Complementing Market Liberalization in Latin America:

What Role for the State?

Tulane University
POLS 695: Seminar on Neoliberal Reforms in Latin America
Professors Pereira and Potter

Ludovico Feoli

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Introduction

Two decades of market liberalization in Latin America have failed to produce the expansion in growth and employment promised by neoliberal reforms. Instead, openness appears to have been accompanied by greater vulnerability and instability. This paper seeks to analyze the inherent factors of the reforms that may account for this divergence between theorized and actual results. It hypothesizes that the positive effects of greater market autonomy can only be realized through an effective strategy of policy activism. This strategy consists of the state-provision of distinct public goods that enhance the mechanisms of the market, unleashing the forces of innovation that drive productivity and economic growth. The paper attempts to identify qualitative differences between reforming countries by complementing typical reform indexes that gauge levels of market neutrality with a second layer of indicators that measure state initiatives in the provision of productivity-enhancing goods.

The Insufficiency of Market Reforms

Latin America’s abandonment of Import Substituting Industrialization (ISI) in the 1980s predicted that increases in productivity and efficiency would result from the dynamics of market-based resource allocation and productive specialization through comparative advantage. Yet, Stallings and Peres show that growth in the post-reform period was disappointing, mainly due to two factors. First, investment took forms that were completely unanticipated by reformers. Rather than privileging labor-intensive activities in which the area was believed to be competitive, investment flowed mainly to capital-intensive applications, concentrated in particular sectors. This implied that the productive capacity destroyed by accelerated trade liberalization was not replaced in many cases, and that new employment possibilities were restricted to high-skilled

1 Barbara Stallings and Wilson Peres, Growth, employment, and equity: the impact of the economic reforms in Latin America and the Caribbean (Washington, D.C., Santiago Chile: Brookings Institution Press, United Nations Economic Commission for Latin America and the Caribbean, 2000).
workers. The remaining employment was therefore provided by sectors with lower productivity such as services, micro-enterprises, and the informal economy. Second, there were many inconsistencies between reforms and macroeconomic policies. Trade and capital liberalization, for example, were incompatible with the use of the exchange rate as an anchor for inflation. In a context of increased international liquidity, rising capital flows worked to appreciate exchange rates, generating massive trade deficits. Although this helped restrain inflation, the eventual reversal of short-term capital flows forced massive devaluations that negatively impacted growth. Free capital flows in the absence of adequate prudential regulatory frameworks also led to risk over-exposure among intermediaries that precipitated systemic financial crises.

This evidence suggests the deficiencies of a simplistic embrace of the market. It shows that without a set of adequate institutions to accompany them, market forces can cause countries to suffer by “misguided economic policies and by private and public predation.”\(^2\) Liberalization, stabilization, and privatization—all hallmarks of the “Washington Consensus” that guided the reforms—are necessary but insufficient conditions for development.\(^3\) Modern economic theory reinforces this skepticism about \textit{laissez faire} by highlighting the burdens of incomplete markets, imperfect information, strategic interactions, principal-agent problems, transaction costs, and bounded individual rationality.\(^4\) Under these circumstances public goods that are essential for productivity growth are under-provided making state agency a critical factor of development.

Neo-classical models linked economic growth to investment and rates of technological change.\(^5\) However, technology was assumed to be an exogenous variable that changed at the


\(^5\) These were, successively, the Harrod-Domar and Solow-Swan models. See Kaushik Basu, \textit{Analytical development economics: the less developed economy revisited} (Cambridge, Ma.: MIT Press, 1997), Ch. 3.
same pace worldwide. New growth theories have made technical change endogenous to each
country⁶, linking its rate to policy-related factors. Technical innovation spills over into multiple
uses making it difficult to bar others from appropriating the benefits of new knowledge. If there
is to be private innovation, therefore, the institutional framework must allow agents to capture a
substantial part of the gains. Such is the role of patent rights and state stimulation of scientific
research, for example. Of course innovation presupposes the existence of adequate levels of hu-
man capital⁷ and its productive employment presupposes the availability of adequate physical
infrastructure.⁸ Given these elements, positive externalities endow physical and human capital
with increasing returns to scale, super-charging the process of economic growth and initiating a
virtuous cycle through accumulation which in turn enhances the possibilities of innovation. Dif-
fferences in growth between countries thus stem from their varying ability to initiate such cycles,
which in turn reflect their relative levels of social capabilities.

