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This is an **author produced version** of a paper published in:

International Journal of Emerging Markets 13.5 (2018): 1088 – 1107

**DOI:** <https://doi.org/10.1108/IJoEM-09-2017-0371>

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# **Institutional Framework and Governance in Latin America**

## **Abstract**

**Purpose:** This article will provide an analysis of the Institutional Framework and Governance in Latin America, which aims at detecting similarities or differences among the countries of the region.

**Methodology:** The objective of the research will be achieved through the application of multivariate factor analysis and cluster analysis techniques.

**Findings:** The paper shows the importance of the institutional framework and governance for the countries of Latin America and demonstrates the heterogeneity in the areas of institutions and governance in the region. The paper also confirms the presence of differentiated groups of countries that can and should collaborate with each other to enhance the socio-economic development of the region in a globalized context.

**Practical implications:** The main contribution of this study in practice is that by classifying countries into clusters with similarities and differences, this study allows politicians and the institutional leaders to redesign current and / or formulate new policies aimed at institutional quality and good governance. In addition, the results of the study should be taken into account by institutions such as the International Monetary Fund or the World Bank when deciding on multilateral support or when taking financing decisions as the type of support and the conditions applied should be differentiated according to the cluster in question. Also, in the context of academic research, the clusters will allow comparative studies that can assess the impact of the institutional framework and other variables on indicators such as direct foreign investment, economic growth, or sociological ones such as poverty, the distribution of income, etc.

**Originality/Value:** The analysis of the Institutional Framework and Governance in Latin America under the multivariate analysis approach.

**Keywords:** Governance, Institutional Framework, Public Performance, Latin America, Comparative Studies.

**Paper Type:** Research Paper

## 1. Introduction

During the first decade of the 21<sup>st</sup> century, the strength of commodity prices had a marked impact on the wealth of most Latin American countries. Some countries took advantage of the economic situation and strengthened their institutional framework, other countries embraced the so-called "progressive wave" exhibiting, today, a truly critical and highly questioned institutional and governance landscape that has divided the region into different blocks.

In general, it can be stated that during the last three decades Latin America has considerably modernized and regained its democratic system, improving the factors necessary for the long-term growth of its economies. Nevertheless, the ghosts that still haunt the continent have favored the emergence of populist waves<sup>1</sup> that have been present in countries like Venezuela, Ecuador and Bolivia with some contagion effect towards others (Weyland, 2013). The analysis of the literature on those regimes ranges between those which emphasize their inclusive, democratizing aspects and, at the other extreme, the strong critique of those that foreshadow authoritarianism, rhetoric and concentration of power in the leader and maintain that populists do not trust institutions, parliaments, media, or monetary rules; they suspect of free markets and free trade. According to De La Torre (2014), the authoritarian feature of these governments, without individual freedoms and strong institutions, is that they attempt to deny civil society the possibility of expressing itself without the intervention of the State.

Authors such as Alcántara (2016), argue that Latin American populism seems to have started to decline because of the death of its most recent artificers (Chavez and Kirchner) or because of the weakness of those called upon to replace them. However, it seems that such decline has been mainly motivated by problems of sustainability of the economic model implemented and the inefficient management of public policies. It is clear that, during the

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<sup>1</sup> In this sense, without performing a detailed review, it is worth remembering that the legacies of classical populism, identified from the 40s to the 70s, have been recognized in the region as neopopulism or right-wing populism of the 1990s and more recently, the so-called left populism (De la Torre, 2013). Therefore, establishing a political chronology, classic Latin American populist leaders such as Lázaro Cárdenas (Mexico), Juan D. Perón (Argentina) and Getulio Vargas (Brazil) stand out throughout the continent, followed by neopopulists, such as Carlos Salinas de Gortari (Mexico), Carlos Menem (Argentina), Alberto Fujimori (Peru), Fernando Collor de Melo (Brazil), and more recently the populism of the 21<sup>st</sup> century or radical populisms of such as Hugo Chavez and Nicolas Maduro (Venezuela), Evo Morales (Bolivia) and Rafael Correa (Ecuador); who all evidence the presence of the populist phenomenon in the region.

period when there was an upward trend in commodity prices, populist governments in the region were able to raise their "socially inclusive growth" flags as the income generated by soy, metals or oil allowed to pay for these policies. However, although they devoted enormous resources to fight poverty, they failed to make progress towards the strategic transformation of their production models, and, when the cycle of their economies started to change, the weakness of their institutions created even more problems for their economies.

The views on the decline of the radical populist wave in the region are not unanimous and other sectors of opinion contend that the social injustices and the institutional weaknesses present in almost all the countries will lead to a resurrection of the fading populist regimes. In the meantime, various articles and research papers are being pursued to study the complex political, social, economic and institutional reality of the region and to alert the public opinion about the continuing risks of the populism rise.

This paper discusses a fundamental issue: we argue that despite the institutional differences existing throughout the region, there are similarities between some countries which allows configuring homogeneous groups capable of facing different ways the challenges imposed by globalization. So far, the overview on Latin America has been presented in an aggregate fashion, however, our study attempt to present an analysis at a country level in order to determine the similarities and differences between the Latin America countries in an institutional and governance context.

Likewise, our study contributes to the strengthening of research in International Business in Latin America, which for a long time was a lack of studies related to this topic in the region (Elahee and Vaidya (2001); Pérez-Batres, Pisani and Doh (2010)). However, in recent years there has been an increase in International Business studies in Latin America (Cuervo-Cazurra and Liberman (2010)). In our line of research we can find, among others, Marini, K., Joslin J. and Hearn, B. (2017); Castro-Gonzalez, S., Espina, M. and Tinoco-Egas, R. (2017); Sarturi, G., França, C., Gama, J., and Aparecido S. (2016); Topolansky, F., Gonzalez, M. and Häufe, C. (2016); Godinez and Liu (2015); Ketelhöhn, N., Artavia, R., Arce, R. and Umaña, V. (2015); Bianchi, C. (2014).

The first part of the article highlights some theoretical framework about institutional quality and governance. The second part provides a descriptive analysis of the variables that we have used to measure the institutional framework and governance in Latin America, and,

finally, findings and discussion about patterns of similarities and differences among the countries of the region, through the application of multivariate techniques such as factor analysis and cluster analysis.

## **2. Theoretical framework**

### **2.1. Institutional quality**

Economic thinking has contributed many and varied definitions of Institutions and Institutional Quality. Many great thinkers have devoted their attention to the definition, and classification, from Schmoller (1838-1917), of the German Historicism school of thought, Menger (1840-1921) and Hayek (1899-1992), of the Austrian school, to Veblen (1857-1929) and Commons (1862-1945) of the American Institutionalism school. However, one of the most widely accepted definition is the economic interpretation of Douglas North (Urbano and Hernandez, 2007).

