TIME FOR EQUALITY

Closing gaps, opening trails

2010

Thirty-third session of ECLAC

Brasilia, 30 May to 1 June 2010

ECLAC

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Explanatory notes

The following symbols are used in tables in this publication:
Three dots (…) indicate that data are not available or are not separately reported.
A minus sign (-) indicates a deficit or decrease, unless otherwise indicated.
A full stop (.) is used to indicate decimals.
Use of a hyphen (-) between years (e.g., 2001-2003) indicates reference to the complete period considered, including the beginning and end years.
The term "dollars" refers to United States dollars, unless otherwise specified.
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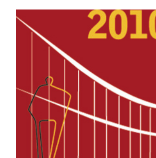

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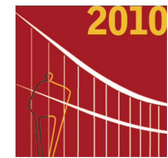


Foreword

The deepening of democracy as a collective order and as a shared global imaginary calls for greater equality of opportunities and rights. This means extending public participation and decision-making to broad sectors of society that have been marginalized for centuries while also enhancing the effective ownership of economic, social and cultural rights. Equality of rights goes beyond the structuring of opportunities on the basis of merit. It means that citizenship, as an irreducible value, fully endows people with the right, by the mere fact of their being part of society and regardless of individual achievements and monetary resources, to access certain minimum levels of social welfare and recognition.

Deepening democracy also means moving towards greater equality in access, especially in fields such as education, health, employment, housing, basic services, environmental quality and social security. When translated into minimum (and incremental) thresholds for welfare and benefits, equal rights indirectly impose limits on inequality in access, especially when this inequality, at some point, means that part of society is deprived of the access legally provided for under an entitlement-based approach to rights.

The concept of equal rights provides the framework and basis for regulating social covenants that generate greater opportunities for those who have less. A fiscal covenant that envisages tax structures and tax burdens with a greater redistributive effect, while strengthening the role of Government and public policy so as to ensure the welfare threshold is respected, is part of the equality agenda, as is the creation of labour institutions that protect worker safety.

A democratic order in which the course of development reflects the will of the majority and enables all stakeholders to participate also reflects the value of equality. A set of economic policies that are implemented with a long-term vision of production, labour, social development and territorial development and seek not only equal opportunities, but also concrete achievements in terms of narrowing existing gaps is the cornerstone of the equality agenda.

Ensuring equal rights neither erodes meritocracy nor discourages individual efforts. On the contrary, it promotes a sense of belonging that motivates people to contribute to the common

good and economic progress, as it results in more effective rights and stronger protection for all. The process calls for the involvement of a wider range of actors and their contribution to the common good. The complementary interfaces of equality, social protection, organized solidarity and the good will of all stakeholders is precisely what the most advanced welfare States of the world have achieved. This does not mean that the benefits of the market are denied; it means that the market becomes a more inclusive institution in which healthier interactions take place. More solid public-private partnerships, more advanced democracies and more shared visions of long-term development arise in more equal societies where the State plays a more active role and acts within the framework of a strategic vision to achieve well-being and progress for all. This is thus a progressive and far-reaching political agenda.

In this regard, the analysis presented in this document wholly adheres to the idea that social equality and the kind of economic dynamism that transform production patterns are not at odds with each other and that the challenge is to find synergies between the two. The proposal made here is headed in this direction and leads to the next point: when we speak of equality we do so in the awareness that we must grow to equalize and equalize to grow. At no point, therefore, do we suggest that we should sacrifice the value of dynamic economic and productive growth on the altar of equality. In strategic terms and in the long term, equality, economic growth and environmental sustainability must go hand in hand, mutually supporting and reinforcing one another in a virtuous dialectic.

We therefore propose growth with less structural heterogeneity and more productive development, and the pursuit of equality through the enhancement of human capacities and the mobilization of State energies. We want to reverse the huge disparities in the region by building more cohesive societies around productive dynamics, constructing positive social and territorial synergies, and strengthening the protection of individuals through improvements in labor markets, stronger financial capacities and better public administration. Just as the idea of equality entails addressing social vulnerabilities, we believe that a macroeconomic framework that protects people against external volatility will play a key role. This goal will not be reached automatically and requires effective policies on several fronts as well as more and better markets. If you have to level the playing field, it must be done by raising average and aggregate productivity and income.

Lastly, in considering the value of equality and how it combines with growth, we cannot ignore climate change, a phenomenon which will have an enormous impact on the future of humankind. In this context, equality means solidarity with future generations, whose situation will be marked by greater uncertainty and by a greater scarcity of natural resources. It also means calling for international agreements to mitigate the impact of climate change that adhere to the principle of common but differentiated responsibilities so as to ensure that it is not the poor or poor countries who end up bearing the brunt of the costs of climate change. It means rethinking the development paradigm on the basis of more compassionate and benevolent relationships among all peoples and of a more environmentally friendly relationship with nature.

In short, equality transforms the dignity and well-being of people into an irreducible value, makes democratic life inseparable from social justice, links access and opportunities with effective citizenship and thereby strengthens the sense of belonging; it becomes the ethical and political basis for pursuing universal coverage of benefits, not only in terms of access but also in terms of narrowing gaps in the quality and trajectories; it provides the regulatory framework for the fiscal covenant and the social covenant, from which emerges the binding force of the rights that have

been ratified and their implications for progressiveness and redistribution; it demands a larger and better role for the State in regulation, transparency, oversight and redistribution of resources and requires a deep respect for global security in order to ensure environmental sustainability.

