

**Rationale and Operating Principles for the Proposed Social Investment Fund  
for the Americas**

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Mr. Chairman:

It is an honor to testify before the House Subcommittee on Western Hemispheric Affairs, and to discuss the proposed Social Investment Fund for the Americas. I believe that the proposal to create a fund has a great deal of merit. My remarks are organized around two objectives. The first is to present findings from my research in the region which contribute to the rationale for the fund as stated in the proposed amendment. These findings highlight the need to address pressing and unresolved social welfare and income distribution issues. The second objective, based on the stated rationale for the fund, is to provide some suggestions for structuring it and for establishing priorities for the activities it should invest in. It will be important to be selective, given the scope of the region's need and the necessarily limited scale of the fund.

**Public Frustration and Reform Fatigue:  
A Rationale for a Social Investment Fund for Latin America**

Latin America is a region with great potential. Yet that potential is jeopardized by its vast and unmet social needs. Long gone is the optimism about Latin America's turn to the market and establishment of democratic government. Instead the 21<sup>st</sup> century has opened with news accounts of one crisis after another, beginning with Argentina's economic collapse in 2001, and now followed by threats of defaults in Uruguay and Brazil, by fears of a populist backlash in a much broader set of countries, and by weak growth performance even in the strongest economies; Chile, Latin America's tiger, is slated to grow at only 2.5% in 2003 and unemployment – at 9.5% - is higher than it has been in two decades.<sup>1</sup> Most recently, one of the region's most committed democratic reformers, Gonzalo Sanchez de Lozada, was forced to resign as president of Bolivia amidst a wave of popular protest against market policies.

Nor have the region's age-old problems gone away, and its weak public institutions are ill equipped to solve them. It has the highest inequality in the world, relatively weak social indicators, and high rates of poverty, violence, crime, and corruption. Progress has been made in some countries in the past decade in improving some of these problems. In others they have

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<sup>1</sup> 'Latin America and the Caribbean: Economic Growth Likely to Fall 0.8% in 2002', *CEPAL News*, Vol. XXII, No.8, August 2002.

gotten worse and, most recently, are being exacerbated by the current crisis. During financial market crises, for example, wealthy consumers who hold assets abroad are much more protected than those at low and middle income levels, as the latter have no alternatives to fragile domestic banking systems. It is well established that when such crises result in poor macroeconomic performance and in particular high inflation, the poor are least able to protect themselves.

The region's participation in the integration of global markets, meanwhile, has been accompanied by a marked increase in the availability of information for the average citizen, which among other things has raised expectations for many. Most Latin American countries have large gaps in the standard of living between the very wealthy and the rest of society, gaps which pre-date the current wave of global integration. These inequalities were exacerbated by integration into global markets as skilled labor in the region benefited disproportionately from the opening of trade and capital markets.<sup>2</sup> Narrowing such gaps, which usually requires expanding the pool of skilled labor, is likely to take years and even decades. This mismatch between public expectations and the ability of both growth and public policy to respond often results in significant public frustration and even political instability in many countries.<sup>3</sup>

## Findings from Survey Research

My research seeks to explain the determinants of income mobility in countries in the process of integrating into the global economy, and the effects of these processes on public perceptions. Stefano Pettinato and I developed a data set which linked detailed longitudinal data on income mobility with perceptions data for the same respondents in Peru. For some of our questions, we were able to impute more general, region-wide trends using a larger, Latin America-wide sample, which is a large cross section survey of respondents in 17 countries (but unfortunately does not have longitudinal data for the same respondents).<sup>4</sup>

In Peru, we re-interviewed a sub-sample (500) of respondents in a large, nationally representative panel for 1991-2000, and asked a number of questions about perceptions of past progress and future prospects.<sup>5</sup> The most significant and surprising finding was that almost half of the respondents (43%) with the *most* upward mobility reported that their economic situation was *negative* or *very negative* compared to ten years prior. We conducted a similar analysis

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<sup>2</sup> For trends in inequality related to the opening of capital markets and the liberalization of trade in Latin America, see Jere Behrman, Nancy Birdsall, and Miguel Szekely, "Economic Reform and Wage Differentials in Latin America", Carnegie Endowment Working Papers, November 2001.