The role of institutions has become more relevant thanks to the contributions of the 1993 Nobel Prize for Economics, Douglas North (1920-2015), who examined their nature and the consequences of institutional change in economic and social performance. According to North (1990) institutions are the rules of the game in a society that reduce uncertainty and provide a structure to daily life. North makes an important distinction between formal institutions (laws, regulations and government procedures) and informal ones (people's beliefs, attitudes and values). Considering the contributions of the theory on transaction costs, the neoclassical theory and the analytical tools of microeconomic theory, he claims that institutional change consists of gradual adjustments to the set of formal and informal constraints which constitute the institutional framework (North, 1990).

In general terms, in his work and empirical research on institutional development and economic performance he argues that institutions are restrictions that arise from human inventiveness to limit political, economic and social interactions, thus forming rules of the game of a society without which there is no order or civilization. In the author's view, institutions facilitate the incentive structure of an economy and, as the structure changes, the direction of change towards growth, stagnation, or economic decline is shaped (North, 2005).

In addition, another issue that is usually addressed in the literature is related to the quality of institutions and to measurement problems. The first is a complex matter, deeply debated

and on which there is no consensus. Authors such as Acemoglu (2003) argue that institutions should play three basic roles: protecting property rights, limiting opportunistic behaviors and encouraging equal opportunities. Likewise, Alonso and Garcimartín (2008) point out that the requirements that must be met by a quality institution are related to efficiency, credibility or legitimacy, security and adaptability; highlighting political stability, the rule of law, efficiency of public management, control of corruption, the government's ability to develop and implement policies, the effectiveness of distributive policies and, finally, citizen participation and accountability, as the most relevant dimensions. In the same sense Ali, A. (2011) in his paper “Corruption and competitiveness” and Rodrik (2011) in his book "One Economics, Many Recipes, Globalization, Institutions and Economic Growth.", devotes a whole chapter to the importance of having adequate institutions and does not hesitate to qualify as good institutions those that put into practice the protection of property rights, contractual enforceability, market-based competition, sound money and debt sustainability.

Undoubtedly, the concept of governance which we will review in the following section, must be added to this discussion. He and Cui (2012), argue that “for institution-strong countries, governance quality will significantly increase an MNE’s degree of internationalization. In contrast, for institution-weak countries, no significant influence of governance findings based on an MNE’s international expansion can be identified”. In the theoretical review carried out by Rottig (2016), the author states that in emerging economies there are, unlike developed economies, institutional gaps that drive the emergence of market failures. The cause of these market failures is the existence of ineffective judicial systems, the inability to enforce contracts which in turn raises legal uncertainty and increases the transaction costs for multinational corporations established in these markets.

Regarding measurement problems, over the last decade, we witnessed the emergence of many indicators regarding institutional quality and the relevant role of institutions and their causal relationship with the degree of development of the countries (Buckley, 2017). However, many indicators have been severely criticized because of problems of definition, ideological contamination, aggregation, validity, international reliability and/or transparency (Echevarria, 2004), which we consider to be, in many cases, important problems, which however should not limit the analysis or objective approach so that institutions cease to be an unexplained residual factor.

It is clear that in Latin America the role of the institutional development in fostering economic growth policies is fundamental (Duarte Alonso, 2017). Therefore, the presence of quality institutions can increase the capacity of countries to benefit from opportunities brought about by an ever increasingly globalized world and strengthen their resistance to adverse external shocks (Cuervo Cazorra and Ramamurti, 2017). According to Prats (2002), populism, clientelism, and corporatism in Latin America are expressions of institutional weakness, the fragility of collective action and social capital with their profound consequences for development. The author understands that this is so because in the region "nothing is what it seems to be" since institutional informality prevails against the formal rules of the legal framework or of those socially proclaimed; this undoubtedly makes the region a much more interesting object of research.

## **2.2. Governance**

The term governance is a relatively new concept. Keefer (2009) pointed out "there is no single solid definition available for the term governance". Even more, we can say that the debate presents a different approach regarding if it is expound in the developed or developing countries.

In developed countries (Europe) the academic debate about the concept of governance started in the early nineties according to Sorensen and Torfing (2009). Authors such as Mayntz (1993a, b), Scharpf (1988, 1994, 1999), Kickert, Klijn and Koppenjan (1997), Rhodes (1997), Kooiman (2003) and more recently Peters and Pierre (2004) have kept it going. Based on institutional theory, we can say that governance is understood as the network of institutions and individuals that work together through a pact of mutual trust, that is, the totality of interactions between public agencies, the private sector and civil society to solve social problems and the creation of opportunities (Sorensen and Torfing, 2009).

In developing countries, the concept of governance has been expounded from different points of view by international organizations such as International Monetary Fund, United Nations, or World Bank.

The International Monetary Fund has given special importance to governance through its advisory and technical assistance policy, which promotes transparency in government accounts, the effectiveness of public resource management and the stability and transparency

of the economic environment and regulatory framework for private sector activity (IMF, 1997).

The United Nations Development Program defines governance as “the exercise of economic, political, and administrative authority to manage a country’s affairs at all levels. It comprises of mechanisms, processes, and institutions, through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences” (UNDP, 1997). Therefore, this international organization identifies three dimensions for governance, namely: economic, political, and administrative. These dimensions imply a competitive, non-discriminatory economic market in order to favors economic growth.

In this sense, the World Bank defines governance “as the manner in which power is exercised in the management of a county's economic and social resources for development. Good governance, for the World Bank, is synonymous with sound development management” (World Bank, 1992). This involves analyzing: 1) the process by which governments are selected, monitored and, replaced; 2) the government's ability to formulate and effectively implement policies; and 3) respect of citizens and the state for the institutions that govern economic and social interactions (Kaufmann, 2004).

The reason that there is no single approach of governance between developed and developing countries is due to the differences of economic, social and politic context. These differences are based in the protection and regulations surrounding of property, the factors needed for contracting, the licensing of new businesses, the informal economy, the presence of corruption, etc. Likewise, developing countries have weak economic structures and dependent on a few industries (agricultural and mineral commodities). This aspect makes emerging economies strongly dependent on the cycles of these few products. Finally, weak financial markets contribute to make business development more difficult (Diaz and Vassolo, 2012).

It is clear that in developing countries, the debate on governance is different and it has been linked to the economic policy suggested in the context of the Washington Consensus, so-called "Second Generation Reforms"<sup>2</sup>. These pointed out, the need to strengthen the

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<sup>2</sup> The Washington Consensus establishes for Latin American countries the following aspects: budgetary discipline, public spending priorities, fiscal reform, exchange rates and market interest, trade liberalization, FDI



capabilities of states and institutions to ensure the functioning of markets, as well, to foster development promoted by International Cooperation Agencies within the context of their policies to help (Haldenwang, 2005).

The impact of governance on economic development has been studied in previous articles. Ahrens (2002) analyzed the governance in underdeveloped countries and post socialist countries, and pointed out that the accountability, participation, predictability and transparency are identify as the key features of a governance structure that fosters development and supports risk reduction.

