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GOOD INTENTIONS, BAD OUTCOMES: SOCIAL POLICY,
INFORMALITY AND ECONOMIC GROWTH IN MEXICO

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Introduction

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PROCEEDINGS

MS. BRAINARD: Well, good afternoon. It's really a pleasure to welcome you to Brookings for what promises to be a fascinating discussion of how well intentioned social insurance policies can sometimes inadvertently work against strong formal sector employment growth.

It is a particular pleasure to welcome Santiago Levy back to Brookings, where he joined the Wolfensohn Center of Development back in 2006 as a non-resident and has been very productive ever since, I have to say.

Santiago is the current Vice President for Sectors and Knowledge. Is that right?

MR. LEVY: Correct.

MS. BRAINARD: Sectors and Knowledge at the Inter-

American Development Bank. And I must say I cannot think of a more dynamic management team than the current group at the IDB, which is led by the indefatigable Luis Alberto Moreno, who is here today, as well as Bob Kaplan and Dan Zeligco, who, parenthetically, taught me everything I ever wanted to know about Tesa Bonos back in the old days.

So, Santiago, I think probably everybody knows was the Deputy Minister at the Ministry of Finance and Public Credit in Mexico during the time that Progres a Oportunidades was developing into this kind of world-class program that it's known as today.

The program was launched in 1997, and, as you all know, provides conditional cash transfers; has been probably one of the most studied poverty reduction programs in the world; and has helped five million families and has been replicated in over 25 countries. And, in fact, when the Mayor of New York was looking at a similar program called over to find Santiago to set this thing up.

Santiago's first book at Brookings, which was also very interesting, looked in-depth at the institutional environment that was necessary to make this thing successful. But while most people, I think, would be content to simply take a victory lap, Santiago went on from there to connect the dots between that set of policies and the social insurance policies connected to the formal sector and tried to start thinking about what the connection of those two sets of policies might have to do with Mexico's productivity and growth performance.

And I think the outcome, which is this book, *Good Intentions*,

Bad Outcomes, is really quite fascinating and has implications for a lot of other countries in the world. It really goes beyond the specific set of policies that Santiago is talking about here.

So I will not steal his thunder and tell you his policy recommendations. We have a truly phenomenal panel here today that Johannes Linn will introduce.

Johannes is the Director of the Wolfensohn Center, who is really is responsible for bringing Santiago and this wonderful work to Brookings. And I think I saw Elaine Wolfensohn here somewhere earlier. Elaine is in the back, who in turn is responsible for bringing Johannes and the portfolios that Johannes has been developing with the Wolfensohn Center to Brookings and for which we're just very excited.

So I'm going to hand it over to Johannes, and then Johannes I think is going to in turn hand it over to Santiago.

MR. LINN: Right. Thank you. Thank you very much, Lael. I'm actually generally prefer sitting and I think it's nicer in a way, but because this is such a long, skinny room, and some of you are very far away, maybe it's better if we stand when we make our comments. We can sit -- see a bit further far and maybe you can hear us.

If you can't hear us, please wave. I don't quite know how well the system works here.

Anyway, let me just join Lael in thanking you all for coming this afternoon, especially our distinguished guests here, and, of course, our distinguished panel.

But most of all, quite frankly, thank Santiago Levy because without Santiago, the Wolfensohn Center wouldn't even be half of what it is today. More than half of our book output so far has been produced by Santiago.

(Laughter)

MR. LINN: So, you know, within -- to produce two books within two years and still remain reasonably sane I think is a great achievement in Santiago's case, I think, as my colleagues from IADB can witness. He's more than sane.

So thank you very much, Santiago. I'm -- it's been an incredible pressure for me personally and actually I'm particularly grateful to Jim Wolfensohn, who, by the way, wanted to be here today, but has to be in Ghana instead. So he sends his apologies, especially to Santiago and also especially to his wife, who has suffered through two books of production process, but I understand Santiago was actually at home while he was writing this, so his two daughters actually saw a little bit more of him than he was at Tresor or in other places that he had to leave early in the morning and come back late at night.

Lael already told you that there are these two books. The two actually are very interconnected, and, to my mind, reflect actually the best of what the Wolfensohn Center wants to achieve, namely to focus on how do you scale up successful interventions and then make them work. And Santiago, of course, in his first book on Progresas sort of told us how the scaling up process works, but then he looked at well, it didn't -- wasn't

really good enough to -- for it to be really successful, we need to do more, and he'll tell us about this.

So without further adieu, let me introduce the panel that we have today. It's a very distinguished panel, as Lael has already said. Professor Jere Behrman, who is to my far right, your left, is the William R. Kenan Jr. Professor and Former Chair of Economics and Research Associate at the Population Studies Center of the University of Pennsylvania; and has published -- researched and published extensively in microeconomics, economic development, labor economics, human resources, economic demography, and household behaviors and very well known in his field. Thank you, Jere, for coming all the way down from Philadelphia for this event.

Next we have-and alphabetically -- we have Nancy Birdsall, who, of course, is known to all of us from her wonderful and outstanding work across the street. I sort of regard myself as the little brother of my big sister, Nancy. And if in a few years, we are even half way to where Nancy has brought CGD, I think we can be more than proud because Nancy has done a wonderful job and, of course, as you know, she was Executive Vice President of the Inter-American Development Bank, so her insights into today's topic, which, by the way, I think the Mexican case study is, in a sense, I hope some of you will talk about that, probably representative of some of the issues that other Latin American countries, and I would say beyond that, other countries face. So I think it's not just a study of Mexico.

I see it as a case study that has broader application, and so Nancy I think will be perfect commentator from that perspective, I believe.

Finally, we have Francisco or maybe better known Chico Ferreira, who is the Lead Economist with the Development Research Group at the World Bank and has published and researched on both theory and empirics of income and wealth distribution dynamics. And he was, among other things, a co-director of the World Development for 2006 at the World Bank on Equity and Development and is also a co-editor of the Journal of Economic Inequality and an editor of *Economia*.

With this, let me go straight and ask Santiago to give us a brief overview, and he personally asked us to -- ask to -- have it kept short, because he actually wanted to hear what his distinguished commentators want to say. Santiago, the microphone is yours.

(Applause)

MR. LEVY: Good afternoon, everybody. Let me begin where I should, which is in thanking Jim Wolfensohn and Johannes Linn for being here today. Without Jim's help and Johannes, the last two years wouldn't have been half as enjoyable and half as productive as they were.

So, Elaine, I know you're -- I can't really see you somewhere, but please give my regards to Jim. And really thank you, Johannes.

And my thanks to Brookings. Lael, you've been a wonderful host for the last two years providing a place to do research. I want to thank David Drasu, which was my assistant in this book and flew all the

way from Mexico just to be here this afternoon. That's really nice.

Gracias, David.

Thank my commentators. I couldn't feel more privileged that three good friends, but three excellent economists who I respect truly would comment the book. So I'm really grateful for the three of you to be here. Luis Alberto and Dan at the IDB, which really I appreciate. Gracias, Luis Alberto y Dan. And all of you for being here this afternoon.

What motivated me to write this book? There are three separate sets of issues that I try to bring together in this book. First, when I was at the Mexican Government and I had the privilege to work for President Salinas, for President Zedillo, and President Fox, what I noticed is that there was this great effort, legitimate effort, by three different presidents of two different political parties to make the best possible social policy for people in Mexico.

And there were a very large and increasing number of programs that you would continuously see appearing for health, for day care, for housing, for pensions; some for the poor; some for the informal; some for these people; some for that people. And at some point, I began to ask myself the question, "Does this all make sense?" What are these programs really doing?