<sup>3</sup> For an extensive discussion of these dynamics and the underlying methodology and data, see Carol Graham and Stefano Pettinato, *Happiness and Hardship: Opportunity and Insecurity in New Market Economies* (Washington, D.C.: The Brookings Institution Press, 2002); Graham and Pettinato, "Frustrated Achievers: Winners, Losers, and Subjective Well Being in Emerging Market Economies, *Journal of Development Studies*, Vol. 38, No.4, April 2002; and Graham and Pettinato, "Happiness, Markets, and Democracy: Latin America in Comparative Perspective", *Journal of Happiness Studies*, Vol. 2, 2001.

<sup>4</sup> The Latinobarometro survey consists of approximately 1000 interviews in 17 countries in Latin America, providing 18,000 observations. The samples are conducted annually by a prestigious research firm in each country, and are nationally representative except for Brazil and Paraguay. The survey is produced by the NGO Latinobarometro, a non-profit organization based in Santiago de Chile and directed by Marta Lagos ([www.latinobarometro.org](http://www.latinobarometro.org)). Access to the data is by purchase, with a 4 year lag in public release. Graham has worked with the survey team for years and assisted with fund raising, and therefore has access to the data.

<sup>5</sup> To avoid errors due to timing of the survey, we repeated this perceptions survey three years in a row.

based on comparable data for Russia in the Russian Longitudinal Monitoring Survey (RLMS), and found an even higher percentage (71%) of frustrated respondents – or “frustrated achievers” as we now call them.<sup>6</sup> **In both cases, the remarkable finding was that roughly half (or more) of the respondents that have made the most income gains with the turn to the market think that their situation is worse now than it was in the past.**

A closer look at these frustrated achievers (FA’s) shows that they are at or about average income (and therefore not the poorest in the sample), and slightly older than non-frustrated respondents with upward mobility.<sup>7</sup> Our frustrated achievers scored lower on several perceptions questions, such as their perceived prospects of upward mobility, and had a higher fear of being unemployed in the future. In addition, they were more likely to want to restrict the incomes of the rich, and were less satisfied with the market process and with democracy.<sup>8</sup>

What explains these frustrations? Relative income differences could certainly be a plausible explanation. Both Peru and Russia have high degrees of inequality. The FA’s were more likely to place themselves lower on a notional economic ladder representing their country (ELQ) than were their non-frustrated counterparts at similar income levels. They also compared their situation to others in their community and their country more negatively.<sup>9</sup>

In Peru the frustrated achievers started from lower income levels, on average, even though they were not the very poorest in the sample at the time that they answered our survey. Thus even large percentage increases in their incomes may seem insufficient to reach the levels of wealthier groups. The FA’s were also more likely to be urban, and therefore more informed about the lifestyles of others, including those of the very wealthy.

A lack of adequate social insurance and insecurity could be another explanation for the frustrations, and is supported by the FA’s higher fear of unemployment. Even though the FA’s are doing well by objective income measures, they may perceive that there is no guarantee of stability or maintaining their earnings level. This is not surprising, given that both surveys were conducted in very volatile economic contexts.

The mobility data, meanwhile, reveal a remarkable degree of vulnerability. A higher percentage of respondents went from “rags to riches” – or from the bottom to the top quintile in a ten year period in Peru (5%) than in a similar period in the United States (1%), for example.<sup>10</sup> Yet a surprising 11% of respondents in the middle of the distribution (quintile 4 in Peru) fell

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<sup>6</sup> Access to the RLMS data can be found at [www.cpc.unc.edu/projects/rlms/](http://www.cpc.unc.edu/projects/rlms/).

<sup>7</sup> For a complete picture of the statistically significant differences between frustrated and non-frustrated upwardly mobile respondents, see Graham and Pettinato (2002), Chapter 4.

<sup>8</sup> In an initial and at this point cursory analysis of the 2003 Peru survey data, Graham and Margaret MacLeod (Mimeo, The Brookings Institution, 2003) find that the frustrated achievers are less likely to favor democracy, but there is no link with market policies. Yet the results are also not fully comparable as a much lower number of respondents had upward mobility during this latter period and thus there was a far lower percentage of frustrated achievers.

<sup>9</sup> The economic ladder question (ELQ) asked respondents to place themselves on a 9 step ladder representing their society, where the poor are on step 1 and the rich are on step 9.

<sup>10</sup> In both these cases, some of the mobility that we find could be driven by newly educated individuals entering the labor force. Yet as neither study controls for this, the rates are comparable – if perhaps slightly higher than they would be if we were able to implement such controls.

back all the way to the bottom quintile during the same period, which is analogous to falling from the middle class into extreme poverty. These temporary drops into poverty often have permanent costs for the families involved, such as when children are pulled out of school to earn additional income.