In the proposal now being submitted by ECLAC for consideration by the Governments of Latin America and the Caribbean, development is conceived in the terms outlined above. In the light of the current challenges, it recreates the technical expertise acquired by the Commission over six decades of intensive study and puts forward a desirable future for the region, one that is more egalitarian as regards opportunities and rights, more dynamic and less vulnerable in terms of its economy, and in which the vicious circle of underdevelopment is transformed into a virtuous circle of development. This proposal upholds the core values to which we adhere unreservedly with the technical rigor that is part of the Commission's heritage.

Why do we endorse equality as a value? The answer is that we are transmitting what we perceive to be a historical claim that has long been voiced and systematically deferred in Latin American and Caribbean societies. This claim has given rise, with greater or lesser success, to revolutions and reforms, different models of government and policy, popular movements, agreements between groups and demands from the wide array of stakeholders. But, just as equality, as a positive value, has been acclaimed throughout the collective history of the region, it has also been systematically denied by that very history. Inequality has permeated five centuries of racial, ethnic and gender-based discrimination in the region, in societies where people are divided into first- and second-class citizens. It has permeated a modernization process built on the back of the worst income distribution in the world. It has permeated recent decades in the region's history, the worsening of the structural heterogeneity of productive opportunities, the deterioration of labour conditions and the segmentation of access to social protection, with inequalities developing on all sides. It permeates the asymmetries that abound in the face of globalization.

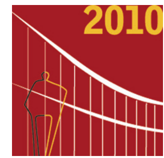
Yet the more prevalent the inequality, the more profound the desire for equality, especially when the course of history is suddenly interrupted by a worldwide crisis which the future demands be converted into a turning point. In this way, the crisis that broke out in 2008 on a global scale is a point at which equality appears once again as an intrinsic value of the development that we are pursuing. In attempting to narrow these gaps, society moves from an individual to a collective approach and seeks to stitch up the wounds of inequality with the threads of social cohesion.

Under the financial model that dominated the world for decades up until recently, inequalities became more acute than ever and evoked widespread indignation in the wake of the crisis when the model was completely discredited. It might be possible to mitigate the financial repercussions, but the global awareness acquired over the past year regarding the arbitrary nature of the model will not be easily erased, nor will the indignation caused by its inequities.

This is why we wanted, and not without a certain degree of boldness, to give this document the title "Time for equality". We are not talking about any kind of equality, however: the lessons of history stand us in good stead once again. When we speak of equality we refer to another great value that has also had to be fought for and needs to be built on constantly: democracy. Equality without democracy is equality without basic rights and without the rule of law, in other words, a contradiction in terms. It should be noted, however, that a low-quality democracy with little involvement of the broadest range of agents in decision-making processes will make it difficult to forge the political will needed to move towards greater equality.

This is our proposal. In the pages that follow, we closely examine the signs of development (and underdevelopment) in recent decades and the vicissitudes and consequences of the recent crisis. We also look to a future in which the State and political action harmonize democracy with equality, promote leaps in productivity and environmental sustainability, inclusive markets and active citizenship, and generate the necessary social covenants in Latin America and the Caribbean, a region in which there are gaps to close and trails to open.

Alicia Bárcena
Executive Secretary
Economic Commission for
Latin America and the Caribbean



Chapter I

Crisis, post-crisis, new era: between the limits of development and the development we intended

A. The crisis: outbreak and outlook

The concept of "crisis" is one whose meanings have been accumulating, like semantic layers, over the past three decades. First, there is the crisis of the fossil-energy-intensive industrial model which has been jeopardizing future environmental sustainability on many fronts and is causing particular alarm now because of the prospect of global warming. Second, there is the crisis of a globalization pattern in which a financial economy that has become increasingly overweening, independent and deregulated compared to the real economy has created both a high level of volatility and a tendency towards greater global concentration of wealth and income.

The crisis that broke out in 2008 is the ultimate expression of this. Furthermore, the financial crisis has been interpreted, not without justification, as the consequence of an unbridled pursuit of individual gain, the naked logic of money and speculation and the de facto power of "invisible" agents overriding individual rights and public goods. The recent crisis also has an epochal feel to it. The two perspectives come together in the analysis carried out in the present document.

The global economic crisis cut short the longest and most vigorous phase of economic growth seen in Latin America and the Caribbean since the 1970s. The background to this growth was an international economic expansion that ran from 2003 to mid-2007 (continuing in the region right into 2008), when the problems that began in the United States subprime mortgage market started to spread around the world. The consequences were felt in financial systems worldwide and significantly affected goods and labour markets, especially after September 2008. The world thus experienced an unusually severe economic shock that many have compared to the Great Depression of the 1930s.

There are indeed a number of points of similarity: both began in the United States financial system before spreading to other parts of the world and other sectors, and both were the consequence of the bursting of an asset price bubble that led to a problem of financial system solvency. On this occasion, however, the financial system was much larger and its international interconnections far more extensive and rapid. It was also unprecedentedly opaque.

The financial crisis quickly spread to real variables and internationalized, chiefly because of four factors: the credit crunch, wealth destruction, the decline in world trade and worsening expectations for the evolution of economic activity. The economic policy response was faster and better judged this time, however. The 1930s crisis had taught that it was necessary to limit the impact of crises as quickly as possible and implement expansionary monetary and fiscal policies to avert the risk of an economic depression. Another important difference with respect to what happened then is that there are now a number of international coordinating bodies, both regional and multilateral, many of them created after the great crisis and the Second World War and others of more recent vintage, such as the Group of Twenty (G20). With all their limitations, these institutions do have some ability to enhance the effects of policies applied by countries in isolation and to prevent or at least limit predatory trading and exchange-rate policy practices that can damage international trade, which has already suffered enough in the crisis.