And that's one motivation for this book that I'm writing.

The second motivation was I had the privilege of being associated with the Progresas Program, as you know. And I began to ask myself the question of okay, what is the next step after Progresas workers

eventually enter the labor force assume that the benefit from the program over the last 15, 20 years of their lives. They got better nutrition. They have better health. They have better education than their elder peers. Are they now ready to enter the labor market and get productive jobs with Social Security coverage and finish poverty?

And it was a very relevant question not only for Mexico, but I believe for many Latin American countries.

And then the third element of this book is a puzzle, which is why has Mexico not grown faster after carving out so many reforms and such a large effort at macroeconomic stability?

So these three different elements are kind of merged together in this book. And this book tries to fit a story from these three different angles.

What does the book do? The book does basically three things.

The first thing it does is it tries to put together a framework -- I don't want to use the word model -- it tries to put a framework, a consistent framework, to think systematically about the social and economic implications of social programs.

And the words social and economic are very important here, because there's a huge literature that thinks about the social implications of social programs. There's another literature that thinks intensely about the economic implications of social programs. But there's not that much work that tries to look at them simultaneously and as part of the same

conceptual framework.

So what I try to do here is I tried to think about social programs in a systematic way, trying to make a difference between programs that are there because we want to redistribute income towards a subset of households versus programs that are there because we want to protect households from risks, being old-age, being health, being disability.

And in many occasions, governments do not distinguish what is it really that they're trying to do with the programs that they're putting in place.

And there's an attitude that any social program is good. Let us maximize subject -- this social spending, subject to fiscal constraint, and the higher your social spending, the more we're doing for low-income households and the more we're doing for the poor.

And I tried to think about systematically also about the economic implications of social programs, trying to, in this framework, think about what they do to labor productivity, what they do to capital productivity in a dynamic context in which the economy is growing, and what are the implications of these social programs for firm size, for investment, for the fiscal accounts, and for something that I think has been much underestimated illegal behavior by firms and workers; illegal in the sense of violating labor laws, violating Social Security laws.

So think of this as a puzzle. And in the puzzle, the pieces of the puzzle are this housing program, this health program, this poverty

program, this severance pay program in the labor market, this -- another non-contributory pension program.

How do I put all these pieces in a puzzle and how I think of that puzzle along two dimensions simultaneously -- a social dimension and an economic dimension? And how do I think of the pieces of the puzzle along two other dimensions that are relevant -- non-poor workers and poor workers, because I want to understand the conditions under which non-poor -- poor workers will cease to be poor workers and become non-poor workers.

So the book is an exercise, an analytical exercise, in trying to systematically think through in these two dimensions and in these two groups the implications of social programs.

That's the first thing that the book does. And it does so in the context of a formal-informal model in which it takes the institutions of Mexico, the Constitution, the laws, as the background that are the framework in which all these social programs are carried out.

The second thing the book does is it tries to apply this framework to Mexico. And basically the book tells not such a good story. Basically, the book says is that the pieces of the puzzle don't fit together. There's an incoherent set of social programs that inadvertently are pushing firms and workers into informality and that informality is not innocuous. That informality actually has social costs, because, in fact, when workers are informal, they're not as protected from risks as they are when they're formal.

But that informality also has economic costs because the interaction of workers and firms in the labor market produces actions by firms and actors -- and actions by workers that are from the social point of view inefficient. And they reduce labor productivity, and they reduce capital productivity. And this will persist.

Investments will occur and through time the economy will continue on a path characterized by low growth, high informality, low productivity. And that I try to show in the book this results in a framework in which even if nothing else was malfunctioning, and I ignore the credit market and I ignore many of the distortions, even if nothing else was malfunctioning, the pure isolated effect of this incoherent set of social programs induces informality and informality thwarts the government's social objectives and is actually negative for productivity growth and for economic growth.

So that's what the book does. The book does, in this part, it also argues that this incentive structure is particularly pernicious for the poor. And the government's best intentions, which is let me do more social programs for the poor, conditional particularly upon their being poor, and conditional upon their being informal, is actually counterproductive.

And it's counterproductive because it traps the poor in poverty. And we have to answer the following puzzle: if the poor have less assets than anybody else, one would expect most poor workers to be salaried and, in fact, to be formal.

But, in fact, we observe the opposite: most poor workers are

informal and a large number of them are illegal in the sense that they're not complying with the institutional framework of Mexico.

So the book tries to provide a story as to why, in fact, this is an equilibrium outcome of a set of social programs.

The third thing the book does -- and I'll end here -- is it discusses the case for reform. After arguing that these good intentions are producing bad outcomes because of what is happening in the labor market with firms and with workers -- and I go through some detail about what happens to the size distribution of firms, what happens to labor productivity, what happens to capital productivity -- I try to argue the case for reform.

And I don't argue the case for reform on social grounds or economic grounds. I argue both, simultaneously on both grounds.

And basically the point here is the only way out of the dilemma in which the Mexican Government has boxed itself in is by going to universal social entitlements.

The institutions of Mexico have boxed in the government in a context in which either they provide benefits to workers because they're formal or because they're informal because that's the way the institutional set up is created.

And their best intentions are actually causing bad outcomes. So the only out to this is a proposal that I develop in the book for universal social entitlements.

So despite the fact that the book has a potentially

pessimistic title, in fact, I end up with a positive note. There is an out. And in the book, I try to propose a fiscally sound and administratively feasible proposal to extend universal social entitlements to all workers, which I think would be better for equity, better for poverty alleviation, better for productivity, and better for growth.

The last thing is what the book doesn't do. The book argues, and it actually presents -- you know, you can improve it -- but it presents a fiscal initiative, sound proposal to get to a system that I think would be better for everybody within Mexico.

What the book doesn't do -- and Johannes pushed me to write a chapter, but ran out of time -- I had to join the IDB in August of last year -- is so why doesn't it happen. And the political economy at least needs another discussion and needs another dimension.

But the point of the book is that if we have a good understanding of the technical elements behind social policy and informality in Mexico, I want to shift the terms of the debate and place the debate where it should be on the political economy elements of what is driving this low-growth, low-productivity equilibrium in Mexico that is trapping Mexico in this bad situation from the technical discussion of informality and place it squarely on the political economy dimensions.

And the work to be done in the future is to understand is it feasible to actually make Mexico escape from this trap. I think it is technically and fiscally (inaudible) feasible to do so, and the challenge is now on the political economy. I end with what a friend of mine, a Senator

from Mexico, used to say, "Politics is the art of making possible what is necessary."

In Mexico, deep social reform is essential. Thank you.

(Applause)

MR. LINN: Thank you. Let's see whether these work. I guess they do work. Thank you. Professor Behrman, your turn.

MR. BEHRMAN: Thank you very much. It's not only a pleasure, it's actually an honor to be here with the launch of this book. I think this is an interesting book and a very important book.

I think it's important because it takes a dimension of the conceptual framework of development that has been perhaps one of the few distinctive dimensions of the analytical development literature, that is, the formal-informal contrast, and develops this contrast in a new way, in a way which I think the book demonstrates is important and which has insights for social and economic policy.

And this new way hinges upon the distinction between salaried workers that have access to certain benefits, stereotypically the bundled Social Security type benefits, and the non-salaried workers who may or may not have access to various types of subsidized social protection.

And the book is developed to show in an integrated way how this distinction has important implications for static efficiency, dynamic efficiency, poverty, and for policies that might be related to all those concerns.

Santiago is very fond of having lists, numbered lists, in his writing, so let me make a couple of numbered lists.

The first of these is that Santiago brings to this book an unusually rich set of traits that are relevant. And I've noted eight of them.