Chauvet and Collier (2004) reported that the countries which are suffering from poor governance have an average GDP growth less at 2,3 percentages per year in comparison with the other developing countries, and they investigates if the international cooperation be able to aid to improve the governance. Record (2005) presented evidence in support of the argument that high levels of corruption and poor governance are broadly believed to be constraints to economic growth in developing countries.

Xiaoming and Lin (2012) use variables proxy of governance through cluster analysis and provides evidence that governance quality at home can facilitate a multinational enterprises expansion into foreign markets.

Recently, Azam and Emirullah (2014), based on analysis panel data, confirmed the importance of governance and pointed out that “good governance is important to achieve investment and thus economic growth by creating sound business environment. Good governance would minimize persistent occurrence of bad policy and therefore, enhance policy implementation”.

### **3. Methodology**

#### **3.1 Variables and sample**

This study has been structured taking into account the notion of governance established by the World Bank and uses its governance variables, because they combine the opinions of a large number of companies, citizens and experts on different areas of governance and institutional framework. The variables used to analyze the institutional quality in the region

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openness policy, promotion of privatization, deregulatory policy and property rights firmly established and guaranteed.

were the following: a) Control of Corruption; b) Voice and Accountability; c) Political Stability and Absence of Violence / Terrorism; d) Government Effectiveness; e) Rule of Law. These variables have been applied in previous studies, such as, He and Cui (2012), in order to demonstrate that MNE's with high governance quality at home are more engaged in internationalization than those with low governance quality at home.

Variables related to governance will be presented, but it should be noted that each indicator is expressed in standard normal units, with scores ranging from -2.5 (low government performance) to 2.5 (high government performance).

**Table #1**  
**Variables related to governance (World Bank)**

VARIABLE	DEFINITION
Control of Corruption	This variable captures perceptions of the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests
Voice and Accountability	This variable captures the perceptions of the citizens of a country in relation to their ability to participate in the election of their government, as well as the degree of freedom of speech, freedom of association and free media. In short, it measures the quality of human, political and civil rights
Political Stability and Absence of Violence /Terrorism	This variable measures the perception of political instability and/or politically motivated violence, including terrorism
Government Effectiveness	This variable captures perceptions of the quality of public administration and civil service, and the degree of its independence from political pressures. It includes as well the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies
Rule of Law	This variable measure the quality of compliance with the rules of society, and in particular the quality of contract enforcement, property rights, police effectiveness and the courts, and the incidence of crime and violence

Source: Elaborated by authors

To complete the analysis and under the influence of the concept of North, a variety of indicators related to economic freedom have been introduced, with the objective of indirectly

measuring how the regulatory framework established by the countries of the region affects the private initiative. These variables, suggested by the Heritage Foundation (2014), corresponding to the following areas of the economy:

- a) Size of the Public Sector, the variables included in this category are Fiscal Freedom and Government Spending.
- b) Regulatory Effectiveness, includes Monetary Freedom and Business Freedom.
- c) Open Market that includes Trade Freedom, Investment Freedom, and Financial Freedom.

Each one of these variables is expressed on a scale of 0 to 100, where 100 represents the maximum freedom score, which means a suitable environment or a compendium of appropriate public policies for the start-up of economic activities.

**Table #2**  
**Variable related to Economic Freedom (Foundation Heritage)**

VARIABLE	DEFINITION
Fiscal Freedom	This is a composite measure that reflects marginal tax rates on both individual and corporate income and the overall level of taxation (including direct and indirect taxes imposed by all levels of government) as a percentage of gross domestic product (GDP)
Government Spending	This variable includes total public expenditure at all levels of government, federal, state and local as a percentage of GDP
Business Freedom	This variable analyzes the difficulties of starting, operating and closing a company, understood as bureaucratic obstacles (Doing Business)
Monetary Freedom	This variable combines price stability with an assessment of price controls as both inflation and price controls distort market activity. Price stability without sector-specific government intervention is the ideal state for the free market
Trade Freedom	Trade Freedom as a composite measure of the extent of tariff and nontariff barriers that affect imports and exports of goods and services
Investment Freedom	This variable evaluates a variety of restrictions normally imposed by the countries on investments, such as access to foreign exchange, transfers and capital transactions, capital controls, among others.
Financial Freedom	Variable of banking efficiency as well as a measure of independence of the financial sector from government control and interference. State ownership of banks and other financial institutions such as insurers and capital markets reduces competition and generally lowers the level of access to credit

Source: Elaborated by authors

The sample used in both parts of this study, the factor and the cluster analysis, corresponds to a total of 20 economies in the Latin American region: Argentina, Bolivia, Brazil, Chile,

Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Panama, Paraguay, Peru, Dominican Republic, Uruguay and Venezuela. In this research the period studied is the year 2014.

### **3.2. Methodology**

After having described the variables that show the institutional situation in Latin America, next we will apply two techniques of multivariate analysis in order to analyze the possible existence of homogeneous groups in terms of governance. Firstly, a factor analysis will be carried out, which will allow, through a reduction of the information contained in the twelve variables, an exploratory analysis to define the underlying structure. Second, the synthetic indicators obtained from the factor analysis will be used in the cluster methodology with the objective of establishing groups or clusters of homogeneous countries in terms of governance.

A cluster analysis has been carried out using a combination of hierarchical and non-hierarchical methods. First, the hierarchical procedure will be used to identify the appropriate number of clusters. Secondly, a non-hierarchical procedure will be used in order to further fine-tune the results obtained previously. The hierarchical method was carried out under Ward's technique. The two variables (economic and institutional framework) from the factor analysis have a typified scale, this will avoid that the differences in the units of measurement of the variables.

## **4. Results and Discussion**

### **4.1. Factor analysis results**

The method used in the factor analysis is the one of principal components applying Bartlett's sphericity test. Given its level of statistical significance, the null hypothesis on the matrix of correlations between the variables that identifies it as an identity matrix is rejected with 100% confidence, so factor analysis is a suitable technique to explain the structure of the data in question.

**Table #3**  
**KMO and Bartlett Test**

<b>Bartlett Sphericity Test</b>	<b>Approx. Chi squared</b>	<b>256,399</b>
	Gl	66
	Sig.	,000

Source: Elaborated by authors

Likewise, the variables included in the multivariate analysis correspond to the 12 variable detailed in the previous section: Control of Corruption, Voice and Accountability, Political Stability; Government Effectiveness, Rule of Law, Fiscal Freedom, Government Spending, Monetary Freedom, Business Freedom, Trade Freedom, Investment Freedom and Financial Freedom. Lastly, it should be noted that the time dimension of the analysis is exclusively limited to 2014, due to the availability of the data at the time of finalizing the research.

We present the commonalities initially assigned to the variables included in the analysis and those reproduced by the obtained factorial solution. As can be seen, in Table #4, the variables related to the Control of Corruption and the Rule of Law are explained almost in their entirety and the variables of Freedom of Investment, Government Spending, Government Effectiveness and Voice and Accountability reach an explained variance of more than 80%. The remaining variables included in the analysis are represented by more than 70% of the extracted factors, with the exception of Fiscal Freedom whose explained variance is marginally below of this percentage.