Given the recent volatility of the global economy, the problems facing the international financial system and the systemic character of the crisis, it is hard to predict how rapidly the global economy will recover or what the economic growth rate will be in the years following recovery. Furthermore, the crisis has led to far-reaching questions about the behaviour of financial markets, the role of public policies and global institutions and the balance between State and market in economic activity.

At the same time, the financial crisis revealed that institutional mechanisms for controlling systemic risk had not developed to match the pace of globalization and financial liberalization. Thus, there will be a need to change the focus and scope of regulation and oversight in national financial systems and make a greater effort to coordinate regulation globally. These changes will probably translate into lower levels of leverage, which will entail a reduction in international financial flows (particularly speculative ones) and, in consequence, a partial reversal of the increasing financial sophistication seen up until the crisis.

1. Gauging the impact of the crisis

The current financial crisis had its origins in a combination of factors that led to a financial bubble of unprecedented proportions. These factors included profound global imbalances and very high levels of international liquidity combined with loose monetary policies and an under-regulated financial innovation and globalization process, owing to the dismantling of the rules created for the financial system after the 1929 crisis (Glass-Steagall Act). These factors explain the dynamic of the crisis and the enormous difficulty in overcoming it (Almunia and others, 2009; Titelman, Peréz-Caldentey and Pineda, 2009). In 2009 the global economy is reported to have contracted for the first time since the Second World War, with some sources putting the decline in global output at almost 3% (see table I.1).

Table I.1
REAL GDP GROWTH
(Percentages)

	ECLAC / DESA		IMF	World Bank
	2008	2009 [a]	2009 [a]	2009 [a]
World	1.9	-2.2	-0.8	-2.9
Developed economies	0.5	-3.5	-3.2	-4.2
Emerging economies	5.4	1.9	2.1	1.2
United States	0.4	-2.5	-2.5	-3.0
Japan	0.7	-5.6	-5.3	-6.8
Euro area	0.7	-4.1	-3.9	-4.5
China	9.0	8.1	8.7	6.5
Latin America and the Caribbean	4.1	-1.8	-2.3	-2.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of figures from JP Morgan, Global Data Watch, 30 December 2009; International Monetary Fund (IMF), World Economic Outlook (WEO) Database, October 2009; World Bank, *Global Development Finance*, Washington, D.C., 2009.

[a] Estimates of the Economic Commission for Latin America and the Caribbean (ECLAC), the Department of Economic and Social Affairs (DESA) of the United Nations, the International Monetary Fund (IMF) and the World Bank.

The contraction of global economic activity is accounted for by the decline in GDP in the developed countries, which different sources put at between 3.2% and 4.2%.[1] Growth in the emerging economies dropped from 5.4% in 2008 to between 1.2% and 2.1% in 2009. Most of the dynamism of the emerging and developing world was provided by China, which grew by between 6.5% and 8.7% in 2009.

This lower rate of global output growth has been accompanied by an increase in the global unemployment rate from 5.7% in 2007 to 6.6% in 2009, equivalent to a rise of 34 million unemployed in the period (ILO, 2010). Unemployment in the developed countries increased even more, from 5.7% to 8.4%, in the period. In the United States it more than doubled to 10% between September 2007 and December 2009, while in the countries of the euro area it rose by 2.5 percentage points from 7.4% to 9.9% (in November). In Latin America and the Caribbean, the urban unemployment rate will reach 8.3% or so in 2009, compared to a figure of 7.5% in 2008 (ECLAC, 2009a).

In the financial sphere, one of the main consequences of the present crisis has been the massive destruction of global financial wealth, most of it concentrated in the developed countries. This was estimated at US$ 50 trillion in 2008, roughly equivalent to the world's GDP for that year (ADB, 2009). The figure is also equivalent to more than three times the GDP of the United States for that same year and more than 30 times the combined fiscal packages of the G20 countries.

The interruption to the normal functioning of the global financial system brought with it a severe credit crunch in the developed economies and a sharp reduction in the external financing available for developing economies. This decline in lending reflected, first, a greater unwillingness on the part of financial institutions to grant new loans owing to the increased level of average risk

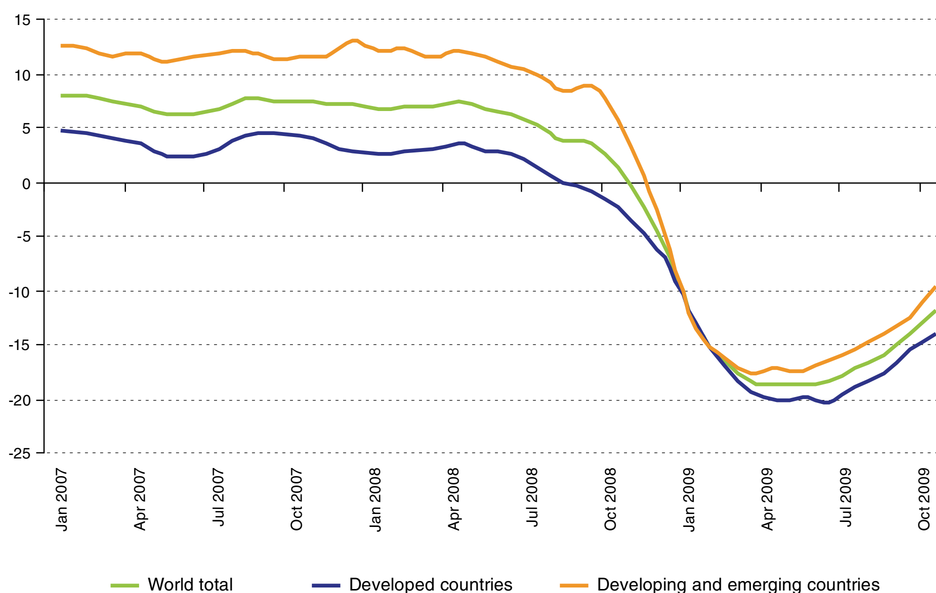
[1] The different institutions agree in revising down their growth estimates despite the differences in the methodologies they employ, which are not discussed in this document.

in countries' economies and, second, a greater unwillingness on the part of the private sector in these economies to incur new borrowings to finance consumption or capital goods accumulation.