First, a simple straightforward, but very powerful use of what at least in the old days we used to call price theory, looking at how economic and social behavior are affected by the various kinds of institutions that exist and by markets.

Second, simple, but thoughtful, and I think David deserves some credit here, empirical analysis, using a range of materials, from socio-economic surveys to administrative data -- very interesting data-for means and international data and using a range of statistical techniques to make a persuasive argument in my judgment that these -- this is an important question and affects substantially what is happening in the Mexican economy.

Third, knowledge of the previous literature and the capacity to both respect the previous literature and recognize what is contributed, but also to articulate how this study differs from the previous literature.

Fourth, a very extensive institutional knowledge about the details of various programs, policies, and markets in Mexico.

Fifth, extensive policy experience of which we're all aware, but beyond the experience I think a profound understanding of the nature of policy and the implications of policy.

Sixth, a formal overall perspective about development policy

and society and related to that the seventh point is an integrated approach, which integrates not only concerns about the economy and social aims, as Santiago emphasized in his comments, but also various dimensions of policies, how markets interact with policies.

And eighth, a quest for understanding that is, in my view, not compromised by excessive self-promotion -- and, in fact, sometimes I think Santiago is a little bit too modest -- but it drives him to examine such questions in depth. And I think frankly there's very few people in the world with this combination of strengths that could undertake such a study.

My second list is just sort of summarizing what the book demonstrates. And it's a shorter list with four points.

First, it demonstrates the conceptual and equally important or perhaps more important the empirical importance of the kind of formal-informal distinction, conditional upon labor market status, that is at the heart of the book and that integrates the book.

Secondly, it demonstrates how this approach differs from the approaches of others who have been concerned about informal-formal considerations, for example, by emphasizing the substantial fluidity between the formal and the informal sector. These are not separate entities. Workers cross back and forth between them easily. By emphasizing that within a standard economic model, workers are indifferent between the two sectors. It's not that all of the informal sectors wish they were in the formal sector within the standard kind of model. They're indifferent between the two sectors.

Emphasizing that policies create incentives for both static and dynamic shifts from the formal to the informal sector or the particular set of policies on which Santiago focuses.

Emphasizing that productivity differences with higher formal sector productivity is an endogenous outcome that originates not from within this framework technological differences, but from the policy distortions that the book is concerned with.

A third the book considers is what are the implications of this approach for a number of important concerns that I mentioned before -- for static efficiency, dynamic efficiency, for poverty, growth, for informality and illegal behavior. As Santiago said, almost all of these implications are negative in a word.

And finally, the argument for decoupling the relationship between labor market status and these various kinds of either Social Security or social protection benefits in order to lessen these distortions with potential gains in many dimensions.

The book also repeatedly has nuggets of very interesting discussions of the incentives and implications of a range of programs in Mexico of various sorts, which add a great deal to the richness of the book.

In my judgment, this project succeeds very well in developing the importance of this particular formal-informal labor market distinction and the need to address the distortions that are introduced by this distinction.

Santiago ends his introduction saying, "I hope that more academically minded readers find the discussion thought-provoking, while the more the policy-minded readers consider the analysis relevant to their task."

I worry a little bit about the second part, because I think some of the more policy-oriented readers will be challenged to digest fully of what Santiago is saying. But speaking hopefully as a part of the first group, one of the more academic-minded readers, I think indeed this book has succeeded in being very thought-provoking.

I've spent some time with it on various airplanes recently. And there are still dimensions that I need to digest.

I need to think more about. But I -- if it is the case, as I anticipate, that other more academic minded readers also will find this book thought-provoking, illuminating, and challenging, then I think it will contribute importantly to the dialogue, including policy makers about the nature and policies, the distortions they might introduce and how we can move forward more positively.

So I think in closing that we in the development community are indeed indebted to Santiago, who somehow found the interest and energy after a number of years, uncountable number of years, of intense work in the government to sit down, pull together his thoughts, put it in a very systematic way, in a way take a very simplified world, putting aside lots of the complications of the real world, such as credit markets, et cetera, in order to make the essential point that the nature of these

policies themselves, whatever their intentions, may and probably do create counterproductive distortions.

So you're to be congratulated, Santiago, on an excellent job.

(Applause)

MR. LINN: It's now Nancy Birdsall's turn. Nancy.

MS. BIRDSALL: Thank you very much, Johannes. I feel quite pleased to have the opportunity to be here with this distinguished crowd and to see some friends from the Inter-American Development Bank. I think it's really a great sign that Luis Alberto Moreno is here to learn from Santiago Levy and think through the tough economics of social policy. And that is really the theme of Santiago's book.

And I was thinking about this issue of the tough economics of social policy and thinking back to the late '80s, mid to late '80s, when I was at the World Bank actually. And there was a kind of view that because everything was such a problem with respect to macroeconomic policies across Latin America that what the World Bank needed to do -- and I think this was true at the time at the IDB as well was lend for social programs.

And I was then working in the social sectors, including on the lending side. And I remember feeling quite frustrated sometimes so that there was this assumption that you could do good programs on the social side and do reform in the social areas when there were these macroeconomic distortions.

And I used to say to colleagues who were on the macro side,

“You know, it’s a lot more complicated politically and economically to fix the health sector or the education sector or to deal with Social Security issues than to, you know, write down a new exchange rate policy.”

Well, what Santiago has done is bring us forward 10 or 15 years, and he’s making the same point analogously this time with respect to microeconomic distortions.

What this book is saying is you can’t think through effective reform of social insurance and social protection policies, you can’t do it just by adding more programs, particularly when there are key microeconomic distortions that are creating this informality. You may be adding to the incentives to create informality instead of addressing them.

So I’d like to just take a few minutes and to wonder out loud about three issues in the hope that Santiago might address them, if not today, in the next book.

(Laughter)

MS. BIRDSALL: And the one -- the first one that I had put down Santiago mentioned, and that is the difficult politics of reform of social programs. What he’s calling for, as you said, is wholesale reform leading to universal social entitlements.

We all know that it is much easier politically to do incremental reforms, where you add fixes to adjust problems, where you provide specific benefits to specific beneficiaries, usually beneficiaries who have some political voice. It’s much easier to do that than to seem -- to take away those benefits and substitute new universal wholesale benefits.

It's difficult because you're taking away something specific from clearly defined beneficiaries, particularly in what Santiago calls the social protection programs, which go to non-salaried workers, with the promise well, that eventually there will be less informality and in the meantime we're going to give you access to these social insurance programs.

But those who already have access to the social insurance programs are in the meantime going to have to cover the fiscal costs of that wholesale reform.

So I'd -- I think it's unfair because Santiago said that's the next big issue, but anything he wants to say about that I'd be very interested in hearing.

The second thing I'd like to do is ask more realistically Santiago to address himself the question whether this particular problem of the distinction between social protection programs, all this pieces, little pieces of a big puzzle, that go to those in the informal sector and their families versus social insurance in the classic sense how specific is it to Mexico.

When I looked at the book, my sense was that although informality is a very generalized program -- problem in Latin America, and although slow growth, because of microeconomic difficulties and distortions-on the tax side, the regulatory side, the credit side-is also I think something quite special about Latin America. The slow growth that goes with those microeconomic distortions despite the macroeconomic

reforms, those things are specific to Latin -- or generalized in Latin America.

But I'm not sure that many other countries have the problem of these bits and pieces of the puzzle. So I'm interested to hear Santiago now that he's been some time at the IDB and presumably started to learn more in-depth about what's going on with social -- the tough economics of social policy in other countries, he might have a reaction.