But such differences are also conditioned by structural factors.⁹ Technological diffusion,
for example, depends on the existence of legal and cultural barriers affecting the flow of people
and ideas across countries. Such barriers may enable the more innovative countries to develop
and sustain significant advantages in their level of development. A country’s long-term eco-
nomic performance tends to look like a random walk around a mean that is determined by struc-
tural factors, which suggests that different policy mixes might be optimal under different struc-

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⁷ The notion of human capital holds that education is an input to production, \( Q = f(E,K) \) where \( E \) are effective units of labor and education raises effectiveness, \( K \) is capital. Empirically, growth of education has contributed substan-
⁹ See Adela Houng, Lucia Pittaluga, Gabriel Porcile, y Fabio Scatolin, "La CEPAL y las nuevas teorías del cre-
tural constraints.\textsuperscript{10} This speaks against prescriptions of one-size-fits-all reform packages of the Washington Consensus variety.\textsuperscript{11} In the context of Latin America's economic reforms it requires complementing the discovery of the market with a \textit{rediscovery} of the state,\textsuperscript{12} rehabilitating it so that it can effectively fulfill its on-going and crucial responsibilities for regulation, infrastructure, social services and welfare.\textsuperscript{13} To the extent that it would be possible to speak of a new consensus about reforms it would entail recognition of the prevalence of markets yet habituated by strong government sensitized to social equity and welfare.\textsuperscript{14}

A strong state, however, raises the specter of government failure. Such failure refers to the state's inability to manage policy without pernicious consequences arising from rent-seeking, the proliferation of interested claims on government, including those of the bureaucracy, and conflicts of interest between administrators and their charges.\textsuperscript{15} Yet, the experience of the East-Asian Tigers, which pursued interventionist policies without being captured by private interests, shows this failure is not inevitable.\textsuperscript{16} The evidence suggests that high levels of education, a more equitable distribution of income, and a highly competent bureaucracy contributed to these cases of successful governance. Other instances demonstrate that, instead of leading to administrative capture, endowing public servants with more discretionary power and individual responsibility can increase their commitment to their jobs, enabling them to develop relations of trust with their

\textsuperscript{10} Charles Kenny and David Williams, "What do we Know About Economic Growth? Or, Why Don't we Know Very Much?," \textit{World Development} 29, no. 1 (2001): 12.
clients, and increasing their productivity and effectiveness.\textsuperscript{17} Clearly, then, organizational factors are crucial determinants of the effectiveness of governments, and "no one has yet shown that the failure of government intervention necessarily outweighs market failure."\textsuperscript{18}

Recapitulating, the path of development requires the crafting of institutions that stimulate the creation of wealth. This includes the provision of free markets with competitive prices, a stable macroeconomic environment in which individuals can plan for the future, and effective property rights systems that stimulate investment. But it also includes an effective state, capable of providing the rule of law and contract enforcement, of producing public goods necessary for the support of production, of improving human capital and stimulating innovation, and of incorporating and disseminating technology throughout the productive process. This is tantamount to a recognition that policies, and hence politics, matter, that the market is not autonomous in creating economic growth.

\textit{Policies for Growth}

So what are the types of policies that governments can pursue to complement the well-functioning of the market? Starting from the assumption that macroeconomic stability is a necessary but non-sufficient condition for economic development, complementary policy initiatives by the state would necessarily be addressed at microeconomic aspects. These refer to the quality of the business environment and a sophistication of firm operations and strategy that are conducive to high levels of innovation via the dynamics of market competition. Such conditions, coupled by a stable macroeconomic framework, enhance productivity and competitiveness, enabling the type of virtuous cycles mentioned above.