Consistently with the credit crunch, global capital flows diminished greatly. After rising from US$ 1 trillion to US$ 10 trillion between 1990 and 2007 (equivalent to 5% and 21% of world GDP, respectively), net global capital inflows fell back to US$ 1.9 trillion in 2008 (3% of world GDP) (McKinsey Global Institute, 2009). Meanwhile, the net private-sector financial flows available to emerging economies fell by almost 50% in 2008 from their 2007 level, and declined again in 2009 (IIF, 2009). For Latin America and the Caribbean, according to ECLAC estimates, net capital inflows in 2008 were some US$ 52.6 billion down on their 2007 level. In 2009 there is reported to have been an additional net capital outflow of some US$ 11 billion. In particular, foreign direct investment (FDI) shrank by about 37%, far and away the steepest decline in at least the past 30 years.

Alongside the sharp contraction in global economic activity, the volume of world trade declined by some 20% year-on-year in the early months of 2009. Although this decline was seen first in the developed countries (July 2008), since late 2008 the trade of emerging economies has declined at rates similar to those seen in the advanced economies, although there have been recent signs of recovery (see figure I.1).

Figure I.1
GROWTH IN WORLD TRADE BY VOLUME
(Year-on-year change, moving quarters, percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from Centraal Planbureau (CPB), Netherlands Bureau for Economic Policy Analysis, 2009.

2. How the crisis caught up with Latin America and the Caribbean

The crisis was transmitted to Latin America and the Caribbean through the traditional channel of exports and credit, with a heavy crunch in foreign trade financing. This was manifested in export volumes and prices, remittances and other items directly associated with economic activity (ECLAC, 2009a and 2009b). There was also a credit crunch in foreign trade financing. Along with the worsening expectations of consumers and producers, these factors account for the sudden halt to six consecutive years of growth and improving social indicators, with a decline of 1.8% in 2009 representing a contraction in per capita GDP of some 2.9% (see figure I.2).[2] It is important to realize that in Latin America and the Caribbean the impact of the crisis was felt more in trade than in finance, and the paradox is that the countries worst affected were those with more open economies (such as Mexico, some Central American countries and the Caribbean). To find comparable shocks in the recent history of the region, it is necessary to go back 70 years in the case of exports and 29 in the case of imports.

The 2009 decline in regional GDP was accompanied by a rise in unemployment from 7.5% in 2008 to 8.3% in late 2009, reversing the steady improvements seen in this indicator over a period of five years. All this contributed to higher poverty in 2009, following six years in which it declined by 11 percentage points (from 44% to 33%) while extreme poverty diminished from 19.4% to 12.9%, in both cases from 2002 to 2008. Because of the crisis, ECLAC projected a rise in the proportion of people living in poverty from 33% to 34.1% between 2008 and 2009, with indigence increasing from 12.9% to 13.7%. This translates into 9 million more people living in poverty in 2009, including a rise of five million in the number of indigent.

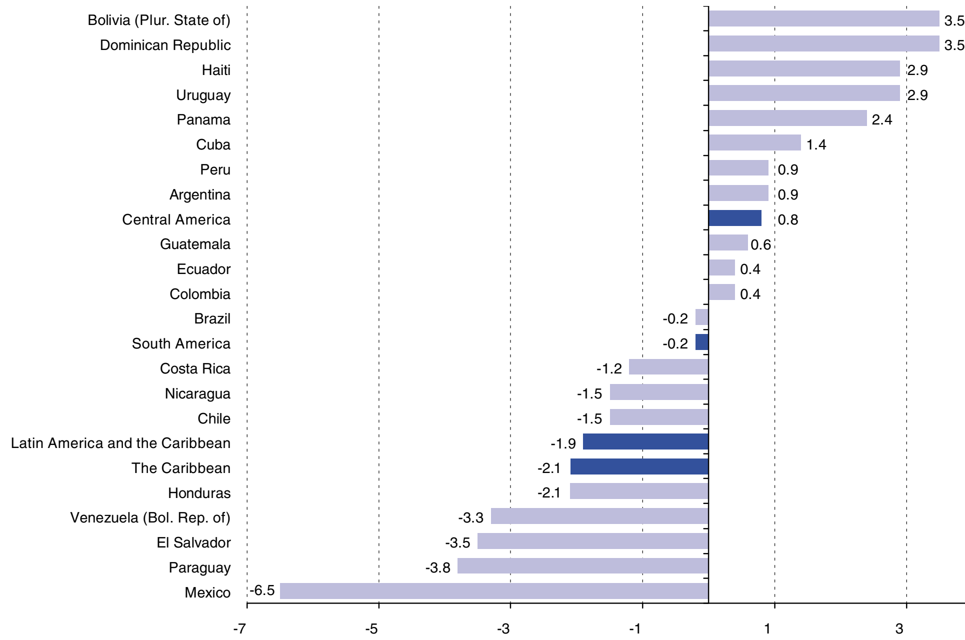
Nonetheless, as the figures show, the effects of the crisis have not been as dramatic as on earlier occasions, something that is due among other things to the combination of a very favourable external environment beforehand and better macroeconomic policy management, which allowed the region to reduce its borrowings, renegotiate debt payments on better terms and at the same time build up its international reserves. A crucial factor has been the countries' success in the recent period in simultaneously growing their economies, building up reserves, controlling inflation, reducing public debt and achieving fiscal and current-account surpluses, as shown in figure I.3 (ECLAC, 2009a; Ocampo, 2009). Thus, albeit with variations among countries, the Latin American economies have enjoyed unprecedented levels of liquidity and solvency.

