008).

istrative infrastructure to manage social assistance programs prevalent in market economies. For instance, in the early years of transition, many EE-FSU countries introduced universal child allowances, but later on transformed them into means-tested programs. Of the 12 countries for which data are available, child benefits absorb between 0.1 and 0.9 per cent of GDP. However, in six of them this ratio declined between 2000 and 2004-6 (Unicef, 2009a). Thus, while the communist social protection systems had a far greater impact on income inequality than in Latin America, the last decade has seen a steady erosion of this initial advantage.

3.2.5 Investment in Education and Distribution of Human Capital among Workers

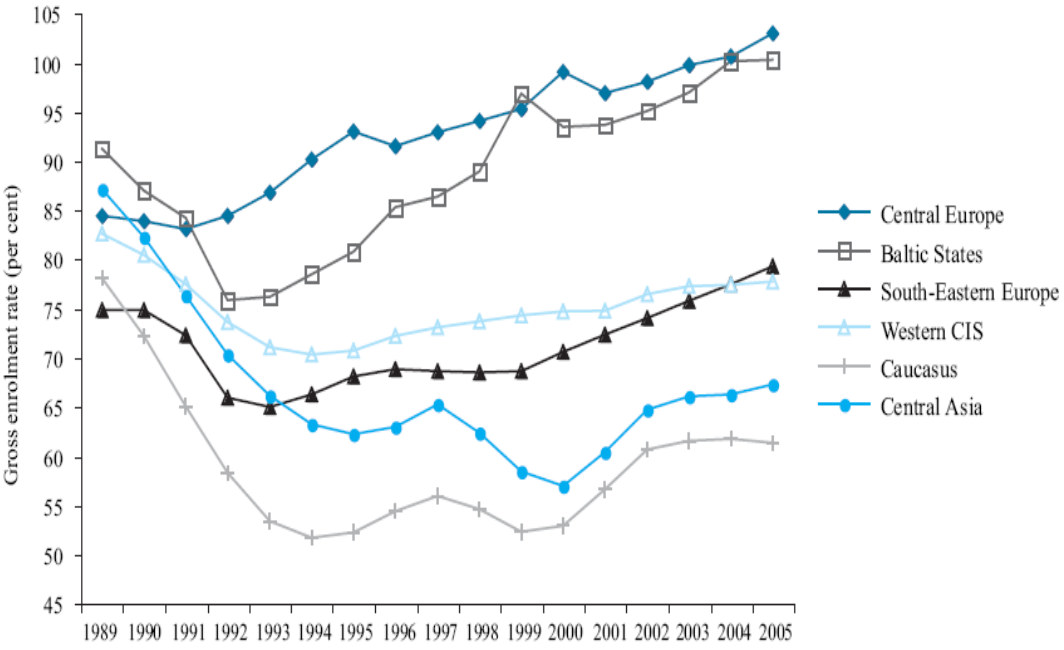
A factor that contributed to the recent fall in income inequality in Latin America is the rise in enrolment rates recorded at all educational levels since the early-mid 1990s (Gasparini et al., 2009), and the subsequent reduction in enrolment inequality in primary and secondary education. For instance, the probability that a child from the bottom decile completes secondary education in relation to that of a child of the top decile rose on average from 36.7 to 50 percent between 1990 and 2005 (ECLAC, 2006). Over time this reduction in enrolment inequality led to an increase in the average number of years of education of the working population, and a reduction in the Gini coefficient of the distribution of human capital among workers (Figure 9), thus contributing – *ceteris paribus* - to the decline in skill premium (Table 4). An IPEA study (cited in ECLAC 2006) concluded that two thirds of the inequality observed in Brazil between 2000 and 2006 was due to a fall in earnings inequality due to a drop in educational inequality among workers.

Figure 9 - Percentage Change in the Gini Coefficient of the Distribution of Years of Education Among the Workforce, Between Mid-1990s and Mid-2000s in 18 Latin American Countries



Source: Gasparini et al. (2009).

Figure 10 - Trends in Gross Enrolment Rates in Upper Secondary Education in Sub-Regions of EE-FSU (Percentage of the Population aged 15-18)



Source: Unicef (2009b).