Then third, I would like him to address one hypothesis for how Mexico got into the box it's in, as he describes it, or the trap it's in, and how Mexico might get out of that box.

And that hypothesis has to do with the idea that's what's been missing in Mexico and in much of Latin America and really all of Latin America for the last three or four decades, despite growth, is a economically and politically powerful middle class, middle class in the sense that we use it in the western world, say, or in mature democracies.

That is a middle class which provides the source of political demands for universal social entitlements.

And here I was -- in thinking about this issue, I think there -- I wanted to say two things: first, a little bit metaphysical. You know, Mexico's evolution of economic and social policy has been putting it in the context of the American Revolution -- Hamiltonian, not Jeffersonian. Maybe some of you have been watching or watched the John Adams HBO -- the series on John Adams. And so you've been rethinking, as I have, how policy evolves in immature democracies.

And at least in those times, in general terms, you could say that the Jeffersonian view was trust the people and the Hamiltonian view was trust the technocrats.

And I think that social and economic policy for much of the reform period in Mexico since the early to mid-'80s has been about trusting the technocrats. And there's a sense -- and the enlightened technocratic elite, represented in some form by the pre -- and even after the election of Fox by the technocrats, including Santiago, in the Fox Government.

Now, of course, Jefferson had this idea that you should trust the people at a time when the people, as it was conceived politically, were male, white property owners, and a small number of them.

But as it turned out, at least in this country, the people -- the franchise was gradually extended and there has been some good work, including at Brookings, some many years ago, about the relevance of the middle class as it evolved sort of you know, 60 acres and a plough sort of approach to development that that's been absolutely critical in developing these social -- universal social entitlement programs.

And you could say that to a limited extent, but still better than in developing countries, the poor in the U.S. and Europe have become our free riders in the best sense of the word on the demands of the middle class, say, for reasonable quality primary education. That would be an example.

So the question for Santiago is: Is it going to be like that in

Mexico that with the political evolution of Mexico toward trusting the people and not just the technocrats and with economic growth, even if it's tepid relative to China and India, but there is economic growth even if it's been heavily reliant on a healthy global environment and on the commodity boom, there is coming along something closer to a prosperous middle class in Mexico. Looking at the data, I can promise that that's the case.

So is that going to be, Santiago, the source ultimately of the kind of wholesale reform you're calling for? And how can those of us who are outside Mexico and outside of Latin America in places like the Inter-American Development Bank ensure that whatever is happening from outside is supportive of that direction? Thank you very much.

MR. LINN: Thank you.

(Applause)

MR. LINN: Thank you, Nancy. Don't fall. Now we have Chico Ferreira. I have to explain that Chico actually brought along some slides, but we early on made a decision not to have a slide set up to make it a bit more informal and not have to dim the lights and so on and what have you.

So, Chico, the test for you is can you do your 10 minutes without slides.

MR. FERREIRA: Without the slides. Yeah. Without.

MR. LINN: We'll see. But I'm sure you can.

MR. FERREIRA: See the slides were particularly important

today because I was coming after Jere and Nancy, and I knew that all the intelligent things would have already been said. And I, therefore, needed, you know, some distraction. And I thought I'll make the slides prettier, largely by copying some of Santiago's graphs from the book, which are just beautiful graphs. And I had them here and I'd even drawn on them, so, but, you know, I'll try and make it without the slides and I also have sort of three parts to what I wanted to say.

And the first one, and this is, as I said, what happens when you come after people is I have a list, as well. The first one looks very much, sounds very much like the one that Jere gave you, but it's where most of the compliments to the book are, so I want to go through them anyway.

And that was, you know, I decided -- I read the book. I didn't notice that it was raining over the last three or four days, because I sort of -- I was there with the book reading it, and it's a great book, as was said before. It really is a great book.

And I said, okay, let me run it through the sort of six-point test for a great book in development economics. And the test goes:

Is the question interesting and policy relevant? Check.
Absolutely.

Is it guided by theory and a clear conceptual framework?
Absolutely. It is. Nowadays, Eric Verhogen at Columbia University and I are part of a small underground crusade for keeping theory and empirical work together, which doesn't always happen. And this does that very well.

In addition, the theory is no more complicated than it needs to be. It's very simple. Very effective theory. Beautifully explained and drawn. So that is very nice.

Is it evidence-based? Yes. In addition to the theory that's there, he draws on a very nice set of datasets from Mexico to great effectiveness, not always necessarily testing the hypothesis that he's putting forward, so there's stuff for the various researchers amongst us in the audience to do as well, but certainly in providing the underpinnings for the analysis that's there.

The fourth point is sometimes you have good theory and good empirics, but the people who are writing it have no knowledge of the institutional context. And that's clearly not the case here. Nobody can have a better sense of the institutional context, as was said before, in a Mexico than Santiago does. And that shines through the book throughout.

And it's not segmented to some other chapter. Every chapter as you read them mixes the theory and the empirics with this knowledge of the institutional context, which makes it very, very effective.

And finally, does it give you, to use Santiago's word, an out? Does it make a policy proposal? And it does make a policy proposal, one that's deceptively simple, but manages to be both sensible and revolutionary at the same time. And those two things don't necessarily always go together, but they do here.

It's partly revolutionary because, as Nancy was saying, it's not incremental which I say, I agree raises issues for the political economy

of how it's -- of how it's feasible.

But on the other hand, from the point of view of an economist, it's just beautifully simple. This is how we should have it. Now, how we get there is perhaps the next book.

Now that was the first thing. The second thing I wanted to say is just to try to convey -- I don't know if I'll manage -- but I wanted to try to convey the very simple basic insight of the book, which is very powerful, and that is the following to me as a reader at least; and that is the following: that if -- that the mere existence of an informal sector is not necessarily inefficient. In fact, given the state of technology and the underlying initial distribution of assets, and he very nicely describes assets could include things like, you know, your back land of unproductive -- a plot where you grow some corn or even access to a certain street corner in Mexico City or some other Mexican city.

Given those things, it may well be efficient for there to be a self-employment and commissionista sector. So that is not where the inefficiency comes from.

The problem comes, as the title of the book says, Good Intentions, Bad Outcomes, when a certain set of policies is applied to them. And in particular if you happen to provide benefits to the formal workers by taxing formal wages, which creates a tax on this sector, particularly if the workers who are there don't fully value the benefit that they get.

So there's a wedge that comes from firms paying a certain

amount and workers only valuing part of that amount, because they perceive some of what they're receiving as a tax. And there's a lot of evidence in the first part of the book to suggest that that's the case, and that, by the way, reminded me of Brazil, where it's certainly the case as well.

So that's one side. But then the other side is you provide -- and that's Social Security for the formal sector.

Then on the other side, you provide social protection benefits for the informal workers, for those that don't qualify for the Social Security, but you don't tax them for that. You bring it out from somewhere else -- oil rents or investment that you don't make -- general tax revenues.

So now you've got a tax on one sector and a subsidy on the other. You've really distorted things, and three things happen.

First of all, informality grows, because people move out of the taxed sector and into the subsidized sector, both firms and workers and it shows that very nicely.

The other thing that happens is the marginal products of labor are no longer equalized, and that's the inefficiency, the static inefficiency there, and there's a little triangle -- you know, for those Jere mentioned price theory. For those of us who like Harberger Triangles, there's a beautiful Harberger Triangle there of that.

So that's all very nice.

So that, to me, is the essence of the book, and I'm going to do something terrible. I think you should do what I did and read the whole

book, but I'm going to do something terrible and tell you if you don't have time, just read chapter six. Chapter six is the essence. Okay.