Most FA's had average levels of education, which is relevant to mobility. In Latin America, with the opening of trade and capital markets, those with higher levels of education are gaining high marginal returns compared to the rest of society, while those with secondary education are seeing decreasing marginal returns compared to those with primary education.<sup>11</sup>

Lastly, it is quite plausible that some of the frustrations that we find are behaviorally driven. There is probably some percent of every sample that will always be negative or unhappy, regardless of objective conditions. That led us to ask if our sample populations were significantly different from other population samples.

We compared the determinants of reported well being or "happiness" in Latin America and in Russia with those of the United States.<sup>12</sup> We find a remarkable degree of similarity: there were similar age, income, education, marriage, employment, and health effects.<sup>13</sup> In all contexts, unemployed people are less happy than others. **The bottom line is that the frustrations that we find in Peru and Russia are not caused by some inherent behavioral difference.** This allows us to impute certain variables from the smaller, country level samples to our region-wide survey for the purposes of more general comparison of public attitudes.

### **How Do The Findings Apply to the Region as a Whole?**

We found that in both Latin America and Russia less frustrated – or happier – people were more likely to support market policies, to be satisfied with how democracy was working, and to prefer democracy to any other system of government. Happier people, on average, had higher prospects for their own and their children's future mobility; were more likely to believe that the distribution of income in their country was fair; placed themselves higher on the ELQ; and had lower fear of unemployment.<sup>14</sup> In contrast, the negative perceptions of our frustrated achievers in Peru and Russia are correlated with lower life satisfaction (happiness) scores; lower ELQ scores; lower perceived prospects of upward mobility; higher fear of unemployment; and less satisfaction with market policies and a lower probability of preferring democracy as a system of government.<sup>15</sup> In sum we find public frustration which is linked to concerns about income inequality and unemployment, and to reduced support for markets and democracy.

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<sup>11</sup> See Behrman, Birdsall, and Szekely (2001).

<sup>12</sup> For the U.S., we used the General Social Survey (GSS) 1973-1998. For Russia, we used the most recent available survey (2000) from the Russian Longitudinal Monitoring Survey (RLMS). For Latin America, we relied on the 2001 Latinobarometro survey, which is comparable to the U.S. and Russia surveys.

<sup>13</sup> The coefficient on marriage for Latin America is positive but short of significant for the 2001 sample. For other years for which we have data, the coefficient on marriage is positive and significant.

<sup>14</sup> Support for market policies was measured by an index based on several scaled questions about the private sector, foreign investment, free trade, and privatization. For detail, see Graham and Pettinato (2002).

<sup>15</sup> See Graham and Pettinato (2002).

Do these results suggest that Latin Americans will turn away from markets and to authoritarian regimes yet again? In a recent paper based on more recent Latinobarometro data (April 2002), Sandip Sukhtankar and I find that respondents' *satisfaction* with how both democracy and the market are working in their countries has dropped markedly in the region in the past few years.<sup>16</sup> At the same time, *preference* for democracy as a *system of government* has increased, as has support for the *market as a system*. Those trends are most notable in the "crisis" countries, simply defined as countries with negative GNP growth in 2002. Respondents are increasingly distinguishing between democracies and markets as systems on the one hand, and how they are operating in their particular countries or contexts on the other – clearly a positive sign. Yet even that positive note must be interpreted with a caveat, as trends since April 2002 have been mixed at best for the region, and unrest has increased in some countries.

Rather remarkably Latin Americans also remain as optimistic as before about their children's chances of getting ahead, demonstrating remarkable resilience. And - surprisingly – responses to a question about support for "lower taxes even if welfare spending suffers" are *negatively* correlated with wealth, suggesting that the wealthy in the region may be starting to see the merits of progressive taxation for social service provision.

**Our findings suggest that Latin Americans continue to value markets and democracy, at least in theory, but are very frustrated with how they are working in practice (a frustration which has increased markedly since our survey data was taken in some cases like Bolivia). Insecurity and inequality are driving those frustrations.**

In the end, stable markets and democracy are central to the United States' interests in the region. It is difficult to imagine such stability with insecure and frustrated middle and working sectors, particularly if their frustrations are driven by the constant threat and the experience of falling into poverty. These frustrations could erode public support for markets and democracy to an extent that results in damaging policy reversals via the ballot box or even in social unrest.