Greater macroeconomic leeway in many of the region's countries created considerable scope for implementing policies to combat the crisis. This came on top of higher social spending in recent years, with programmes in this area having made a significant contribution to containing the social costs of the crisis.

Positive signs could be seen in the region's economies in the second half of 2009. Industrial output and exports began to recover, even as rising overall activity levels and increased international trade volumes pushed up demand for commodities, the result being higher prices and better terms of trade.

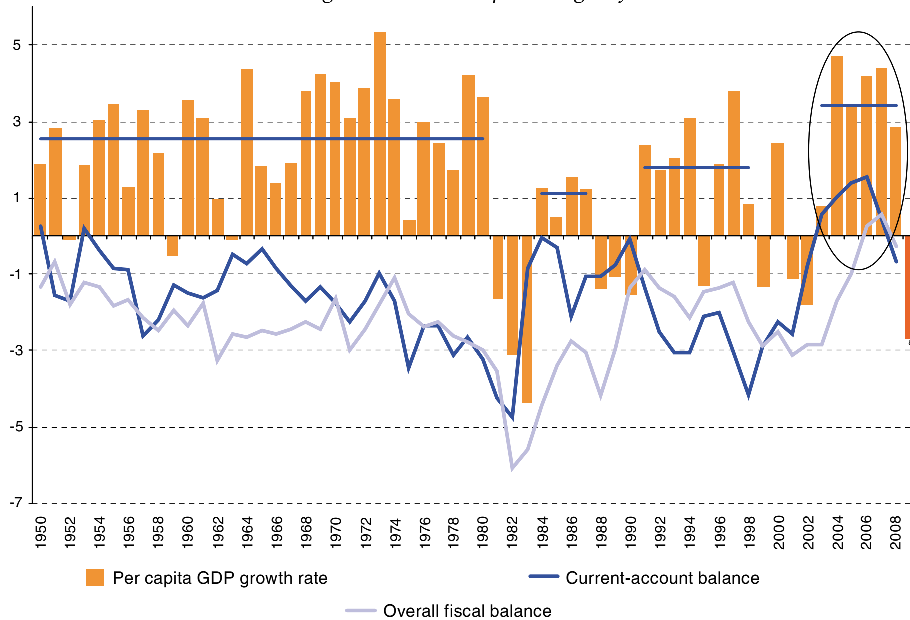
[2] From the standpoint of economic growth, there had been half a decade in which per capita GDP growth rose from 2.2% in 2003 to 5.8% in 2007. This momentum allowed the region to grow at a rate of 4.2% in 2008, giving annual per capita GDP growth of over 3% for five years running.

Figure I.2
LATIN AMERICA AND THE CARIBBEAN: GDP GROWTH, 2009
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure I.3
LATIN AMERICA AND THE CARIBBEAN: PER CAPITA GDP GROWTH, CURRENT-ACCOUNT BALANCE AND OVERALL FISCAL BALANCE
(Annual growth rates and percentages of GDP)



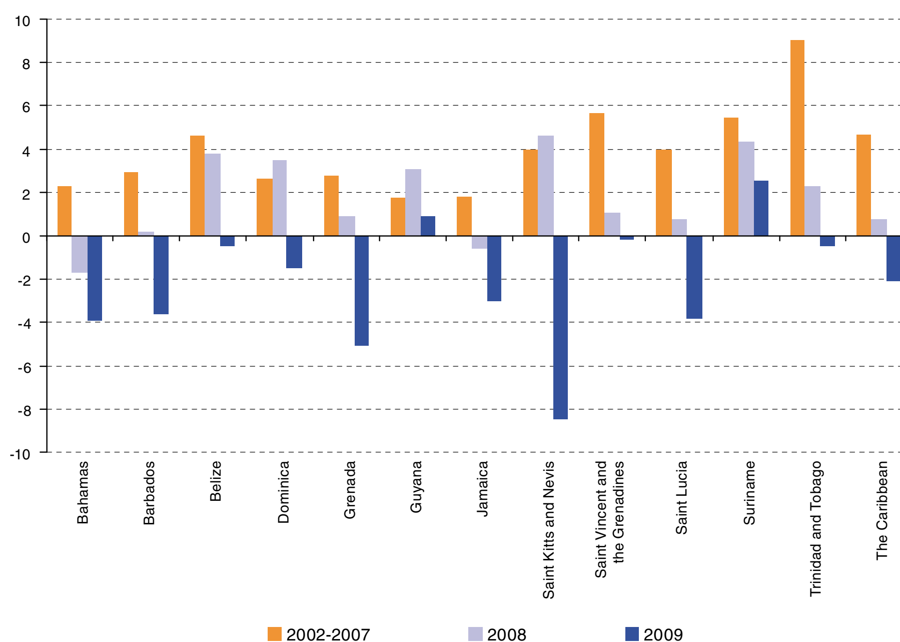
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Estimate.