Now, you know, so I know this is a book launch and not a seminar, but it's kind of inevitable that when you're a discussant, you want to earn your keep by saying okay, so here are the things I didn't quite understand, and I wanted to ask them from Santiago and see if he can enlighten me.

The bit that I didn't buy as much was, you know, he's kind of -- he's on a run. He's shown this, which I've just told you, and, you know, he's shown it so convincingly. He says, let me keep going. And it also is bad for growth.

And it's bad for growth, he says, dynamically, so we move now from static losses to dynamic losses, it's bad for growth because, you know, there's a certain ranking of investment projects in the absence of these interventions.

Now you put this intervention in place, and, of course, the ranking changes and some of the investments in the informal sector now become more attractive than they should be in some sense.

So there's excessive investment in the informal sector, which has lower productivity, so the extra output you get for that investment is lower. The I-core goes up in the new situation, which is a bad thing. You're growing less.

To me, that's kind of compelling, but it ignores three points. It ignores a number of things, but let me talk about three points.

First of all, it ignores that -- and this is -- you know, this is the question to see whether it ignores or not -- the fact that this subsidy or the stacks on the formal sector subsidy or the informal sector isn't only an income effect, subsidizing the sector, and, therefore, making these projects more attractive, it also changes the price of capital and labor, the relative price of capital and labor. That's essential to the story before.

Now when you do that, there's a substitution effect, which makes it cheaper to hire labor in the informal sector, more expensive to hire capital. And the net effect so is more capital going to the informal sector? That's what you get from chapter eight is there's more capital going to the informal sector.

That's -- it doesn't really gel with one's intuition, but also, you know, it's possibly because the relative price has changed of the subsidy. So there's a substitution effect as well as an income effect and that's not clear that it's there.

There is a paper by Aruj de Paulo and Josette Schenkman called the "Informal Sector." It's an NNBR working paper in 2007. It would have been great fun to get Schenkman and Santiago together to talk about this. And they are the two most interesting analyses of informality that I've seen in the last couple of years is these two papers.

But this -- they don't talk to each other yet. In their paper, one thing that happens is that the price distortion makes the informal sector too labor intensive; that too little capital in the informal sector. And it's sort of DeSoto like, if you like. And it's a very plausible story, too. So

it's a different story from what Santiago has, and it would be nice to have them talking together.

It also -- it also ignores a couple of other things. I had this -- Santiago's beautiful graphs and I decided to put growth in there by shifting the demand curves up. I'll send them to you just for fun later on.

And, you know, I was playing with the idea that actually if skill bias to technical progress is kind of, you know, as the name says, it's complementary to skills, and if those are more abundant in the formal sector, which Santiago argues earlier in the book, they would be, then, in fact, it's possible that skill bias technical progress is also formal sector bias to technical progress, which would lead to the elimination of the problem over the long run.

Now that's not to argue again -- you know, the questions that I'm raising about the dynamic thing do not invalidate the main points of the book at all and do not reduce the case for reform immediately.

But I think, for all those people who work for Santiago in the Research Department at the IDB, there are some other questions that we can ask, interesting questions that we can explore on those dynamics here.

Finally, the last thing I want to talk very briefly about is the policy proposal itself. Again, just to summarize what it is in two words and then to ask two questions about it.

So basically what he suggests is these universal social entitlements, the key point being that you're not going to tax the formal

sector workers and not tax the other ones. You're going to tax everybody. In fact, he suggests you have a consumption tax, a kind of VAT, and you use those resources to fund these benefits, a bundle of benefits, largely retirement pensions and health, life, and disability insurance, for everyone, for all the workers. Self-employed or not, there would still be a self-employment. Remember I said earlier the informal sector in that sense is not inefficient. So there would still be self-employment in Santiago's world, but these workers would qualify. They would get a number. He describes the -- how this works, you know. He'd get a number and you'd qualify for this thing.

So it's very nice. I have two questions only on that. One is, Santiago, and again, it's a pity I don't have the graph, he has all the workers in a box, but it's a box. There's only so many workers.

Now I wonder if there isn't a sort of information revelation problem with respect to other working age adults. So the issue is okay, now you're self-employed. You get a number. You get these benefits. It's not a trivial benefit. It's in retirement, pension, and all whole bunch of insurances; right.

So what's to stop, you know, if I'm living there with, you know, and my wife and three grown kids and, you know, I worked the land or, say, one of my kids worked the land and I sit and drink beer on the porch all the time, and I'm not a worker. Well, what's to prevent me from saying, oh, I work in the informal sector.

So the revelation, the monitoring of that I was curious about

and I missed the discussion on that.

Finally, he mentions corporate income taxes. Those would remain. Now those don't distort the relative price between capital and labor in the formal sector, but they still only apply to the formal sector and not to the self-employed or at least I got this sense.

And you know he knows that, because at some point in chapter 10 he says and this shouldn't be too high. Well, but, you know, they're still there. And so what happens to that?

And again, let me point Santiago and others to this De Paulo and Schenkman paper, where they actually argue, and they have some evidence from Brazil, from a very nice survey of informal businesses in the slums of Rio, they argue that-actually it's the slums of all Brazil, I'm sorry, they argue there that VAT schemes, because of the credit systems going up and down the chain, can actually act as a propagator, as a transmission mechanism of informality in some sectors, which is interesting. Again to get these two sort of papers talking.

But on the whole, as I say, don't follow my advice. Don't read only chapter six. Read the whole book. It's very well worth reading. Thanks very much.

(Applause)

MR. LINN: Thank you. What I suggest we do now actually if -- if that's okay with Santiago is that we actually get him to quickly respond to a few of the points that the commentators have made, because I think none of you I suspect will have read the book already in the last 45

minutes or so. So it'll probably take at least an hour I expect; right?

So why don't we -- because I think it would be to hear. I think some very interesting comments were raised. And so if it's okay with you, Santiago, will you just maybe engage a little bit on those comment.

If you wish, you can stay right there. Okay. You can get up now. But, you know, you can undo it and get up if you feel more comfortable.

So and then maybe so or another five or seven minutes from Santiago, and then we'll open it up, because I think there may well be lots of questions on what is indeed a very interesting book. And I've read it three times, so I can assure you it remains interesting after three times.

MR. LEVY: Okay. First, thank Jere and Nancy and Chico for really excellent comments. I can't take them all because I would monopolize the time, which is not the idea, but let me just give some quick reactions to point made both by Nancy and Chico, which is there's this proposal for wholesale reform and that's going to be extremely difficult to pull through.

I'm one step behind. The book wants to say wait. Think what you're doing. No longer add social programs erratically. Don't think that just because a program is well targeted on the poor it's a good program. Don't think that just because a program delivered benefits it's worth it.

And secondly, have a vision of where you want to be. If you're going to design social policy reform, what is most important is not

really the speed at which you get to that but having a clear idea of where you want to get.

So that, at the margin, the reforms that you carry out are aligned in the direction where you eventually want to get to.

It doesn't really matter whether it takes five years or seven years or 10 years, but get there. And I want to make this analogy: think of a man who's digging the hole and this man has been digging this hole for a long, long time, and then you come and you tap him on the shoulder and you say, "Look. You know, you're digging a hole. You should go the other way." And the man stops digging, looks up, looks at the sky and says, "Oh, my, you know. I really need a very, very long ladder to get out of here. Let me keep digging."

(Laughter)

MR. LEVY: We need to stop. We need to think. Have a clear vision of where you want to go. The book tries to provide that understanding, and then let's agree upon a marginal sequence of changes to eventually end there.

It might take four years, five years, seven years. It doesn't really matter. But what the book tries to do is sort of provide the end view and push the policy direction in a different way.