From this perspective, economic development "is a process of successful upgrading, in

\begin{footnotesize}
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\item[\textsuperscript{17}] Judith Tendler, \textit{Good government in the tropics} (Baltimore ; London: Johns Hopkins University Press, 1997).
\item[\textsuperscript{18}] Fishlow, "The Latin American State," 66. Emphasis in the original.
\end{itemize}
\end{footnotesize}
which the *business environment in a nation evolves to support and encourage increasingly sophisticated and productive ways of competing.*”¹⁹ Porter speaks of three stages of competitive advantage and modes of competition that nations progress through: the Factor-Driven stage, the Investment-Driven stage, and the Innovation-Driven stage.²⁰ This progression leads from price-based competitiveness in the first stage to technological self-sufficiency and innovation-based competitiveness in the third one, passing through a transitional second stage of efficiency-based competition driven by foreign technology. The role of government in this context is to facilitate this progression by providing a climate favorable to competition and investment, while abstaining from the imposition of costs that do not contribute to enhancing competitiveness.²¹ This involves the provision of economy-wide factors that facilitate innovation and initiative (public or quasi-public goods), and abstention from stimulating particular firms or sectors (subsidies, protection) while focusing on common constraints and linkages.

More specifically, in addition to providing macroeconomic and political stability, the state should improve the general microeconomic capacity of the economy by improving the quality and efficiency of general purpose inputs, such as an educated workforce, an appropriate physical infrastructure, and accurate and timely economic information. The state should also establish microeconomic rules and incentives for competition that foster productivity growth such as a competition policy that enhances rivalry among firms, a tax system and intellectual property law that encourages investment, a fair and efficient legal system, a consumer protection regime, a corporate governance structure that holds managers accountable for performance, and a

²⁰ Ibid., 58.
regulatory structure that stimulates innovation. The state is called upon to provide these goods because, as public goods, they are poorly provided by markets.22

**Complementarity of the Latin American Reforms**

Having established the theoretical basis for an instrumental complementation of market mechanisms by the state, and having identified the types and stages of necessary policy, we may examine the actual reform processes in Latin America to determine cross-country differences based on these criteria. We are interested in determining (1) the different levels of market liberalization among countries, (2) their relation to levels of state activism, and (3) the typological characteristics that emerge from the comparison of these two factors.

**Market Liberalization**

The Interamerican Bank has developed a structural reform index to gauge the extent of market liberalization in Latin America.23 The index incorporates composite measure of reform in trade policy, financial policy, tax policy, pri-

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22 Because this paper focuses on business-related public goods its omission of labor-impacting public goods, such as education, health, equal opportunity and others, should not be construed as implying their lack of relevance. These important elements will be incorporated into the analysis at a further stage.

vatization, and labor legislation. It describes the degree of neutrality of economic policies, that is, their relative degree of interference with market mechanisms. A value of 1 represents complete neutrality (no interference) and a value of 0 its absence. The structural reform index is a simple average of the indices in the five areas. Table 1 summarizes the index values for the region in 1999.\textsuperscript{24}

A brief examination of the data shows that reforms are divergent across countries and areas. The areas of reform in which liberalization seems to be more entrenched are trade and finance, while those where they have advanced the least are privatization and tax reform. Labor flexibilization shows a relatively intermediate level of reform. Within countries, trade appears to be uniformly liberalized with little variance between countries. Privatization shows the greatest inter-country variance ranging from a level of 0.9 in Bolivia to a level of 0.004 in Uruguay. On the other hand, tax reform appears to show relatively uniform low levels with little variance between countries. Financial reform, though high, shows greater dispersal than trade. In terms of overall reform, Bolivia and Uruguay have the highest and lowest levels of liberalization, respectively. Most countries seem closely clustered around the regional average of 0.583. Following the IDB we consider those countries above the regional average as “fast reformers” and those below the average as “slow reformers”. By this criteria we find Argentina, Bolivia, Brazil, Chile, Dominican Republic, Guatemala, Jamaica, Nicaragua, Peru and Trinidad and Tobago in the first category while Colombia, Costa Rica, Ecuador, El Salvador, Honduras, Mexico, Paraguay, Uruguay and Venezuela are in the second.

The regional average of reform is approximately twice as high as that for 1985,\textsuperscript{25} which


\textsuperscript{25} Ibid., 30.
reflects the considerable progress in market liberalization registered during the 1980s and 1990s. On its own, this fact leads to the puzzle analyzed above: the coexistence of aggressive reforms with lackluster growth. Can an evaluation of state initiatives in the improvement of microeconomic aspects provide a better understanding?