**Table #4**  
**Commonalities**

	<b>Initial</b>	<b>Extraction</b>
<b>Fiscal Freedom</b>	1,000	,668
<b>Government Spending</b>	1,000	,854
<b>Business Freedom</b>	1,000	,723
<b>Monetary Freedom</b>	1,000	,715
<b>Trade Freedom</b>	1,000	,775
<b>Investment Freedom</b>	1,000	,881
<b>Financial Freedom</b>	1,000	,730
<b>Control of Corruption</b>	1,000	,910
<b>Rule of Law</b>	1,000	,941
<b>Government Effectiveness</b>	1,000	,831

<b>Voice and Accountability</b>	1,000	,800
<b>Political Stability and Absence of Violence</b>	1,000	,740

Source: Elaborated by authors

Table #5 below shows the relative explanatory power corresponding to each of the 12 components that can be extracted from the analysis.

**Table #5**  
**Total Variance Explained**

Component	Initial eigenvalues			Sums of extraction of loads squared			Sums of rotation of loads squared		
	Total	% of variance	% of cumulative variance	Total	% of variance	% of cumulative variance	Total	% of variance	% of cumulative variance
<b>1</b>	6,317	52,641	52,641	6,317	52,641	52,641	5,388	44,901	44,901
<b>2</b>	3,250	27,081	79,722	3,250	27,081	79,722	4,178	34,821	79,722
<b>3</b>	,756	6,297	86,019						
<b>4</b>	,555	4,628	90,647						
<b>5</b>	,378	3,150	93,797						
<b>6</b>	,268	2,234	96,031						
<b>7</b>	,171	1,425	97,455						
<b>8</b>	,130	1,087	98,542						
<b>9</b>	,090	,746	99,289						
<b>10</b>	,051	,421	99,710						
<b>11</b>	,029	,246	99,956						
<b>12</b>	,005	,044	100,000						

Source: Elaborated by authors

As can be seen, according to the criterion of eigenvalues greater than unity, two are the number of appropriate factors, which reproduce 80% of the original information contained in the variables. The first component extracted explains approximately 45% of the changes experienced by the variables, while the second one agglutinates the remaining 35%.

Finally, the rotated component matrix is presented, in which we can observe the existing saturations between each one of the original variables and the extracted components. The use of a rotated solution facilitates the interpretation of each one of them. In this case, we can clearly see that all freedoms have a higher correlation (above 70%, even reaching 92%) in the first component, while institutional variables related to Control of Corruption, Rule of

Law, Government Effectiveness, Voice and Accountability and Political Stability (with a correlation ranging approximately from 72% to 95%) saturate the second component.

**Table #6**  
**Rotated Component Matrix**

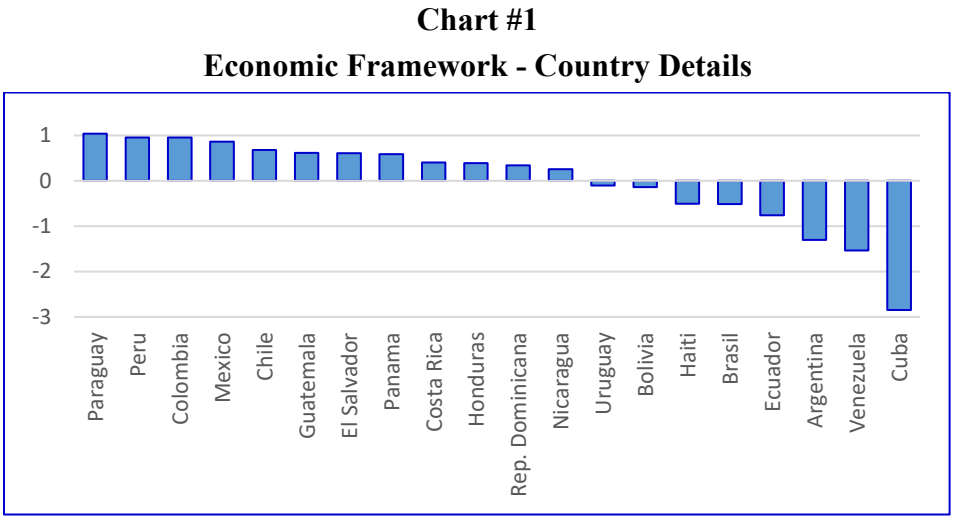
	Component	
	1	2
<b>Fiscal Freedom</b>	,737	-,354
<b>Government Spending</b>	,923	-,046
<b>Business Freedom</b>	,786	,323
<b>Monetary Freedom</b>	,813	,233
<b>Trade Freedom</b>	,864	,169
<b>Investment Freedom</b>	,862	,372
<b>Financial Freedom</b>	,850	,088
<b>Control of Corruption</b>	,073	,951
<b>Rule of Law</b>	,345	,907
<b>Government Effectiveness</b>	,199	,889
<b>Voice and Accountability</b>	,522	,726
<b>Political Stability and Absence of Violence</b>	-,258	,821

Source: Elaborated by authors

In view of these results, the first factor can be associated with the country's economic framework, since it measures the effect of public policies implemented by the government of a nation on the activity of the other economic agents. The second component include the remaining variables of governance, and could be associated with the institutional framework itself. An important aspect to mention is the direction of the saturation of each of the variables in relation to the factorial component to which it is associated. As can be seen, saturation was direct in all cases, which implies a greater strength of the region's governance in the face of increases in each variable.

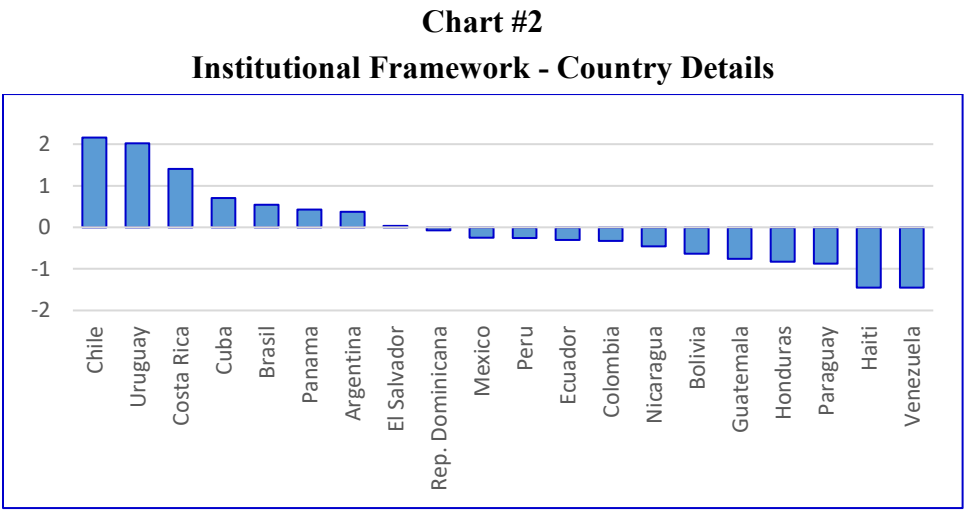
When analyzing the economic framework (first component) through the ranking that follows, we can say that a high percentage of the Latin American countries (68% of those that make up the sample), guide the conduction of their public policies towards the free market, countries like Paraguay, Peru, Colombia and Mexico lead this group. The economies of Uruguay and Bolivia are in a relatively neutral situation. At the other extreme we find

Argentina, Venezuela and Cuba, countries where a high degree of public sector intervention is perceived at all levels of the economy.