The transition might take a -- you know, 10 years. It doesn't matter, but that's sort of one point I want to go.

MS. BIRDSALL: So when the next First Lady wants the next milk program or --

MR. LEVY: Yeah.

MS. BIRDSALL: -- or children under two or --

MR. LEVY: There's a very important political point here, and I'm glad Nancy brings this up. I think part of the politics driven behind this has to do with the fact that there's this distinction between legal entitlements created by Congress and social programs created by presidential will.

I think they should no longer be -- the executive should no longer have the ability to do that. I think that in a democratic society all these programs must be entitlements to all, approved by Congress, and, therefore, take them away from the tinkering and the electoral, the electing and all these, you know, populist stuff that continues all the time.

And I think in our transition to democracy, this is the chapter I didn't write. In our transition to democracy, I think we have to have a societal understanding that this is no longer play a game for political parties.

And because we want to be a democracy, we want to ensure that whatever social benefits are provided are a result of the will of Congress and the rights of citizens. And this is an important political dimension to the proposal, aside from sort of the technical (inaudible).

A quick comment on Chico and growth. The growth chapter tries to ask the following question. You see a man in the corner of Mexico City, and he has a stand, and he has a fruit juice stand. And the fruit juice

stand is very old and he's probably stealing the electricity from some pole. And then he invests money in it. And you see somebody with a very old truck that is moving cargo from one city of Mexico to the other. And the truck is 10, 15 years old. And the truck breaks down, and the guy invests money in that old truck.

And you see a peasant with a half hectare of land, and it's, you know, steep slopes and it's pretty eroded. And the guy invests money in the land.

So the question to answer is why is investment being allocated? Why are savings being allocated to these projects in the informal sector? And if it's one or two, it's not really relevant. There are millions.

So why is it that continuously, and the question is relevant because that's what makes informality persist. If there were no further investment, eventually these assets would dwindle down, would be wasted and then eventually people would sort of, in a European-styled transition, get salaried jobs with Social Security.

So we can talk some more details, but the dynamic part is important in terms of understanding what motivates people to actually engage in these investment projects. And there must be, if you take the point of view that they're rational and they're maximizing profits from a private point of view, there's something in the incentive structure that's forcing them to do that.

So those are two sort of quick reactions to Chico and to the

point made (inaudible). I shouldn't rationalize.

MR. LINN: Well, if I may on that and all of us, but I'll push you a bit more on Nancy's question regarding sort of how does that apply - the Mexican situation as you've analyzed in great detail and I think to great effect, how can we generalize -- can it be generalized for Latin America and maybe possibly even beyond?

MR. LEVY: I think Mexico is a hyper example of what in my view is going to happen in the next 10 years in Latin America.

It's a hyper example in the following sense: all Latin America has this -- I wouldn't say all -- many countries in Latin America inherited this European vision of Social Security in which the institutional construction is Social Security is associated with firms and salaried labor.

By design, that leaves an important segment of the population out, because, as Chico was saying, you do want self-employment, and you do want other people in non-salaried jobs. But then the government has a dilemma. It says I have all these guys. And these guys are not getting health insurance. They're not getting retirement. They're not saving for the pension, so I have to do something.

Mexico is an hyper example because -- but the inherent design -- and I see -- I'm very aware of it, actually -- I see that politically, particularly in a macro context in which the revenue is abundant. It's extremely difficult for governments to resist the political pressure to provide some benefits to these people and because you cannot tax them -- the wage bill -- there's not a firm involved, and you can't tax them, you

must pay them out of general revenues.

And when you do that it happens what Chico was describing. You're subsidizing these guys and you're taxing these guys.

So the institutional design of Latin America is putting it in a path of which Mexico I think is a four (inaudible) country and I think it behooves us to fix it now before it gets even more difficult to fix it. So I think it's relevant in that sense.

MR. FERREIRA: And if I can just say, I really think Brazil is there already. It perhaps doesn't have quite as many of the subsidies on the social protection side as Mexico, but it certainly has the tax on the Social Security side, creating a big wedge in firms there. In fact, I think we should send a couple of spare copies to some Brazilian policy makers there. I'll give you the list later.

MR. LINN: Well, be happy to. Okay. Let me make just in that context say when Raj Desai and I were in -- from the Wolfensohn Center, we were in China, and we actually discussed the poverty programs and the way the social -- actually the Social Security system evolves in China, it appeared to us and when we talked to some of our Chinese colleagues that very similar problems, not the same problems obviously, but similar problems of inconsistency because you add on, you add on, you add on, and then various types of inconsistencies arising is also now a rising concern in China. And it's interesting to note that Indian colleagues of ours from India think tanks have been very, very interested in getting Santiago to come and talk to them in India.

So I warn his bosses that he may be drawn off a little bit here or there to share some of these insights more generally.

But let's open up. We have about 15 minutes. Let me just say that for those of you who can stay, there will be a reception at the end starting at about five thirty or so. Just across the hall. So if you can stay, please stay. And don't run away too quickly.

I will start just for fairness in the very back and then come -- make my way forward. So there's a hand with a blue shirt, in almost the very back. Blue shirt. Maybe I should stand up so I can be more (inaudible).

MR. CHEN: I have to stand up?

MR. LINN: Yes, that would be great.

MR. CHEN: If I stand up, I cannot see my notes.

MR. LINN: Oh, well, if you could at least introduce yourself that would be great.

MR. CHEN: Okay.

MR. LINN: Then at least we know who we don't see.

MR. CHEN: Okay. Chao Chen, freelance correspondent. I didn't read your book, but I just heard what you and the commentators say. I have some observation.

If we say good intentions, bad result, then the problem is either the problem is no good or there's a problem in implementation. And so we heard two commentators say that to be realistic. I think the first one is you have to understand the society and you have two approach to the

society and to the individual. To the society is you got to build the infrastructure. My infrastructure, for example, is the transportation, public health, education, and to create a job.

MR. LINN: Could you ask it as a question, please, because otherwise, we're not going to get to the --

MR. CHEN: Could I have a comment?

MR. LINN: Okay. Keep it a little short.

MR. CHEN: Yeah, I'm just about finished.

MR. LINN: Thank you.

MR. CHEN: Yeah. And it's individual you got to give them education, give them knowledge and the technology. For example, we should not give people the fish. You can teach them how to fish and also we got to tell the -- provide them a nice place to fish and also a fish market. Thank you.

MR. LINN: Thank you very much. We'll go and take a few more comments, questions or the case may be. There's a question in the very back also, right behind you, Eileen.

MS. LOPEZ: Yes.

MR. LINN: Could you introduce yourself, please?

Ms. LOPEZ: Gladys Lopez from the World Bank. I have two questions. Whether the book provides a roadmap to get to this long-term vision, like some suggestions on where to start either pension either pension reform, health reform, something that could guide the government,

And the second question is whether in the book you were able to compute the effect of these social programs on productivity and informality.

MR. LINN: Thank you. Let's move right in front here, if we could get a --

MR. KASTLES: Kevin Kastles from the University of Costa Rica.

One of the endemic problems with social policies in Latin America is the lack of reliable evaluation instruments. I'm wondering if the lack of coherence of the set of policies that you describe in your book reflects a failure of evaluation mechanisms. That's number one.

Number two. In a number of countries in Latin America, they've chosen to establish, to introduce some kind of centralized social authority, typically a ministry of social development or, you know, a creature of this sort, one of whose functions is precisely to secure that kind of coherence between social policies.

Would it make a difference in Mexico?

And number three, I must say that I really like Nancy Birdsall's comment on the middle classes because I think it's spot on, up to a point.