Projected growth for 2010 is 4.1%, but the figure is expected to be somewhat higher in South America than in the rest of the region, given the greater relative size of some countries' domestic markets and the greater diversification of their export markets, the orientation of their trade towards raw materials whose prices are rising and the greater share of trade accounted for by China in a number of cases. Conversely, slower growth is expected in more open economies with a less diversified portfolio of trading partners and a greater emphasis on manufacturing trade, this being the case with Mexico and Central America.

The crisis caught the Caribbean in a far more unfavourable position in terms of public debt, fiscal and trade deficits and reserves. Thus, a number of that subregion's economies are facing more difficult situations in terms of finances and exchange rates and are heavily dependent on tourism, which shrank considerably in 2009. The effects of the global economic bust began to be felt in the Caribbean in 2008. As figure I.4 shows, the subregion's output fell by 2.1% in 2009 following the small increase of 0.8% recorded in 2008, already sharply down on the 4.7% annual average of the 2002-2007 period. GDP contracted in almost all the Caribbean countries in 2009, the worst affected being Saint Kitts and Nevis (-8.5%), Antigua and Barbuda (-6.6%), Grenada (-5%), the Bahamas (-3.9%) and Barbados (-3.6%).

Figure I.4
THE CARIBBEAN: GDP GROWTH, 2002-2009
(Percentages, in dollars at constant 2000 prices)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean* (LC/G.2424-P), Santiago, Chile, 2009. United Nations publication, Sales No. E.09.II.G.149.

The only countries to record positive output growth in 2009 were Guyana and Suriname (0.9% and 2.5%, respectively). In the former, this was due to an upturn in the sugar industry associated with the start of operations at the new Skeldon sugar factory; in the latter, to a rise in

gold output between April and August as the subsidiary of a Canadian firm, IAMGOLD, increased production and the State firm Staatsolie financed its ambitious investment plans out of its 2008 profits.

In the Caribbean, the application of countercyclical fiscal policies to cope with the crisis was very constrained by public-sector over-indebtedness. In the 2008-2009 fiscal year, for example, interest payments on central government debt accounted for 14% of GDP in Jamaica, 8.8% in Saint Kitts and Nevis, 4.2% in Saint Lucia, 3.7% in Saint Vincent and the Grenadines and 3.3% in Barbados. In general, given the chronic shortfall in fiscal revenues in all the subregion's countries other than Suriname and Trinidad and Tobago, policy responses to cope with the global economic crisis would not have been possible without financing from external sources. This financing provided some fiscal space for introducing countercyclical economic and social policy measures at a time of falling tax revenues and onerous public debt servicing requirements. Jamaica, for example, secured about US$ 900 million in standby credits from the World Bank, the Caribbean Development Bank and other international financial institutions to support its fiscal and debt sustainability programme and expand its main social programme, the Programme of Advancement through Health and Education (PATH).

Nonetheless, growth in 2010 is projected to be lower than the rates seen during the six-year-long boom cut short by the crisis, and may be insufficient to meet the demand for employment, which would hinder a rapid recovery in the quantity and quality of jobs and thus in social indicators. Investment will also contract, and this will not only have an immediate negative impact on demand for goods and activity levels, but will also affect the region's growth potential in the future.[3]

Furthermore, it remains to be seen whether the developed economies will be able to maintain their momentum when large stimulus packages in the United States and Europe are withdrawn. Combined with higher unemployment and the still volatile international financial market, this raises questions about the robustness of the recovery that began in 2009.

Looking ahead, the region will face a twofold challenge. First, it needs to recover economic activity levels and minimize the social after-effects of the crisis. Second, for future development it will be crucial to reduce structural heterogeneity —that is, to pursue greater convergence in productivity levels— thus providing a structural solution to chronic problems of social inequality (see chapters III, V and VI). The third need is to return to the path of growth through higher competitiveness underpinned by knowledge and innovation, stronger institutions and mechanisms that allow the benefits of growth to spread to all parts of the population (especially the most disadvantaged), sustainable use of natural resources and protection of the environment.

Although the region has learnt to cope with external volatility, the development of capabilities for confronting long-term challenges has generally been inadequate. A great deal of progress is still needed on matters such as the development of a climate of innovation, systems for creating, adapting and disseminating know-how and applying it to every sphere of production, the strengthening of social protection and inclusion mechanisms and the creation of the infrastructure needed to ensure the sustainability, in a broad sense, of the growth process.

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[3] It is often pointed out that the region took 14 years to regain the level of per capita GDP it enjoyed before the 1980s debt crisis and 25 years to return to the pre-crisis poverty level. However, the rates of investment relative to GDP seen in the region in the 1970s were not repeated. The countries of Latin America and the Caribbean have been trying to increase their investment rates in recent years, but the process was cut short before they could restore them to the level needed for sustained higher growth.

3. Constraints and opportunities on the new international scene [4]

There is a growing perception that the effects and lessons of this economic crisis, in combination with measures for moving towards low-carbon economies, will determine the dynamic of growth and the coordination of economic, financial and trade relationships in the shift towards a new global economic scene. This would comprise at least the following: lower global growth rates, a new role for emerging economies, a slowdown in the growth of trade flows, less financial transnationalization originating in the countries of the North, a new global financial architecture and a move towards lower-carbon economies.