Source: Elaborated by authors, based on the results obtained from the factor analysis

On the other hand, after ranking the countries according to their institutional framework (second component), a low performance of the majority of Latin American economies is observed in this dimension. However, as we can see in chart #2, the economies of Chile, Uruguay and Costa Rica show a set of institutions with a greater degree of strengths compared to other countries in the region. At the other extreme we find Paraguay, Haiti and Venezuela as the countries whose institutional framework is comparatively more vulnerable.



Source: Elaborated by authors, based on the results obtained from the factor analysis



## 4.2. Cluster methodology results

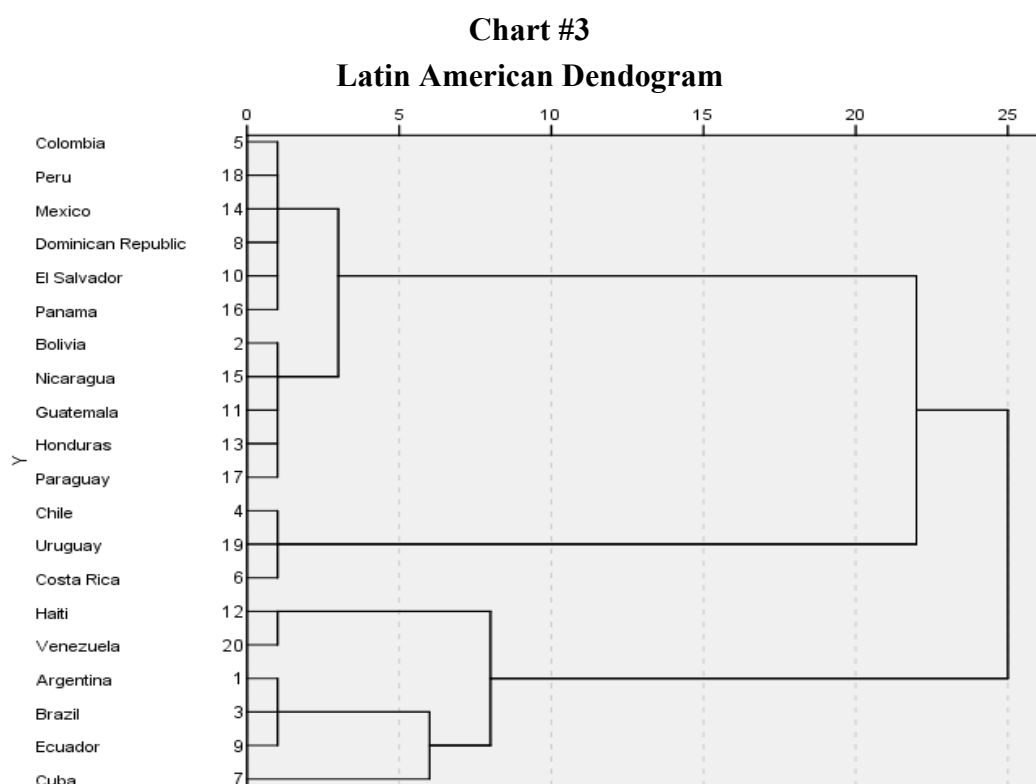
As mentioned above, the present research attempts to determine, through the economic and institutional framework (using the dimensions or factors obtained in the previous section), the existence of common underlying patterns (similarities), that allow to establish relatively homogeneous groups of countries in terms of governance among Latin American economies.

**Table #7**  
**Agglomeration Coefficient for Hierarchical Cluster Analysis**

Number of clusters	Coefficient of Agglomeration	Percent change in the following level coefficient
10	1,48	27,1%
9	1,88	26,8%
8	2,38	22,4%
7	2,91	19,0%
6	3,47	38,1%
5	4,79	65,9%
4	7,95	54,9%
3	12,31	96,1%
2	24,14	57,4%
1	38	-

Source: Elaborated by Authors

Table #7 shows the agglomeration coefficient as well as the rate of change that it has experienced in the aggregation process. Considering a reduced value of this indicator reveals that the groups being formed in each stage are homogeneous. In view of the change that the agglomeration coefficient undergoes when reaching four groups, the composite result with five cluster is the most adequate and it is the one we have taken into account for the purposes of this research. The graph below illustrates the process of cluster formation.



Source: Elaborated by authors

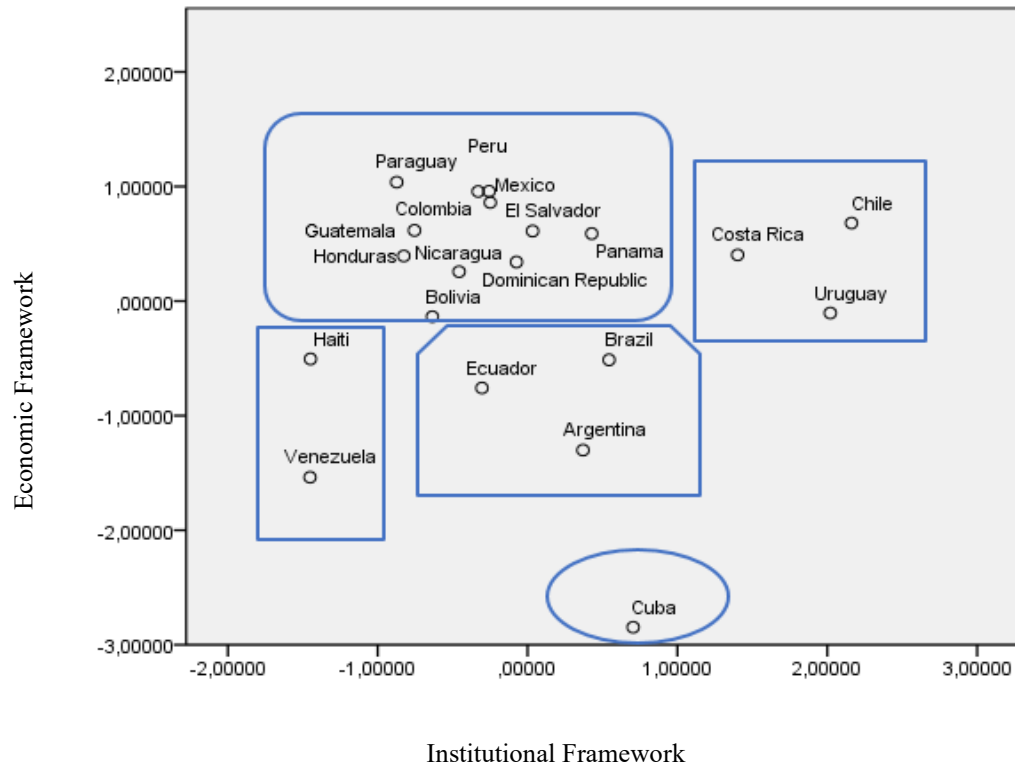
According to the dendrogram, the solution of five clusters would be composed of the following groups of countries that we find in Table #8 and Chart #4.