In contrast, in EE-FSU the 1990s were characterized by a fall in enrolment rates in upper secondary education catering to pupils of 15-18 years of age. Except in Central Europe and, to some extent, the Baltic countries, this fall lasted till the mid 2000s (Figure 10). The enrolment decline was very marked among pupils of vocational schools from low and middle income groups but was also true (till the mid 1990s) for general secondary and tertiary education. Enrolment in the latter have since recovered steadily (except in Bulgaria and some Central Asian and Caucasus countries), mostly because of an expansion of costly private universities affordable only to well off families.

The decline in enrolment was mostly due to the introduction of school fees, a fall in family incomes, the perceived low returns to technical education, and the deteriorating quality of educational institutions. These trends suggest that a growing number of youth did not enrol in secondary education, and that the supply of skilled and semi-skilled workers declined over time. In other words, the average level of education of the labour force in many EE-FSU countries stagnated or declined during the 2000s, precisely when fast growth and modernisation raised the demand for skilled labour. All these changes possibly pushed skilled wages upward and exacerbated educational inequality, as measured by the Gini Coefficient of the human capital distribution among the workforce.

4 Policies to Control Inequality and Promote Growth in an Open Economy

The prior discussion suggests that the LA countries seem to have learned from the negative impact of the neo-liberal policies implemented during the 1980s and 1990s. In contrast, this does not seem to have been the case in much of EE-FSU, where the policies adopted during the last decade broadly ignored the distributive and growth lessons of the neo-liberal policies illustrated in section 2 of this paper. This seems to suggest that countries learn from their own policy mistakes but – alas - not from those of other countries.

What policy lessons can we draw from the evidence on the inequality impact of international economic integration, and the comparison between the recent development experiences of LA and the EE-FSU? Leaving aside the issue of stabilization measures to be adopted to overcome the current crisis, which development policies should be adopted in an increasingly open economy, in which – as the literature reviewed in sections 2 suggests – economic integration may increase instability, raise the probability of crises and generate adverse distributional effects? The suggestions provided below – inspired to some extent by the above regional comparison and the review of the literature in section 2 – are of general nature. Specific measures will have to be introduced to reflect the different size, economic specialization, level of development, and institutions of the countries considered. Yet, de-

spite the need for adaptation to local circumstances, in all countries the measures suggested below offer some guidance for avoiding crises, promoting growth and reducing inequality.

(i) Limiting foreign indebtedness and mobilizing domestic savings. The comparison between LA and EE-FSU confirms once more that while liberalization of the capital account offers an opportunity to access a global pool of savings, this policy entails several risks if it is accompanied by large and persistent capital account deficits financed with rising public or private foreign indebtedness. Such risk declines but does not disappear if the capital inflows take the form of FDI. Thus, the recourse to foreign resources should be sustainable and selective. In fact, countries with a large foreign debt should gradually reduce it, as illustrated recently by the successful experience of several Latin American countries. This means that capital accumulation should be funded mainly by mobilizing domestic private and public savings through the development of a well regulated domestic banking network, as shown by the experience of Malaysia, China, Vietnam and, more recently, by a number of Latin American countries (Rojas Suarez, 2010). Overall, the empirical evidence shows that open economies with larger domestic banking systems have smaller portfolio inflows than those with smaller domestic banking systems. A policy of moderate financial restraint could also be used to raise domestic savings and capital accumulation.

(ii) Controlling capital inflows and harnessing their sectoral allocation. Capital inflows can increase capital accumulation and (under certain conditions) exports, but can also cause a number of perverse effects. In countries with a large labour supply, openness to green-field FDI in manufacturing is likely to generate positive growth and distributional effects, as shown by the past experience of Malaysia, Mauritius and a few Central American countries. The impact of FDI in other sectors needs closer assessment (see part 2) as its effect may generate trade-offs and require compensatory measures, e.g., public work schemes for the people made redundant. In contrast, even in the presence of sound macroeconomic policies and strong regulatory institutions, countries should be free to impose market-based and administrative controls on portfolio inflows and outflows if these are likely to cause large swings in the real exchange rate and affect negatively the distribution of income. Such types of measures have been introduced recently in Argentina, Brazil, and Colombia and in the 1990s in Colombia, Spain, Chile, India, China and other countries. In addition, the central bank can set limits on the foreign exposure of domestic banks and the volume of hard currency loans in the domestic sector, forbid banks to borrow internationally or to extend loans to the non-tradable sector. The IMF now supports introduction of temporary controls during crisis periods, but countries may consider extending such measures as long as they are needed, as China is currently doing.