Major changes are anticipated in international conditions in terms of alliances between blocs, countries and groups of countries. A reordered global economic equilibrium, the increasing presence of emerging countries, particularly the so-called BRICs (Brazil, the Russian Federation, India and China) and their ability to act as a focus for regional energies, the new multilateral institutions needed to deal both with the international economy and with the threat of global warming, the more active role being taken on again by States: all this represents a new direction. A new political and economic geometry is leading to the emergence of a new international geopolitics.

(a) The new growth pattern: lower economic growth rates

The post-crisis world will be characterized by a more subdued pattern of growth owing to a decline in aggregate demand in the developed countries, which could be partially offset by increases in aggregate demand in developing countries. Between 2010 and 2014, the global economy is expected to grow at about 3% (The Economist Intelligence Unit, 2009). This implies a drop of some two percentage points in the global growth rate from the 2003-2007 average (4.9%) to something quite similar to what was seen in 1980-2002 (3.1%).[5]

Where the supply side is concerned, output growth in the developed economies is expected to trend downwards, as revealed in a study presented by the Organisation for Economic Co-operation and Development (OECD, 2009a and 2009c) (see figure I.5). In particular, the OECD estimates show scenarios in which, as a result of the crisis, developed-country output could potentially grow by between 1% and 1.5% a year in 2010-2014, as compared to the 2.4% a year in 2000-2008 (OECD, 2009b).[6]

The factors accounting for this slowdown in the potential GDP growth rate of the OECD economies include: (i) the severe contraction in investment and the resulting lower growth in capital stock, which has accounted for almost two thirds of the projected decline in potential output; (ii) the increase in the average unemployment rate and a fall in the labour force participation rate, and (iii) the possible reduction in total factor productivity owing to a considerable decline in research and development investment, which could slow the incorporation of new technologies into the production process.

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[4] We have chosen to speak here of the new international scene rather than the "new normal", the term now used in many international forums, because the concept of normality creates a semantic ambiguity, suggesting as it may the idea of new "norms" (what ought to be done) as well as a new reality (in a purely descriptive sense). The word "scene" is used to avoid this dual reference.

[5] Other estimates from the International Monetary Fund (IMF) point to global growth scenarios with rates of around 4.4% which, while lower than those seen in 2003-2007, would be higher than those of 1980-2002.

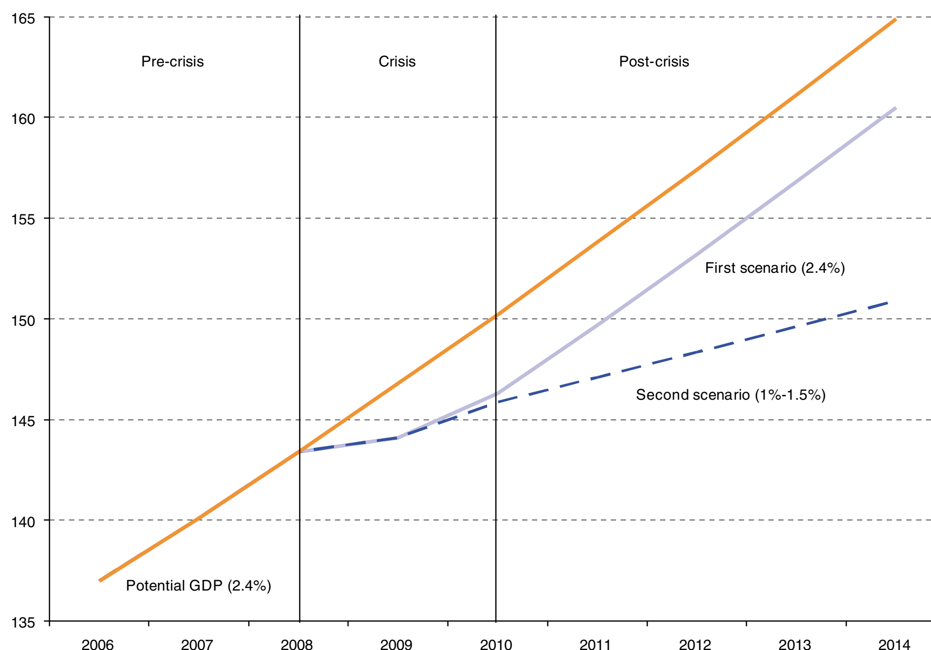
[6] Another of the scenarios suggested by OECD, which looks less likely given the analysis referred to, is that potential GDP will be affected by the current crisis but will return to its trend annual growth rate of 2.4% from 2010.

Table I.2
GLOBAL AND REGIONAL PER CAPITA GDP GROWTH, 1970-2007
(Percentages)

	1970-1980	1981-1991	1992-2002	2003-2007
United States	1.9	2.0	0.2	1.9
South Asia and the Pacific	5.1	5.9	8.1	8.8
Europe and Central Asia	…	…	-7.1	6.9
Euro area	3.1	2.1	1.5	1.4
Latin America and the Caribbean	3.2	-0.6	0.9	3.5
Middle East and North Africa	2.8	0.5	2.6	3.0
South Asia	0.9	2.9	1.7	6.7
Sub-Saharan Africa	1.2	-1.1	-2.9	3.1
World	1.9	1.3	0.3	2.4

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of World Bank, *World Development Indicators, 2009*.

Figure I.5
COUNTRIES OF THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT: REAL-TERM GROWTH IN ACTUAL AND POTENTIAL GDP, 2010-2014
(Index 1994=100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of European Commission, "Impact of the current economic and financial crisis on potential output", *Occasional Papers*, No. 49, June 2009; Organisation for Economic Co-operation and Development (OECD), *Economic Outlook*, No. 86, November 2009 [online] www.oecd.org/oecdEconomicOutlook and "The effect of financial crises on potential output: new empirical evidence from OECD countries", *OECD Economics Department Working Papers*, No. 699, 2009; and International Monetary Fund (IMF) projections for some OECD countries.