Protests which have toppled governments – ranging from de la Rúa's in Argentina to Sanchez de Lozada's in Bolivia – were driven by workers and middle class urban populations concerned about insecurity and frustrated with inequality, rather than by the extreme poor, who are typically consumed with day to day survival. Addressing the root causes of these concerns warrants the attention of social policy experts, as well as those with stakes in sustainable democracies, market economies, and a stable world trading system.

### **Can a Social Investment Fund Help?**

A U.S. led effort to address some of the pressing social problems in the region could have important symbolic effect as well as genuine impact at a timely moment. The U.S. has neglected the region since September 11. The Argentine crisis was resolved with little U.S. input. Policy towards Venezuela is indecisive at best. Sanchez de Lozada's cries for assistance in Bolivia fell on deaf ears. And the promised Free Trade Area of the Americas (FTAA) is nowhere in sight. In

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<sup>16</sup> See Carol Graham and Sandip Sukhtankar, "Is Economic Crisis Reducing Support for Markets and Democracy in Latin America? Lessons from the Economics of Happiness", *Center on Social and Economic Dynamics Working Papers*, No. 30, The Brookings Institution, November 2002 ([www.brookings.edu/es/dynamics](http://www.brookings.edu/es/dynamics)).

a number of countries, democracies are being shaken to the core, and insurgent or anti-system movements are on the rise, as in Colombia, Bolivia, and possibly in Peru. The U.S. has demonstrated remarkable complacency in the face of these trends.

Not surprisingly, there is a great deal of latent public frustration in the region, even among individuals with economic opportunities. Our image has also suffered in the past year. A recent poll of Latin American elites found that only 12% rated President Bush's performance in Latin America as positive. The poll also found unease about who stands to benefit from an FTAA. This contrasts with 2000 and 2001, when support for free trade was remarkably strong in the region, and linked to higher levels of income and education.<sup>17</sup> **A new effort to pay attention to the region's pressing social needs could be a timely and strategic way to correct course.**

### **Proposed Structure for the Fund**

The launch of a social investment fund for the region would demonstrate new U.S. commitment to the pressing needs in the region, something which in and of itself could alleviate public frustration. Yet such a launch would generate numerous and competing claims for the fund's resources and attention. Thus its structure and priorities should be clearly established in advance, transparent to the public, and based in a technically sound analysis of where the most value added can be generated.

In the past decade, there has been wide experience with social investment funds in Latin America and beyond, although most of it has been at the country rather than at the regional level.<sup>18</sup> The **advantages** of the social investment fund approach are many. These include:

- the ability to respond to bottom-up local level demands and thereby avoid mismatch between central government-led objectives and local priorities
- a lean administrative structure that can manage a large number of activities; freedom from strict and cumbersome public sector regulations
- the ability to support both private and non-government sector projects and public sector ones

The **disadvantages** of the social fund approach are:

- limited ability to establish priorities at the central government level;
- heterogeneity in project outcomes; and
- little impact on permanent operations of the public sector.

A region-wide fund will face similar constraints and challenges, some of which will be compounded by its being a supranational organization attempting to reach out to micro level

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<sup>17</sup> Ninety-eight percent of Brazilian respondents gave the President a negative mark. University of Miami School of Business/Zogby International poll cited in the *Financial Times*, 29 October 2003, p.6. While not a completely comparable question to the FTAA one in the poll, the evidence of strong support for free trade in earlier years is based on several years Latinobarometro data, author's calculations. In 2001, for example, 75% of respondents in the region thought that there were benefits to be had from free trade.

<sup>18</sup> Much of this is reviewed in Carol Graham, *Safety Nets, Politics, and the Poor: Transitions to Market Economies* (Washington, D.C.: The Brookings Institution Press, 1994).

actors. At the same time, it will have the advantage of learning from accumulated experience as well as the ability to circumvent national level politics and partisan pressures.