(iii) Choosing an appropriate exchange rate regime. Such a regime should minimize the risk of currency crises, and at the same time provide adequate incentives for the expansion of the traded sector, where the majority of the poor is often (but not always) employed. This means rejecting the views about the superiority of 'two corner solutions' over intermediate exchange rate regimes. Indeed, the EE-FSU countries that suffered the largest GDP falls in 2009 and 2010 are precisely those with currency boards and fixed pegs (Table 1). It is obviously difficult to generalize, but in medium-small developing countries an intermediate regime aiming at credibly stabilizing the real exchange rate and its expectations seems to be the best option. An example of such an exchange rate regime is the BBC (basket, band and crawl) regime adopted in Chile in the 1990s and in Argentina during the 2000s. Empirical research has shown that a stable and competitive exchange rate has been a key factor in kick-starting growth and improving long-term performance of the economy (Rodrik, 2003). However, this approach leads to a slower decline of inflation, and needs to be supported by countercyclical fiscal and monetary policies and by measures to control capital inflows. In addition, the BBC exchange rate may not help to improve income distribution in countries where the poor are located in the non-traded sector (e.g., the urban informal sector), where the traded sector is skilled-labour intensive, or where the benefits of nominal devaluation are only in part passed-through to the people employed in the traded sector. In addition, the BBC exchange rate regime may be inappropriate in very small economies with highly volatile terms of trade and difficulties in diversifying their exports. Under these circumstances, dollarization may be an option. Finally, in large developing economies, a competitive exchange rate is less necessary for growth, poverty alleviation and reducing inequality as these objectives can equally be pursued through an expansion of domestic consumption and investment.

(iv) Countercyclical fiscal policy and stabilization funds. In many developing countries government revenue oscillates widely because of fluctuations in the demand and prices of their exports and weather shocks. Capital markets behave pro-cyclically and so reduce the possibility of stabilizing consumption in bad years. All this leads to large public expenditure cuts that exacerbate the shocks and worsen inequality. As the recent experience of a few Latin American countries shows, these problems can be tackled with prudent, countercyclical fiscal policies. Indeed, during the current crisis these countries were in a position to follow a flexible monetary and fiscal policy entailing a sizeable fiscal stimulus and lower interest rates. This was possible because of budget surpluses, low levels of public debt, large accumulation of currency reserves, and decline in inflation achieved during the boom years. In countries with valuable commodities, countercyclical policies can be achieved via the creation of 'stabilization funds' as done in Chile, Venezuela, Russia, Kazakhstan and Azerbadjian. Countries which

can count on such funds can control the rise of inequality during crises. The good use of such stabilization funds is not, however, to be taken for granted, as indicated by the recent Kazakhstan experience where much of the funds drawn down were used to recapitalize failing domestic banks.

(v) Trade measures. As noted in section 2, in many cases trade liberalization has led to increases in inequality because of short run factors immobility, trade-induced skilled biased technological change, the confounding effects of simultaneous capital inflows and exchange rate fluctuations, and other factors. Any further liberalization must therefore consider both the growth and inequality impact of these measures and avoid any further opening when the expected results in both areas appear negative or highly uncertain. In contrast, if trade liberalization promotes growth (e.g., via technological modernisation) but affects negatively inequality (e.g., by making redundant unskilled workers), then trade liberalization must be accompanied by compensatory programs and active labour market policies to reduce the impact on inequality.

(vi) Supportive domestic policies. These measures have to be introduced for two reasons: first, to compensate the adverse distributive effects of some international measures that may be desirable in terms of growth but not in terms of their distributive impact; second, domestic equality-enhancing measures can generate positive effects on growth while reducing the un-equalizing effect of some measures as, for example, when a substantial increase in the supply of skilled workers offsets the un-equalizing effects of a trade liberalization which increases the skill bias of production.

As shown once more by the recent Latin American experience, the domestic measures which impact the distribution of income directly are those pertaining to taxation, income transfers and human capital formation. Space limitation forbids detailed illustration of the rationale and impact of these policies which are however briefly reviewed hereafter.

Tax policy must aim at gradually increasing tax/GDP ratios so as to be able to provide public goods, carry out those transfers that are considered 'socially desirable', and finance compensatory programs required to offset the adverse effects of greater economic integration. Several countries in both LA and EE-FSU already moved in this direction, but in most cases there is a continued need to increase the progressivity of the tax instruments and to enhance the horizontal equity of taxation. This can be done not only with traditional progressive income and wealth taxes but also with a sufficiently high flat tax rate and a sizeable no tax area, graduated VAT rates, as well as an appropriate taxation of mining rents and windfall profits. Greater taxation is important also to avoid large accumulation of public debt or inflation due to monetization of the public deficit.