You know, to cut short a long story, I guess most people agree in Latin America that we need a set -- that in order to go forward we need a set of equity-oriented reforms.

The big question is, of course, where's the political coalition

to bring that about. And if we talk about the middle classes, I mean, who are the middle classes in Latin America? In light of two things: number one, that those middle classes are increasingly getting a lot of their social services and public goods from the market. Number one.

And number two I'm wondering whether the middle classes in Latin America or anywhere else can be regarded as a progressive actor. You know, if you look back at the history of Latin America, you can certainly muster a lot of evidence that shows you that middle classes can be capable of incredibly reactionary attitudes toward social change. So those are my three points.

MR. LINN: Thank you. Let's take one more question up front here, and then I'll come to the middle after we give Santiago a brief chance because we don't want to overtax him. Go ahead, please. Introduce yourself.

MS. ZAFER: My name is Rahilla Zafer, and I'm from Davex. And my question is how you convince the elite that are part of the Mexico Government who are benefiting from this informality and who may feel threatened by people in the informal market suddenly being part of the formal market. How do you bring them on board and convince them that overall, they'll be better off and society will be better off with these reforms?

MR. LINN: Thank you. Actually, I'll change gear. Rather than -- because we're going to run out of time, and I want to give a few more -- a little more time and then we'll just ask the commentators and

Santiago to sort of see where they want to pick up on this or that other comment.

So let's go this gentleman right over here.

SPEAKER: And what does the role of corruption have in terms of implementing some of your strategies that you mentioned in your book?

MR. LINN: Okay. Corruption. What will get in the way. Yes. Right here.

SPEAKER: How long for the clear vision to really be able to define a socio-economic policy that brings both Mexico and Latin America for a better understanding of growth and equity?

You said that it doesn't matter if it takes seven or 10 years. But I guess the whole entire continent have been waiting at least for 30 or 40 years for this specific right, socio-economic policies to combine growth and equity. I am an ex-IDB and a political scientist.

MR. LINN: Thank you. The gentleman to -- right there. And then we'll go further back. Yes.

MR. DAMAS: Luis Damas from Haiti. And I listened to you talking about it doesn't matter how long it takes and the first gentleman who talks about shows a man how to fish. And but, at the same times now and looking at the case in Haiti where there is so much poverty. I don't -- in terms of benchmarking your system, I think if you just go and say does it matter how long it takes with the reality of the people there, I wonder how -- if you're telling of IDB and the World Bank to just to go to

programs, does it matter or how long it takes.

At the same time, some people need immediate help and that social entitlement that's needed. It's, to me, it's a different program that we're talking about there. I'd like to see some elaboration on reality as well. The politics and so forth.

MR. LINN: Thank you. I think we have some very clear questions on timing, but let's -- and sequencing. Let's go the very end, the far left from your side, Eileen. Over there. Yes. Sorry. It's a little difficult here.

MR. SINAR: Cabo Sinar . Santiago --

MR. LINN: Can you introduce yourself, please.

MR. SINAR: in your experience as a former policy maker in Mexico, what is your thinking? Why growth in Mexico after several important reforms has remained relatively low up to this point? Thank you.

MR. LINN: Okay. Two more questions and then I think -- here -- take the one -- the blue shirt in the middle. Right there. Yes.

MR. LEWIS: Bill Lewis from McKinsey. I would like to ask whether your proposal of universal social programs wouldn't also have some adverse unintended consequences.

I wish I had read the book, 'cause I don't really know the mechanism you're talking about causing the informality, but I'm inferring that this is primarily a phenomenon in the labor market, with people moving from formality to informality.

Well, if you move to a universal social welfare program, that has to be financed through general revenues, and, of course, the general revenues have to come from somewhere, and that's probably also from taxes -- corporate profit taxes, but also sales or value added taxes, which in a country at the stage of development of Mexico probably also has to be built in primarily in the price structure or the cost structure of the formal activities.

That makes, of course, the problem move into price competition between formal activities and informal activities with again the formal activities having the penalty of having to collect the taxes in their prices and the informality not having to collect the taxes.

So I worry that you're shifting the problem from a labor market problem to a product market problem and really not improving informality.

MR. LINN: Thank you. Let's go to the very back, the lady I think with --

MS. GEORGE: Hi. I'm Cara George from Partners of the Americas. And I was curious about the conditional cash transfers under the Progresa Oportunidades model and why that was replicated in so many countries. What was so successful about it?

MR. LINN: Thank you. It was because Santiago went around telling everybody.

(Laughter)

MR. LINN: Just kidding. No, and I will come back.

MS. BIRDSALL: Jere, too.

MR. LINN: Oh, Jere. Okay. And everybody up here except me, Jacques back there. And then I think we'll give the panel a last set of comments because otherwise we won't be able to go and enjoy the reception. Go ahead, Jacques.

MR. FINEGART: I don't want to keep you away from the reception, so I'm sorry.

MR. LINN: You're in a dangerous position.

MR. FINEGART: I'm Jacques Finegart from Wolfensohn Center, Brookings. Santiago, I haven't read the book, but I definitely will. But I get the impression from the presentation that there is some bias or some fear of the informal sector.

Now, it seems to me that a priori the formal sector surfaced from taxation, regulation, all kinds of other stuff. So you would assume that the informal sector is more efficient rather than the formal sector. And I wouldn't have asked the question if you wouldn't have said the following: that if those poor farmers stop investing in their plots and the juice seller doesn't, you know, in the little truck or whatever, they somehow magically automatically will end up getting jobs in the formal sector. And I have no idea how that would happen.

MR. LINN: Okay. Let us now turn in some order -- and I'm not quite sure which-let me ask Chico. Chico, do you -- given what you've heard from Santiago in response to your comments or anything that you heard from the audience that you can pick up on and want to add since

you've read the book. So.

MR. FERREIRA: I did read it. At least that much was clear. So that's good.

No, I mean, this growth thing will require a longer conversation, and I think Jacques has a point. I think I know what your answer to it would be, but anyway, the growth, the dynamic story is more complicated.

But nevertheless, you know, clearly the point is that these -- the existence of the distortionary policies affects a whole set of decisions in a negative way and if we could change that and make everybody -- and I believe that Santiago is right that there's a (inaudible) to improvement that can be made here. And, therefore, it is, you know, the political economy should be simpler than it is going to be.

I just want to say one thing and that is an ongoing discussion in a number of panels Nancy and I end up having about the middle class. And I just want to say picking up on what you said as well. I just want to say the following thing about the Latin American middle classes.

Maybe the middle class would be a good thing, but it has to be the middle class the way a statistician would define it, not the way Latin Americans define it.

The way we define a middle class in Latin America it means the rich. And they are not very positive force in political economy in my view largely.

So when we say -- you know, I'm Brazilian. We say, "Oh,

well, you know, we're middle class." And that kind of middle class is the elite and there's a lot of elite capture going on, and there's well informed elites as well, but there was a conference in Mexico not long ago -- I think you might have been there, Santiago, and Mike Walton and Francois and so about elite capture and everything.

Now if we've defined the middle class as around the median or between the median and the sort of upper quartile, maybe that would make a difference, but not the middle class as it's presently defined. That's just a quibble.

MR. LINN: Nancy.

MS. BIRDSALL: Two points. I think this point about the reactionary middle class is interesting, and it's not only the issue that Chico raises that the middle class should not include the very rich -- and, in fact, I've done a little empirical work that suggests that it's absolutely the case that if you take just people who are earning at least \$10 a day or more, and you cut out the top five percent of households, there's almost no one left in many countries of Latin America between \$10 a day and excluding the very top households.

So that's the missing middle class.