**Table #8**  
**Number of Cases in Each Cluster**

Cluster Number	Number of cases in each cluster	Countries
1	One	Cuba
2	Two	Haiti and Venezuela
3	Three	Ecuador, Brazil and Argentina
4	Three	Chile, Uruguay and Costa Rica
5	Eleven	Colombia, Peru, Mexico, Dominican Republic, Salvador, Panama, Bolivia, Nicaragua, Guatemala, Honduras and Paraguay

Source: Elaborated by authors

**Chart #4**  
**Economic Framework vs. Institutional Framework**



Source: Elaborated by authors

Afterwards, we carried out a non-hierarchical type cluster analysis, in order to corroborate, and further adjust, the results obtained through the hierarchical procedure. In this sense, according to the results of the K methodology, it can be seen that the size of the five groups of countries (compared to those established in the hierarchical analysis) were similar, as was the profile of the cluster which were also perfectly adjusted, as shown in Table #9 below.

**Table #9**  
**Affiliation to Clusters**

Cluster membership			
Case Number	Country	Cluster	Distance
1	Cuba	1	,000
2	Argentina	3	,474
3	Brazil	3	,485
4	Ecuador	3	,517
5	Haiti	2	,517
6	Venezuela	2	,517
7	Bolivia	5	,775
8	Chile	4	,465
9	Costa Rica	4	,466
10	Uruguay	4	,459
11	Colombia	5	,369
12	Dominican Republic	5	,381
13	Salvador	5	,397
14	Guatemala	5	,393
15	Honduras	5	,502
16	Mexico	5	,294
17	Nicaragua	5	,346
18	Panama	5	,791
19	Paraguay	5	,679
20	Peru	5	,383

Source: Elaborated by authors

As shown in Table #10, the high variance among the different cluster with respect to the intragroup variation allows to conclude, on the one hand, that the clusters obtained are largely homogeneous within each group (despite the distance that the economies of Panama and Paraguay exhibit in Table #9 compared to the center of the cluster N° 5) and, on the other hand, that these clusters have clearly differentiating characteristics between each of the groups formed from the gradients related to the economic and the institutional framework.

**Table #10**  
**ANOVA Contrast**

Variables	Cluster		Error		F	Sig.
	Quadratic mean	Gl	Quadratic mean	gl		
<b>Economic Framework</b>	4,135	4	,164	15	25,234	,000
<b>Institutional Framework</b>	4,167	4	,155	15	26,818	,000

Source: Elaborated by authors

Taking into account the value of the final centers of each of the five cluster it was possible to establish the profiles of each one of them.

**Table #11**  
**Final Cluster Centers**

Variables	Cluster				
	1	2	3	4	5
<b>Economic Framework</b>	-2,84679	-1,02183	-,85775	,32653	,58947
<b>Institutional Framework</b>	,70434	-1,45016	,20289	1,86117	-,36329

Source: Elaborated by authors

The description of the general framework that defines governance in Latin America, through the two synthetic indicators estimated in the previous section, can be summarized in terms of the main characteristics (final cluster centers, Table #11) of each one of the cluster.

### 4.3. Discussion

The first thing to be noted is the heterogeneity of the Latin American region in most areas of governance, being more pronounced in the dimension related to government effectiveness (See Table #A-1). Diaz and Vassolo (2012) have also pointed out the heterogeneity as characteristic of the region in comparison with the Asian countries.

However, among the countries that make up each cluster resulting from our research there is a certain degree of homogeneity based on institutional and governance factors that we discuss following:

Cluster #1: Composed of a single country, Cuba, which clearly represents the atypical case in the region, attributed mainly to the communist regime under which its institutions operate. It should be noted that, although it is the country whose level of public sector intervention on the private initiative holds the highest position, with respect to the institutional framework, Cuba is one of the four economies that are, in relative terms, better positioned within the region. This improvement is due to the current reforms facing the Cuban government, such as: currently, 143.000 Cubans have been authorized to work in the private sector; restrictions for obtaining bank credit and doing business with state entities will be lifted (Becherer and Helms, 2011).

Cluster #2: Integrated by Haiti and Venezuela<sup>3</sup>, in general terms it corresponds to the group of countries worse placed.

The negative result of Venezuela in both dimensions (economic and institutional) is due to the price and exchange rate controls that the economy has been based for more than a decade. This policy has led to distortions in different markets, the main characteristic being the high level of inflation, an increase in the size of the public sector, a progressive loss of independence of the legal system and the rule of law complemented by higher levels of corruption. The assessment of Haiti on its part is characterized, like Venezuela, by a deep fragility of the institutional framework, however, this country registers in the economic framework a comparatively more stable position in the monetary sphere and a lower degree of intervention in the trade making the country more attractive to foreign capital flows.

Cluster #3: Comprising Ecuador, Brazil<sup>4</sup> and Argentina. This cluster has in common that the quality of the institutional framework can be classified as moderately low because of high level of corruption, non- independent legal system and weakness of property right. It also has a large size of the public sector with low levels of government efficiency. It presents a high interference in the monetary sphere and government controls that make the establishment and continuity of private activity difficult.

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<sup>3</sup> In order to investigate in depth about Venezuela, we can resort to: Duarte, C., Ettkin, L., Helms, M. and Anderson, M. (2006) "The Challenge of Venezuela: A SWOT analysis", *Competitiveness Review*, Vol. 16, N° 3&4, pp. 233-247.

<sup>4</sup> In order to investigate in depth about Brazil, we can resort to: Puffer, S.; McCarthy, D. and A. Jaeger. (2016): "Institution building and institutional voids. Can Poland's experience inform Russia and Brazil?", *International Journal of Emerging Markets*, Vol. 11 N° 1, pp. 18-41.

Cluster #4: Chile, Uruguay and Costa Rica. The countries of this cluster are characterized, in institutional terms, by applying more effective anti-corruption policies than the rest of the countries that make up the sample, as well as by presenting a fairly transparent judicial system and by maintaining strongly protected property rights, although in the case of Costa Rica and Uruguay are more vulnerable to political interference. In the economic field, they have a high openness to trade and international investment, as well as a clear stability in the monetary sphere.

Cluster #5: Constituted by Colombia, Peru, Mexico, Dominican Republic, El Salvador, Panama, Bolivia, Nicaragua, Guatemala, Honduras and Paraguay, it includes 55% of the countries that make up the region.