Income transfers generally generate strong redistributive effects, as already observed in Central Europe and a few Latin American countries. An intensification of income transfers can be carried out through both social in-

surance and social assistance. In this regard, the recent evidence suggests that the best approach may consist in 'walking on two legs'. In a country with a limited formal sector, social security expenditure is not progressive, as it mainly covers a limited number of comparatively well-off formal sector workers. Focusing only on its expansion would be regressive. This raises the question of how best can a government expand social security coverage, whether by actively extending the formal sector or by setting up solidarity-based, non-contributory, universal or targeted funds providing basic benefits to informal sector workers and their families, including also conditional and non-conditional cash transfers. In middle income countries, both approaches should be pursued at once.

Labor market (or income) policies are also required, and in both LA and EE-FSU there is a need to strengthen 'labor institutions' which help regulate the distribution of earnings, by addressing the problems of unemployment, job informalization, minimum wages, and weak institutions for wage negotiations and dispute settlements. Specific programs in this area include passive and active labor market policies, such as unemployment insurance, retraining programs, and self-targeting public-work schemes. Minimum wages – which most of the literature shows reduce inequality – need also to be raised to adequate levels. Finally, wage bargaining institutions, which have been weakened substantially in most countries during the last three decades of neo-liberal policies, now need to be strengthened. Efforts at 'formalizing employment', if at the cost of greater employment flexibility, may also be needed.

Finally, the recent evidence suggests that an improvement in the distribution of educational achievements among the members of the workforce has a strong impact on the distribution of income, as it increases the supply of skilled and semi-skilled workers and reduces the rise of the skill premium. In many middle income developing countries this means raising enrolment and completion rates in secondary education and broadening the access to subsidized tertiary education. The effects on inequality are lagged by 5-10 years but the long term effects are quite powerful. The impact on inequality of increased supply of skilled labor is not automatic, however, as an increase in employment and drop in wage inequality can come about only if additional jobs are created.

References

Alarcon, D. & McKinley, T. (1996), Increasing Wage Inequality Accompanies Trade Liberalisation in Mexico. In Berry, A. (Ed.) *The Social Challenge of the New Economic Era in Latin America*. FOCAL discussion paper no. 1995-8. Centre for International Studies, University of Toronto.

Åslund, A. (2009). *The East European Financial Crisis*. (CASE Network Studies and Analysis n. 395). Warsaw: Center for Social and Economic Research.

Baldwin, R. (1995). The Effect of Trade and Foreign Direct Investment on Employment and Relative Wages. (Working Paper No. 5037). Retrieved from Nationl Bureau of Economic Research website: http://www.nber.org/papers/w5037.

Barrientos, A. & Santibánez, C. (2009). New Forms of Social Assistance and the Evolution of Social Protection in Latin America. *Journal of Latin American Studies, 41*(1). 1-26. doi:10.1017/S0022216X08005099

Benassy-Queré, A. & Salins, V. (2005). Impact de l'Ouverture Financière sur les Inégalités Internes dans les Pays Emergents. (CEPII, document de travail n° 2005 – 11). Retrieved from Centre d'Études Prospectives et d'Informations Internationales website: http://www.cepii.fr/francgraph/doctravail/pdf/2005/dt05-11.pdf.

Berhrman, J., Birdsall, N. & Székely, M. (2000). Economic Reform, and Wage Differentials in Latin America. (Working Paper of the Research Department n. 435). Retrieved from Inter-American Development Bank website: http://pws.iadb.org/res/publications/pubfiles/pubWP-435.pdf

Bourguignon, F. & Morisson, C. (1989). Income Distribution, Development and Foreign Trade: a Cross-sectional Analysis. *European Economic Review*, *34*(6). 1113-1132. doi:10.1016/0014-2921(90)90071-6

Caprio, G. & Klingebiel, D. (2003). Episodes of Systemic and Borderline Financial Crises. (World Bank Working Paper). Database available at: http://go.worldbank.org/7FWQNEJD30

Chami, R., Fullenkamp, C. & Jahjah, S. (2003). Are Immigrant Remittance Flows a Source of Capital for Development? (IMF Working Paper n. WP/03/189). Retrieved from International Monetary Found websites: http://www.imf.org/external/pubs/ft/wp/2003/wp03189.pdf.