As is stipulated in the existing proposal, **the Fund should accept proposals from a range of actors, including local governments, non-government organizations, and partnerships between public and private sectors.** However, it should first establish clear guidelines and priority areas for the kinds of projects and activities it will fund. This will entail consultation with the national governments involved and with the international agencies, such as the Inter-American Development Bank, as well as with outside experts. National level priorities should be taken into account via a clearing house process. While national governments should not make decisions on proposals or prevent their submission to the fund, they can provide a score or ranking of how they fit with national policies in the social policy and the poverty reduction arenas. The Global Fund to fight Aids, Tuberculosis, and Malaria provides one model of such a clearing house process.<sup>19</sup>

Another important issue is the **management structure** of the Fund. To the extent possible, the Fund should maintain a small and lean but well paid administrative staff. Having at least some managers with private sector experience has proven to be an effective way to increase the efficiency of social policy projects in many countries. In addition, the staff should NOT design and implement its own proposals, but rather respond to proposals from actors in the countries. Fund staff should select proposals on the basis of need and merit, under the umbrella of the established operational guidelines. These priority areas, as well as the criteria used for selection, should be broadly communicated and as transparent as possible. Finally, a minor, but perhaps symbolically important point would be to house the Fund's management staff in a Latin American country rather than in Washington.

**The critical issue is the substantive areas where the Fund chooses to operate and support projects.** The Fund should avoid duplicating the vast number of donors and agencies (such as the World Bank and the Inter-American Development Bank) already working in the standard line ministry activities, such as health and education, and of the many actors already involved in the provision of micro-credit (such as Accion, the Banco Sol, and Mi Banco). While health and education are without a doubt priority areas, their resolution must inevitably involve the public sector – and the central line ministries – in a central manner. This is not the kind of activity that is ideally suited to a decentralized, bottom up social investment fund. Micro-credit, meanwhile, is an area which is already populated by a host of actors.

Need in the region is an order of magnitude greater than the amount of resources likely to be at the fund's disposal. **In this author's view, the greatest value added from a fund of this size would come from giving priority to the testing of new programs and approaches to unresolved problems.** The Fund could support activities in novel approaches to poverty reduction and to developing better social insurance mechanisms. If such activities are supported and rigorously tested by the Fund, and prove successful, they then could be adopted on a much broader scale by public sectors throughout the region.

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<sup>19</sup> For detail, see chapter 2 in Lael Brainard, Carol Graham, Nigel Purvis, Steve Radelet, and Gayle Smith, *The Other War: Global Poverty and the Millennium Challenge Account* (Washington, D.C.: The Brookings Institution Press and the Center for Global Development, 2003).

Supporting the development of a successful new approach to safety nets or unemployment insurance, for example, in one country is something that could be replicated region-wide and have very large multiplier effects. The PROGRESA program in Mexico is a good example of a program that began on a pilot basis, with control and intervention groups, which was then refined and implemented at the national level.<sup>20</sup> It is now one of the most successful anti-poverty programs in the region, with part of its success hinging on the linking of benefits to parental investments in child health and education. Other countries now look to PROGRESA as they design their poverty and safety net programs.

A similar approach could be developed to the provision of social insurance. As is suggested by the above results, insecurity and volatility are major concerns for the population in the region. Yet the challenge of providing workers in the region with any sort of unemployment insurance is daunting, in no small part because of the large number of workers in the informal sector and also because of the limited resources available to most governments.

A few countries, such as Chile, have experimented with unemployment insurance which relies heavily on individual contributions as well as employer contributions. Ultimately, such systems are risk-sharing schemes. The Fund could support novel approaches to the development of such schemes for informal as well as formal sector workers, and include in the support package small amounts of working capital to set up the insurance funds, which would be matched by worker contributions, as well as funds to test the effectiveness of the programs a few years after they are implemented.

Addressing distributional issues in the region is a much more difficult and complex problem, and there are less easily identifiable programs that the Fund could support. In this area, given the changing attitudes on distribution that we have found in our research, the Fund might support analytical work – conducted by local scholars – which compared and contrasted the distributional effects of various tax schemes. These could serve as alternatives to the strict reliance on the VAT by most countries in the region, which is far from a progressive approach to fiscal policy. In addition, new proposals for implementing progressive taxation schemes could be supported on a pilot basis in willing countries. (In these instances, the Fund's support would have to be direct to the governments involved).

**In sum, the Fund should distinguish itself by supporting novel approaches to the reduction of poverty, insecurity, and inequality, as well as by testing the effectiveness of those approaches.** If, in the end, a small number of very effective programs result, which can then be duplicated across countries throughout the region, the Fund will have invested its resources widely and in a manner that achieves significant economies of scale in a region where the scope of need is too great to be addressed by any one external assistance effort.

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<sup>20</sup> The PROGRESA program was implemented via control and treatment groups and randomized evaluations, which helped to determine the most effective poverty alleviation interventions.