State Activism

State activism is defined as the provision of those public or quasi-public goods described above as determinants of a good microeconomic environment. The Global Competitiveness Report measures many of these aspects through a detailed survey of over 4,600 business leaders in 75 countries. It identifies sets of microeconomic variables that measure firm sophistication and national business environment quality, and that are related to GDP per capita at a statistically significant level. A group of these indicators was selected for the year 2000 in seven areas based on their qualifications as productivity-enhancing mechanisms. An intervention was judged to be productivity-enhancing when it provided a public good or, when quasi-public, it was geared to applications with high potential for spillovers. For example, the provision of high quality infrastructure is considered a public-good, productivity-enhancing intervention, while the provision of a subsidy for research is considered a quasi-public good, productivity-enhancing intervention because of the spillover effects of knowledge. The indicators were selected in the areas of Macroeconomic Environment, Research and Development, Information and Communication Technology, Physical Infrastructure, Rule of Law, Corruption, and Competition. A description of the relevant variables is included in the appendix. The results for the indicators are summarized in Table 2. Values are arranged on a scale of 1 to 7 with 7 representing the highest level of competitiveness-enhancing intervention.

27 Non-excludable and non-rival
The data reveals a significant level of convergence between countries at a relatively low level of effective state intervention. The general index shows a regional average of 3.45, slightly less than 50% of the maximum score on the scale utilized, yet significantly lower than the relative level of market liberalization. The standard deviation for the region on this index is only 0.5, which shows that variations among countries are not high. Only four countries, Chile, Trinidad and Tobago, Uruguay, and Brazil approach or exceed a level of state activism comparable in magnitude to the level of market liberalization (58% of the scale). The individual categories of state intervention also show relatively low levels, with the exception of Corruption. The lowest level of effective agency is Research and Development followed by the Rule of Law.

Within categories variation between countries, while not uniform, is not unduly large. By introducing this second analytical layer we are therefore able to show that, at the very least, most
countries in the region have not accompanied their market liberalization with productivity-enhancing state complementation.

If we define a "High" level of state activism as that approaching the average of market liberalization (0.58) we can group the region according to both dimensions of the analysis, as is done in Table 3, and devise a general typology describing the four resultant categories. Those countries showing high levels of activism together with high levels of market liberalization may be termed "Directed Neo-Liberals" to emphasize that the greater role assigned to market mechanisms has been complemented by an array of productivity-enhancing interventions. In the case of Chile, for example, financial regulation is highly stringent, communication and air transport infrastructure is of high quality, tax evasion is low, organized crime is virtually null, and irregular payments in business are virtually inexistent.

Countries with high levels of liberalization and low levels of state activism may be identified more closely with "Pure Neo-liberalism" as the autonomy of the market has not been compromised by any significant level of state microeconomic agency. This would correspond with a

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stylized conception of the deep neoliberal reform initiatives carried out in Argentina and Bolivia, for example, or the weak state capacity and institutionality of Nicaragua, Guatemala, or Peru. On the other hand, countries with both low state activism and low market liberalization could be described as "Protected Passives" to highlight the fact that state interventions remain distortive while liberalization has not advanced sufficiently to enhance market forces. Surprisingly, this is the category that captures the greater number of countries which appears counterintuitive to the general perception of liberalization in the area. We must bear in mind, however, that these classifications refer to relative levels of reform which means that these countries may have advanced significantly in certain areas of reform, although they are laggards with respect to the other Latin American countries. Finally, the category of high state activism and low liberalization, in this case reserved exclusively for Uruguay, may be termed "Protected Activists" to highlight the fact that the state still retains a considerable presence in the economy as attested by the low degree of privatization. It must be noted, however, that state interventions are productivity-oriented and that, while labor markets are not liberalized, competition seems to prevail in other areas, as attested by the significant level of trade and financial liberalization.