The other thing is that across the developing world we need to think through where is the middle class that is not dependent on the state or state enterprises or on rents that are fundamentally derived from state programs like sometimes these social programs.

So the whole issue of looking for a defining and

characterizing this group of people and how it's changing because I do think it is growing is important to -- I think it's important. That's why we keep talking about it.

The other thing I want to mention is this tax question just to say that to leave it in the air that for the IDB perhaps to take on as a big issue the question of tax policy in Latin America, because the difficulty with what I think Santiago's view is, namely to increase the VAT or the EVA, in order to finance universal programs is that in most of Latin America -- I'm not sure about Mexico because of oil income -- but in many countries the VAT already constitutes 60 percent more or less of total revenue.

In Europe, it constitutes 30 percent of total revenue. And what that means is that Latin America is already laboring under a tax regime which is fundamentally in the regressive direction or at least fails to introduce any progressivity.

Now there's this idea of economists and it used to be the case in the IMF, which I railed against for some period, that you must do all distribution on the expenditure side and preserve on the tax side, you know, neutrality.

I think that that is politically a non-starter. At least it has been politically a non-starter in mature western economies.

So it's an interesting dilemma. It's an interesting area perhaps for the IDB to develop some deeper thinking.

MR. LINN: Thank you. Thank you, Nancy. Jere.

MR. BEHRMAN: Two question points. One on the applicability to other economies. You know, half the story is the distortion from the Social Security system and that is fairly universal, whether or not there is the additional distortions introduced by social protection. So I would argue that the basic story is quite widely applicable, not only in Latin America region, but to other parts of the world.

Secondly, I've missed all these interesting discussions about the middle class, but I'm not -- because I haven't been sitting at panels with Nancy and Chico I guess -- but it's not clear to me what the operational significance if we're talking about you know -- I think we are talking about association in societies that have larger middle class defined as Chico would like them defined rather than as Brazilians might define them probably function better. So what? How do you get there? You don't say boomp, there's a middle class. So I -- maybe I'll be invited to further discussion on the middle class.

MR. LINN: All right. Now I will ask I think Santiago to come back up here so we can all see him as he closes up. Santiago, you want to come up here and -- you need to take your mike off. Okay. And then we'll adjourn to our reception. Come around.

MR. LEVY: This is a great discussion. Great questions and great discussion. I'm going to try to just make four points very quickly.

On Gladys' question, yes, in the last chapter I try to say look there's a lot you can do even without reforming VAT and even without all of the laws. There's a lot of administrative measures. There's a lot of

sequencing stuff that you could do right now even in this very complex political context that would at least begin to move in the direction you want to move and I provide some numbers. But I don't have to deep. But I think there's a roadmap.

There's the end point and there's a roadmap. And what's important is the internal consistency and the temporal consistency of the roadmap.

Now discussion of the middle class is super interesting.
Okay.

MS. BIRDSALL: The book after the next book.

MR. LEVY: Think of the following. Think of an electrical engineer in Mexico in a Ford Motor Company plant or in any big corporation. He's a salaried worker. He's a formal worker. His income is -- clearly puts him in the middle class. He probably earns 10 to 12 minimum wages a month. He's clearly by any definition in the middle class.

But the government does something to this guy. The government says, "Look. I'm going to take away about 25 percent of your wage every month, whether you like it or not, and I'm going to force you with that money to buy health insurance, housing credits, retirement pensions, day care services, and I've got to do middle class or not middle class.

And then there's a doctor who's self-employed, very competent. He goes from house to house. He visits patients. He doesn't

have a boss. He's self-employed and assume that he works and he earns the same as the electrical engineer.

The government doesn't come to this doctor and says I'm going to take away 25 percent of your salary and force you to buy health insurance, retirement pensions, housing loans, day care centers.

The fundamental asymmetry that I'm looking at is that the government treats differently similar workers and that it does so regardless of the income level -- they could be poor; they could be middle class; it doesn't matter. It does so on the basis of whether they're salaried or they're not salaried.

And the reason I do -- the government does this is because the government -- and the government be right. There's a huge discussion on this. The government thinks that it knows better than the guy. That's why he tells the electrical engineer, "Look. You're myopic. You ain't going to stay for your future. Or you're going to be a free rider, a and I don't want you to be poor when you're old, and there's all sorts of moral hazards stuff that I want you to buy health insurance."

Whatever the reasoning is, the government imposes its preferences on the electrical engineer. But the government doesn't have the mechanism to impose its preferences on the doctor, because all this imposition is constructed upon wage-based taxes. That's what the book is about.

So then the question is, what is it that the government wants. Do you want the engineer to be forced to save because he's salaried and

the doctor not to be saving because he's self-employed? Or is that the result that you're unable as the government to tax this guy, but you can tax this guy.

The book says that he's taxing this guy and not this guy not because the government wants, because it's extremely difficult to think that this one's myopic and this is not. This one engages in moral hazard and this one doesn't. The government does that because it has no other option, because it's easy to tax the electrical engineer.

Once a month, Ford Motor Company issues him a check. He picks up his check and just before he picks up his check, the (inaudible) comes by and says, "un-huh. Let me take 25 percent. I'll give it back to you in health services and come back for a piece of it in 30 years from now when I give you back your retirement pension."

But the doctor the government can't do that. So let's go talk about EVA.

What did the electrical engineer suffered from? He really paid a consumption tax. And then with that money, the government purchased for him a bundle of goods. But this guy didn't.

So the EVA discussion is really a discussion about is there a tax that can fund the set of social entitlements that the government in principle wants everybody to have. And the question is whether one is less distorting than the other.

What this book says is in a country that's abundant in unskilled labor, perhaps the worst possible tax that you could think of is a

tax on unskilled labor, particularly if it's about 35 percent. That's what this book says.

And it then says if you really want all these people to have all these goodies, do it through a different instrument. And you can't do it on the basis of whether they're salaried or not salaried, because the book also shows that people go back and forth between the formal and informal sector.

So a discussion about the taxation is a discussion not about getting to an optimum. It's a discussion about is there a better source of doing it than this one.

The book doesn't say that this will end informality. There'd be other reasons for informality. People are evading taxes, income taxes, and all sorts of stuff.

But the book says from the social point of view, it would no longer be irrelevant whether it's informality or not because from the social point of view everybody would be getting the bundle of goods that the government wants them to get.

And, by the way, this would increase productivity because a very distorting tax disappears. Of course, it wouldn't be a first best, because there's another distorting tax somewhere else, which is the EVA tax, which, in the case of Mexico, there's a lot of room to do it. There's a lot of room to do it because particularly in Mexico the EVA only takes about four percent, four and half percent of GDP.

So we have a beautiful opportunity in Mexico. If we only tell

people we already have an EVA on you, under a different name, we just want to change the EVA for a different EVA. Let's get all this ideological clack, clack, behind us, and let's do it through a way that's much more efficient and clear and much more equitable because then we'll be able to reach these other people.

So a discussion of the EVA is centerpiece, because at the end of the day, I say the government is doing all this not really because it wants to do it, but because it has no other options and would (inaudible) produce constructive alternative option.

Okay. So I end here. I really thank both my three commentators because there were super comments and we'll continue these conversations. And I thank all of you really for being here. Thanks again, Johannes.

MR. LINN: Thank you.

MR. LEVY: Thank you so much.

(Applause)

MR. LINN: For those of you who are wondering who EVA is it's actually the value added tax in Mexico.

MS. BIRDSALL: And everywhere.

MR. LINN: Okay. Everywhere in Latin America. Anyway, thank you very much. Across the hall. And thank you to all our commentators and especially, of course, to Santiago. Good night.

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