Although in general terms the countries of this cluster are characterized by an adequate size of the public sector, as well as a reduced tax burden, they still have to make some progress in terms of government effectiveness. It should be noted that in the last decade, barriers to international trade have diminished, as well as controls on capital flows, in addition to applying adequate regulation in the monetary sphere, which has made it possible to maintain stability in inflationary pressures. Despite maintaining macroeconomic stability and openness to international trade and finance, there are still some regulations in most countries that limit the start-up of private initiative, such as inefficient administrative requirements. At the institutional level, there is a certain degree of weakness characterized by a lack of independence of the judicial system and protection of property rights, as well as high levels of corruption.

## **5. Conclusions and policy recommendations**

From the review of the theoretical framework we can conclude that in recent years, academic literature has given special importance to the analysis of the institutional framework and governance for economic development (Chang, 2011) and, as consequence of the complexity of the subject, there are still many topics to be studied, especially in International Business in Latin America.

In any case, this paper shows that in recent decades some Latin American countries have strengthened their economic policies and institutional framework. However, progress has been uneven across the continent and many countries face problems of inequality, continuous

demands of the middle class and difficulties in ensuring sustainable growth. It is clear that the region still has challenges to overcome due to possible issues such as volatility in commodity markets, less favorable international financial conditions and uncertainty regarding the global economic recovery have increased the importance of maintaining strong institutions.

Regarding the empirical results, we can conclude that the heterogeneity of the region is confirmed by the presence of five clearly differentiated groups of countries. Within these groups, the cluster formed by Chile, Costa Rica and Uruguay stands out. This group exhibits a solid institutional and an appropriate economic framework. On the other hand, the cluster of Colombia, Peru, Mexico, Dominican Republic, El Salvador, Panama, Bolivia, Nicaragua, Guatemala, Honduras and Paraguay shows a better average score in the economic context, but a moderately low one in the institutional framework. Meanwhile, in a position of greater fragility in both factors stands the group of countries formed by the economies of Ecuador, Brazil and Argentina.

The worst positioned cluster, in both factors, corresponds to the group formed by Venezuela and Haiti in these countries the public sector presents simultaneously a high intervention in all areas of the economy, as well as an enormous fragility in the institutional framework. The atypical case of the region corresponds to Cuba since it constitutes the country whose degree of intervention in the economy by the public sector is maximum, while presenting itself as one of the best positioned economies in relation to the institutional framework.

Although this article prove the existence of homogenous groups of countries gathering in clusters in terms of governance, it should be mentioned that Latin America in general presents a high degree of corruption, a judicial system vulnerable to political interference and a elevate degree of bureaucracy, institutional elements that hinder private initiative and therefore the economic welfare of the region.

The main contribution of this study in practice is that by classifying countries into clusters with similarities and differences, this study allows politicians and the institutional leaders to redesign current and / or formulate new policies aimed at institutional quality and good governance. In addition, the results of the study should be taken into account by institutions such as the International Monetary Fund or the World Bank when deciding on multilateral



support or when taking financing decisions as the type of support and the conditions applied should be differentiated according to the cluster in question.

Also, in the context of academic research, the clusters will allow comparative studies that can assess the impact of the institutional framework and other variables on indicators such as direct foreign investment, economic growth, or sociological ones such as poverty, the distribution of income, etc.

Due to the limited Latin America countries example in this paper, we consider for future studies would be to enlarge the number of countries and to implement same study to Asian countries.

### **Policy recommendation:**

This paper suggests to policy makers in Latin America to give priority to institutional quality and governance. It is clear and evident that the institutional quality and governance contributes, directly and indirectly, to the economic development of the region. Therefore, it is necessary to apply the institutional policies in the context of homogenous groups of countries (cluster). It is necessary, also, to create work teams in each cluster of countries in order to design policies adapted to their realities to improve the problems they present in terms of governance.

Following Chang (2006), an adaptation model and institutional innovations schemes could be proposed among groups of countries in order to favour and enhance the institutional and governance framework of the region. So that those country groups, with lower institutional development, can import, adapt and innovate institutions with the support of country groups with good practices and better results. In this process, the role of international organizations is crucial. It is because of that this research suggests an evaluation of the current lines of work since the scarce results achieved can be improved. In any case, it would be necessary to strengthen alliances and International Cooperation and, at the same time, to take into account those formal and informal aspects that define the institutional framework of each country. As well as the political configuration that influences decision-making, as well as the historical and cultural burden that characterizes the Latin American reality.