By focusing on the growth data included in Table 3 we can see that the correspondence between the typological classifications and economic growth is not entirely homogeneous. This is not surprising given that the typology provides a "snapshot" view focused on the state of affairs at the end of the 1990s, while the economic growth data encompasses the entire decade. More in-depth quantitative analysis of the data beyond the scope of this paper would be required to draw final conclusions. However, some aspects of relevance to our working hypothesis can be grasped from an exploratory evaluation of Table 3. First, the country with the highest economic growth rate throughout the decade in the entire region, Chile, is a Directed Neo-liberal. This is
consistent with the proposition that complemented liberalization leads to sustainable and high growth. Second, the country with the lowest economic growth rate, Jamaica, is a Pure Neo-Liberal. This highlights the fallacy that liberalization is a sufficient condition for efficiency and productivity enhancement and, through that route, growth. Clearly, as the cases of Argentina and Dominican Republic illustrate, high growth is achievable through high liberalization. However, in light of the recent collapse of the Argentine economy (and with the benefit of hindsight) it would be valid to question whether this growth comes at the cost of greater vulnerability, which in turn compromises the sustainability of growth. The Economist blames the Argentine collapse on the country's inability to complement the "sweeping market reforms" of the 1990s with public-sector reform and sustainable monetary institutions. In other words, the absence of state activism as defined in this paper. On the other hand, Brazil's lackluster growth suggests the need to complement the analysis with further qualification of state activism. For example, Brazil has the highest level of debt service in the region with payments representing over 110% of its goods and services. This could indicate, among other things, a low level of efficiency in public intervention. Finally, if we consider the categories as a whole we find that, as illustrated in Table 4, category growth levels conform to the terms of our hypothesis: the countries that grew the most as a group were the Directed Neo-Liberals, followed by the Protected Activists, the Pure Neo-Liberals, and finally the Protected Passives. The fate of Protected Passives shows that the worst combination possible is a distorted market with no state provision of productivity-enhancing public goods. Moving to the left from this category, increasing productivity-enhancing state-activism, produces higher growth than moving upwards, increasing market liberalization. The best growth is achieved by the combination of high productivity-enhancing state activism and

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30 World Bank, World Development Indicators 2002(accessed).
high levels of market liberalization.

**Conclusions**

Latin America’s deep structural crises of the 1980s discredited state intervention in the economy. Structural reforms sought to dismantle the interventionist state, replacing it with autonomous market forces theoretically capable of maximizing allocation efficiency and eliminating rent-seeking. These reforms came packaged as a “consensus” which was hard to refute under the pressure of debt and the absence of alternative options. Most countries liberalized trade, finance, and labor markets. A more selective group of countries, also made advances in privatization and tax reform. Yet these efforts did not produce the rise in productivity, investment, and economic growth that was promised by the reform proponents. This may in part be due to the inability of weakened states to complement markets with appropriate institutions and infrastructure. Most states in the region have not undertaken productivity-enhancing strategies that could trigger virtuous cycles of innovation and growth, certainly not at levels comparable to the extent they have embraced the market. Further research could attempt to link relative economic development levels more precisely to levels of productivity-enhancing state activism and seek to develop more refined indicators of effective state action.