Cornia, G.A. (2010). Transition, Structural Divergence, and Performance: Eastern Europe and the Former Soviet Union over 2000-2007. (UNU/WIDER Working Paper n. 32/2010). Retrieved from World Institute for Development Economic Research websites: http://www.wider.unu.edu/stc/repec/pdfs/wp2010/wp2010-32.pdf

Cornia, G.A. & Martorano, B. (2009, September). External Shocks, Policy Changes, and Income Distribution: Latin America During the Last Decade. In *Overcoming Persistent Inequality and Poverty.* A conference in Honour of Frances Stewart, Oxford Department of International Development, Oxford. Retrieved from: http://www.qeh.ox.ac.uk/pdf/pdfstewart/cornia%20and martorano.pdf

Diwan, I. (1999). Labour Shares and Financial Crises. (World Bank Preliminary draft). Retrieved online from: http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.41.8369&rep=rep1&type=pdf

Docquier, F. & Rapoport, I. (2003). Remittances and Inequality: A Dynamic Migration Model. (IZA Discussion Papers n. 808). Retrieved from Institute for the Study of Labor website: http://ftp.iza.org/dp808.pdf

ECLAC (2005). *Panorama Social de America Latina 2005.* Retrieved from: http://www.eclac.org/publicaciones/

ECLAC (2006). *Panorama Social de America Latina 2006*. Retrieved from: http://www.eclac.org/publicaciones/

Faini, R. (2002). Development, Trade, and Migration. *Revue d'Économie et du Développement*, *16*(1-2). 85-116. Retrieved from: http://www.cairn.info/load_pdf.php?ID_ARTICLE=EDD_161_0085

Feenstra, R. & Hanson, G.H. (1997). Foreign Direct Investment and Relative Wages: Evidence from Mexico's Maquiladoras. *Journal of International Economics*, *42*(3-4). 371-393. doi:10.1016/S0022-1996(96)01475-4

Galbraith, J.K & Jiaqing, L. (1999). Inequality and Financial Crises: Some early Findings. (UTIP Working Paper n. 9). Retrieved from University of Texas Inequality Project websites: http://utip.gov.utexas.edu/papers/utip_09enc.pdf

Gasparini, L.C., Cruces, G., Tornarolli, L. & Marchionni, M. (2009). A Turning Point? Recent Developments on Inequality in Latin America and the Caribbean. (CEDLAS, Working Papers n. 0081). Retrieved from Center for Distributive, Labor and Social Studies websites: http://cedlas.econo.unlp.edu.ar/download.php?file=archivos_upload/doc_cedlas81.pdf

Halac, M. & Schmukler, S. (2003). Distributional Effects of Crises: The Role Of Financial Transfers. (World Bank Policy Research Working Paper Series WPS3173). Retrieved from World Bank websites: http://www-wds.worldbank.org

Honohan, P. (2005). Banking Sector Crises and Inequality. (World Bank Policy Research Working Paper Series WPS3659). Retrieved from World Bank websites: http://wwwwds.worldbank.org

IMF. (2005). *World Economic Outlook*. Washington D.C.: International Monetary Fund.

Keefer, P. (2007). *DPI2006, Database of Political Institutions: Changes and Variable Definitions*. Retrieved from World Bank websites: http://siteresources.worldbank.org/INTRES/Resources/469232-1107449512766/dpi2006_vote_share_variable_definitions.pdf

Keen, M., Kim Y. & Varsano, R. (2008). The "Flat Tax(es)": Principles and Experience. *International Tax Public Finance*, *15*(6). 712–751. doi:10.1007/s10797-007-9050-z

Koujianou Goldberg, P. & Pavcnik, N. (2007). Distributional Effects of Globalization in Developing Countries. (Working Paper n. 12885). Retrieved form The National Bureau of Economic Research websites: http://www.nber.org/papers/w12885.pdf?new_window=1

Lindert, P. and J. Williamson (2001), "Does Globalisation Make the World More Unequal ?", paper presented at the NBER 'Globalisation in Historical Perspective Conference' in Santa Barbara, California, May 3-6, 2001

Lundberg, M. & Squire, L. (1999). *Growth and Inequality: Extracting the Lessons for Policymakers*. Unpublished manuscript. The World Bank.