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## Attachments

**Table #A-1**

**Descriptive Statistics about governance in Latin America detail by variables**

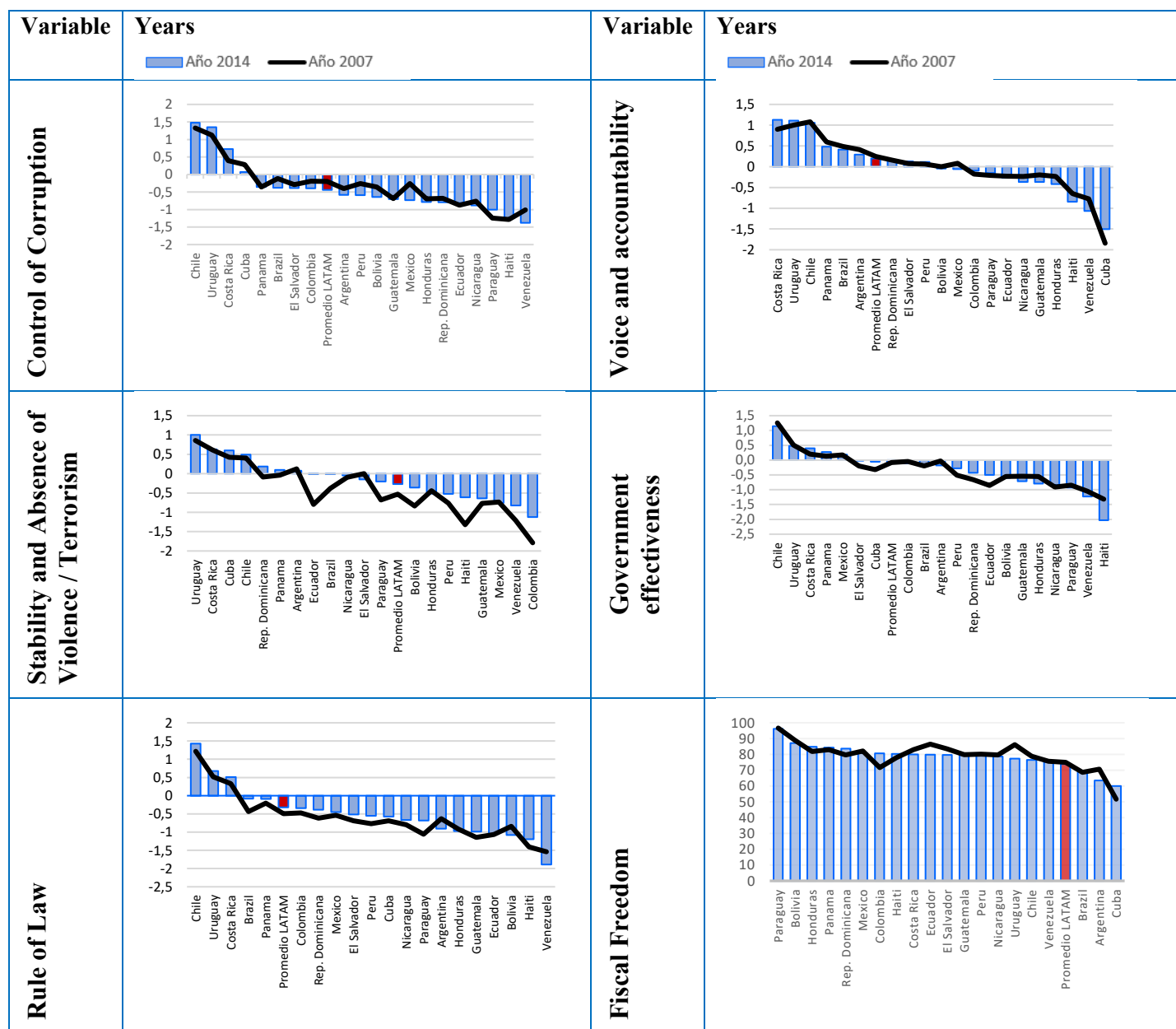
	Mean		Rank		Coefficient of Variation	
	2007	2014	2007	2014	2007	2014
<b>Control of Corruption</b>	-0,2	-0,44	2,6	2,9	-3,36	-1,69
<b>Voice and accountability</b>	0,25	0,19	2,9	2,6	2,6	3,4
<b>Political Stability and Absence of Violence/Terrorism</b>	-0,53	-0,27	2,6	2,1	-1,27	-2,01
<b>Government Effectiveness</b>	-0,08	-0,08	2,6	3,2	-7,19	-8,07
<b>Rule of Law</b>	-0,49	-0,32	2,8	3,3	-1,29	-2,25
<b>Fiscal Freedom</b>	75,05	73,88	45,0	44,2	0,12	0,10
<b>Government Spending</b>	72,54	64,74	86,1	94,3	0,25	0,34
<b>Business Freedom</b>	65,19	62,28	73,5	58,2	0,22	0,24
<b>Monetary Freedom</b>	73,36	71,76	28,2	49,9	0,09	0,11
<b>Trade Freedom</b>	71,94	75,17	22,2	23,8	0,09	0,10
<b>Investment Freedom</b>	49,3	57,6	60,0	85,0	0,35	0,44
<b>Financial Freedom</b>	49,55	55,55	60,0	60,0	0,31	0,31

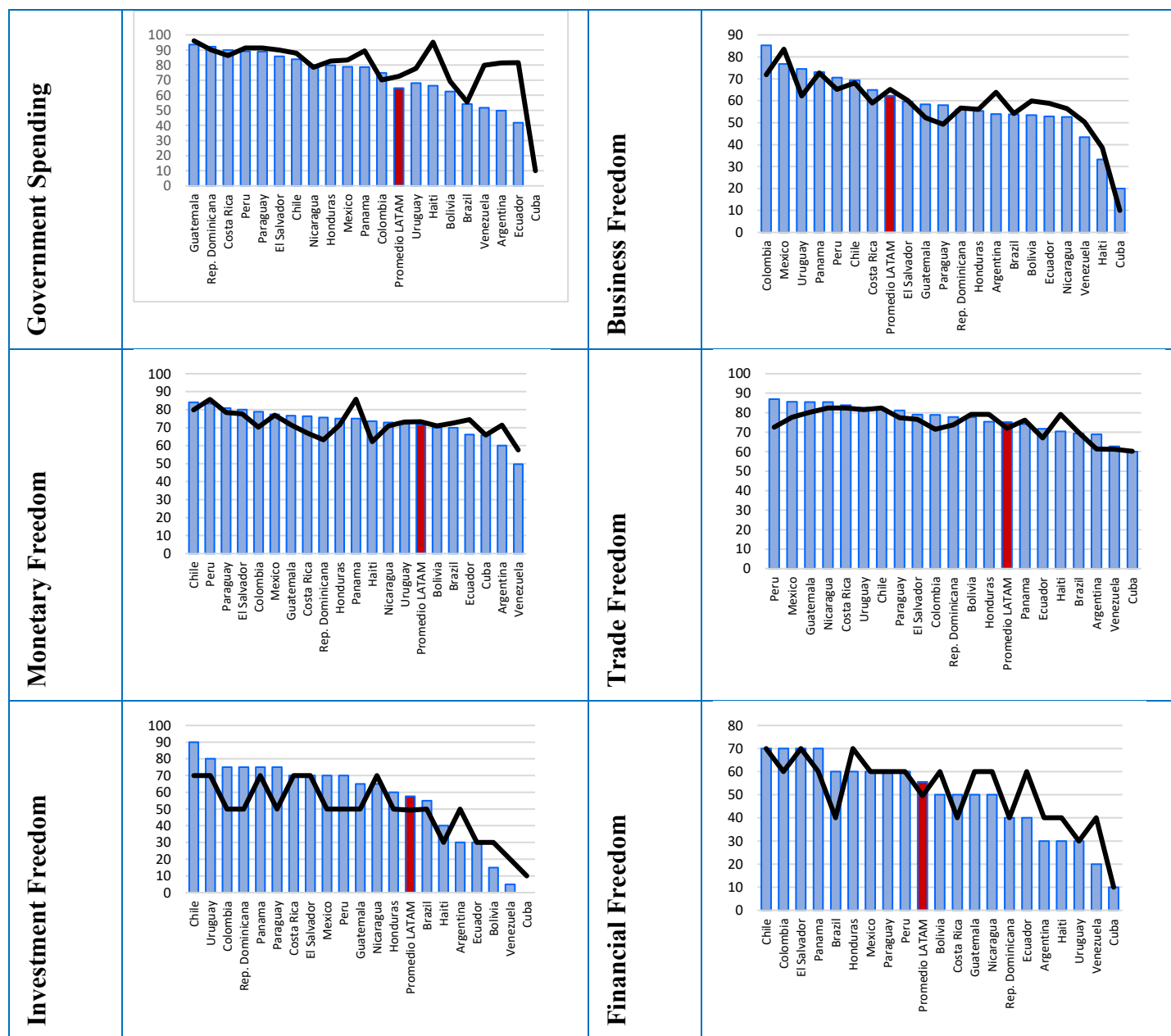
Source: Elaborated by authors from the information by Worldwide Governance Indicator and Heritage Foundation



Chart #A-1

Variables about governance in Latin America detail by country





Source: Elaborated by authors from the information by Worldwide Governance Indicator and Heritage Foundation