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<th>State Activism</th>
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<td>High</td>
<td>Low</td>
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<tr>
<td>Market Liberalization</td>
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<tr>
<td>High</td>
<td>Directed Neo-liberalism 4.37%</td>
<td>Pure Neo-liberalism 3.46%</td>
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<tr>
<td>Low</td>
<td>Protected Activists 4.13%</td>
<td>Protected Passives 2.84%</td>
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<td>Appendix</td>
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<tr>
<td><strong>2.14 Financial Regulation and Supervision</strong></td>
<td>Regulations and supervision of financial institutions are (1= inadequate for financial stability, 7= among the world's most stringent)</td>
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<td><strong>2.2 Composition of Public Spending</strong></td>
<td>The composition of government spending in your country (1= is wasteful, 7= provides necessary goods and services not provided by the market)</td>
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<td><strong>2.22 Extent of Distortive Government Subsidies</strong></td>
<td>Government subsidies to business in your country (1= keep uncompetitive industries alive artificially, 7= improve the productivity of industries)</td>
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<td><strong>3.05 Quality of Scientific Research Institutions</strong></td>
<td>Scientific research institutions in your country, such as university and government laboratories, are (1= non-existent, 7= the best in their fields)</td>
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<td><strong>3.07 Subsidies for Firm-Level Research and Development</strong></td>
<td>Direct government subsidies for firms conducting research and development in your country (1= never occur, 7= are widespread and large)</td>
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<td><strong>3.08 Tax Credits for Firm-Level Research and Development</strong></td>
<td>Government tax credits for firms conducting research and development in your country (1= never occur, 7= are widespread and large)</td>
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<td><strong>4.02 Public Access to Internet</strong></td>
<td>Public access to the Internet through libraries, post offices etc is (1= very limited, 7= pervasive - most people have frequent access)</td>
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<td><strong>4.03 Internet Access in Schools</strong></td>
<td>Internet access in schools is (1= very limited, 7= pervasive - most children have frequent access)</td>
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<td><strong>4.05 IT Training and Education</strong></td>
<td>Your country’s IT training and educational programs (1= lag far behind most countries, 7= are among the world's best)</td>
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<td><strong>4.08 Government Prioritization of ICT</strong></td>
<td>Information and communications technologies are an overall government priority (1= strongly disagree, 7= strongly agree)</td>
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<td><strong>4.1 Government On-line Services</strong></td>
<td>On-line government services – e.g. downloadable permit applications, tax payments – in your country are (1= not available, 7= commonly available)</td>
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<td><strong>4.11 Laws Relating to ICT Use</strong></td>
<td>Laws relating to electronic commerce, digital signatures, and consumer protection are (1= non-existent, 7= well-developed and enforced)</td>
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<td><strong>4.12 Legal Framework for IOT Development</strong></td>
<td>The legal framework in your country supports the development of IT businesses (1= no, strongly impedes, 7= yes, significantly promotes)</td>
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<td><strong>5.01 Overall Infrastructure Quality</strong></td>
<td>General infrastructure in your country is (1= poorly developed and inefficient, 7= among the best in the world)</td>
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<td><strong>5.02 Tap Water Safety</strong></td>
<td>Tap water in your city is (1= unsafe and inaccessible for drinking, 7= safe and easily accessible for drinking)</td>
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<td><strong>5.03 Industrial Water Availability</strong></td>
<td>Water for industrial purposes is (1= not available, 7= readily available)</td>
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<td><strong>5.04 Road Infrastructure Quality</strong></td>
<td>Accounting for road quality outside of major cities, the typical driving speed between cities is (1=10km/hr, 7= 150 km/hr)</td>
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<td><strong>5.05 Railroad Infrastructure Development</strong></td>
<td>Railroads in your country are (1= underdeveloped, 7= as extensive and efficient as the world's best)</td>
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<td><strong>5.06 Port Infrastructure Quality</strong></td>
<td>Port facilities and inland waterways in your country are (1= underdeveloped, 7= as developed as the world's best)</td>
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<td><strong>5.07 Air Transport Infrastructure Quality</strong></td>
<td>Air transport in your country is (1= infrequent and inefficient, 7= as extensive and efficient as the world's best)</td>
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<tr>
<td><strong>5.08 Telephone/Fax Infrastructure Quality</strong></td>
<td>New telephone lines for your business are (1= scarce and difficult to obtain, 7= widely available and highly reliable)</td>
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<td><strong>5.12 Quality of Public Schools</strong></td>
<td>Public (free) schools in your country are (1= of poor quality, 7= equal to the best in the world)</td>
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<td><strong>5.13 Difference in Quality of Schools</strong></td>
<td>The difference in the quality of schools available to rich and poor children in your country is (1= large, 7= small)</td>
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<td><strong>5.14 Difference in Quality of Healthcare</strong></td>
<td>The difference in the quality of healthcare available to rich and poor people in your country is (1= large, 7= small)</td>
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<td><strong>5.15 Public Health Agencies</strong></td>
<td>Public health agencies in your country are able to deal with public outbreaks of disease (1= barely at all, 7= very effectively)</td>
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<td><strong>6.04 Favoritism in Decisions of Government Officials</strong></td>
<td>When deciding upon policies and contracts, government officials (1= usually favor well-connected firms and individuals, 7= are neutral among firms and individuals)</td>
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<td><strong>6.05 Government Commitments</strong></td>
<td>New governments honor the contractual commitments and obligations of previous regimes (1= not true, 7= true)</td>
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| **6.06 Competence of Public Officials** | The competence of personnel in the public sector is (1= lower than
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<td>Irregular Payments in Government Procurement</td>
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<td>Irregular Payments in Tax Collection</td>
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<td>Irregular Payments in Public Contracts</td>
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<td>Days to Start a Firm</td>
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