Mc Cormick, B. & Wahba, J. (2001). Overseas Experience, Savings and Entrepreneurship amongst Return Migrants to LDCs. *Scottish Journal of Political Economy*, *48*(2). 164-178.

Mitra, P. & Yemtsov, R. (2006). Increasing Inequality in Transition Economies: Is There More to Come? *Policy Research Working Paper Series No. 4007*, The World Bank.

Morley, S. (2000). Distribution and Growth in Latin America in an Era of Structural Reform. In *Poverty and Inequality in Developing Countries: A Policy Dialogue on the Effects of Globalisation*. Conference conducted at the OECD Development Centre, Paris.

Nuti, M. (2009). The Impact of the Global Crisis on Transition Economies. *Economic Annals*, *54*(181). 7-20. doi:10.2298/EKA0981007N.

Ocampo, J.A. (2009). Latin America and the Global Financial Crisis. *Cambridge Journal of Economics*, 33(4). 703-724. doi:10.1093/cje/bep030

Panizza, F.E. (2005). Unarmed Utopia Revisited: the Resurgence of Left-of-Centre Politics in Latin America**.** *Political studies*, *53* (4). pp. 716-734. doi:10.1111/j.1467-9248.2005.00553.x

Porzekanski, A. (2009). Latin America: The Missing Financial Crisis. Munich *Personal RePEc Archive, No. 18974*. Retrieved from: http://mpra.ub.uni-muenchen.de/18974/

Prasad, E., Rogoff, K., Wei, S.J. & Kose, M. (2003). Effects of Financial Globalisation on Developing Countries: Some Empirical Evidence. *IMF Occasional Paper 220*. Retrieved from: http://www.nber.org/˜wei/data/prwk2003/prwk2003.pdf

Rodriguez, F. (2007). Openness and Growth: What Have We Learned? (Department of Economics and Social Affairs Working Papers n. 51). Retrieved from United Nations, Department of Economics and Social Affairs websites: http://www.un.org/esa/desa/papers/2007/wp51_2007.pdf

Rodríguez, F. & Rodrik, D. (1999). Trade Policy and Economic Growth: a Skeptic's Guide to the Cross-National Evidence. (Working Paper No. 7081). Retrieved form The National Bureau of Economic Research websites: http://www.nber.org/papers/w8228.pdf

Rodrik, D. (2003). Growth Strategies. (Working Paper No. 10050). Retrieved form The National Bureau of Economic Research websites: http://www.nber.org/papers/w10050.pdf

Rojas Suarez, L. (2010). The International Financial Crisis: Eight Lessons for and from Latin America. (CGDev Working Paper n. 202). Retrieved form Centre for Global Development websites: http://www.cgdev.org/files/1423709/_file/_Rojas/_Suarez/_Lessons/_FINAL/ _web.pdf

Savvides, A. (1998). Trade Policy and Income Inequality: New Evidence. *Economic Letters*, *61*(3). 365-372. doi:10.1016/S0165-1765(98)00197-9

Taylor, L. (2000). External Liberalization, Economic Performance, and Distribution in Latin America and Elsewhere. (UNU/WIDER Research Paper n. 215). Retrieved from United Nations University World Institute for Development Economics Research websites: http://www.wider.unu.edu

te Velde, D.W. and O. Morissey (2002): Foreign Direct Investment, Skills and Wage Inequality in East Asia. *Journal of the Asia Pacific Economy*, *9*(3). 348-369. doi:10.1080/1354786042000272991

UNCTAD (2009). *World Investment Report*. Geneva: UNCTAD.

UNICEF (2009a). *TransMONEE Database.* Geneva: UNICEF Regional Office for CEE/CIS. Retrieved from: http://www.transmonee.org/

UNICEF (2009b). *Innocenti Social Monitor*. Florence: IRC Unicef.

Wacziarg, R. & Horn Welch, K. (2003). Trade Liberalization and Growth: New Evidence. (Working Paper No. 10050). Retrieved form The National Bureau of Economic Research websites: http://www.nber.org/papers/w10152.pdf

Wood, A. (1995). *North-South Trade, Employment and Inequality*. Oxford, United Kingdom: Clarendon Press. doi:10.1093/0198290152.001.0001

Zaidi, S. (2009). Main Drivers of Income Inequality in Central European and Baltic Countries: Some Insights from Recent Household Survey Data. (World Bank Policy Research Working Paper Series WPS4815). Retrieved from World Bank websites: doi:10.1596/1813-9450-4815