(b) The new role of emerging economies as drivers of global growth

The anticipated loss of momentum in the developed economies could be partially offset by a more prominent role for emerging economies, which are well placed to expand their aggregate domestic demand. These economies have fiscal scope to increase public spending, financial systems unhampered by poor-quality assets and levels of international reserves that should allow them to maintain comfortable levels of liquidity.

To take on this new role, emerging economies would need to re-evaluate their export-based growth strategy and consider other sectors as alternative sources of growth. Thus, some economies such as China and India, faced with large declines in their exports, have implemented fiscal policies to orient aggregate demand towards domestic sources of growth.

Similarly, some countries in the region have also taken steps to enhance the role of domestic aggregate demand as a source of growth. In the particular case of Brazil, the government has increased the capital of the public banking system (3.5% of GDP in the case of the National Bank for Economic and Social Development (BNDES)) to boost its lending power and partially offset the reduction in private credit. This has been supplemented by support for domestic producers in the form of production development policies.

(c) The slowing and recomposition of trade flows

The loss of momentum in aggregate global demand and external trade credit will result in a major slowdown in the growth rate of trade flows owing to the tendency for countries to protect their own markets and the unwinding of global imbalances. A number of estimates suggest that, following the slackening of global trade volumes in 2008 and the contraction expected for 2009 (13%), volume growth rates for international trade will remain well below the 8.8% recorded in 2004-2007. In particular, estimates from different specialist sources put the volume growth of world trade at somewhere in the region of 6% in 2010 (IMF, 2009a) (see figure I.6).

The different factors making this lower world trade growth likely include the prolonged fall-off in demand for imports from the developed economies, which has reduced the scope for emerging economies to sell their products into these markets. This is because of lower household consumption in the developed economies as a result of the financial wealth adjustment process that began with the crisis and lower demand for investment goods from firms that have had to scale down their production plans.

Another factor is that some of the policies adopted by governments in both developed and developing countries to stimulate aggregate domestic demand could include protectionist practices. Buy-local policies could introduce a clear anti-trade bias into national recovery policies. These practices, far from creating the conditions under which aggregate global demand might recover, could make this process more difficult, particularly if they trigger reprisals, as they may well do.

Nonetheless, looking further ahead, international trade will continue to be a source of growth opportunities to the extent that special niches or the advantage of being junior partners in world trade will allow the countries to explore openings and develop strategies that should yield considerable export growth. This should happen even if projections for world trade growth are modest overall, at least for the next five years. Even in 2008 and 2009, data from some service industries, electronic commerce and specialized goods show double-digit export growth. The challenge is not only to identify these sectors but to build up the human, technological and production capabilities for competitive positioning in them.

Figure I.6
INTERNATIONAL TRADE VOLUME GROWTH
(Percentages)

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Organisation for Economic Co-operation and Development (OECD), *Economic Outlook*, No. 86, November 2009 [online] www.oecd.org/oecdEconomicOutlook and *Economic Outlook*, No. 85, June 2009 [online] www.oecd.org/oecdEconomicOutlook.

South-South trade will take on a vital role as emerging economies increase their share of world GDP and global demand. Furthermore, the fact that per capita income growth will be from a low base means that the income-elasticity of consumption for the goods and services these economies require will be high. A greater role for emerging countries in international trade will increase global demand for energy, food, metals and minerals, which will boost the figures for the volume and value of the region's exports. This means that, without ceasing to be volatile as always, commodity prices will be higher than in earlier decades. This will tend to mean better terms of trade for net exporters of these products, but at the same time will discourage export diversification efforts by affecting the profitability of non-traditional exports. This scenario is also negative for net importers and may represent an opportunity to seek alternative sources of food and energy.

The workforces of the BRIC countries will increase and diversify their consumption as incomes rise. This will open up a variety of opportunities in these countries' markets: massive demand for high-volume, low-value products, consumption niches for high-priced special goods and services, and a whole range of intermediate situations. The challenge is to approach BRIC markets with a strategic focus rather than just as an opportunity to increase traditional exports. The existence of more sophisticated goods and growing demand for modern services will be what characterizes import demand in these countries, and the same characteristics will gain ground in South-South trade, opening up renewed opportunities for progress with production and export diversification. This trend could be strengthened if a firmer contribution were made by public policies at the country level and appropriate measures were taken in the context of regional integration and cooperation systems.

Some of the largest emerging economies, such as China and India and a number of Asian countries, have an abundance of cheap labour in the lower-skilled categories, but also large numbers of highly trained scientists and engineers with a growing ability to absorb and progressively develop new technologies. This will eventually turn them into leading actors in global production and the nurturing of new technologies. These new global competitors are making increasing inroads into the competitive advantages of industries in the OECD countries, but also into those of the natural-resource-intensive manufactures of Latin America and the Caribbean.

(d) The future financial landscape

The financial crisis revealed that institutional mechanisms for controlling systemic risk had not kept pace with financial globalization and liberalization. National regulatory authorities were not ready to regulate globalized financial institutions, and this has laid bare the need for deep reforms to the international financial architecture, and regulatory and supervisory systems in particular, to ensure greater global financial stability.

Consequently, the need to pursue a new regulatory process for financial systems is now on the table. First, there is likely to be a change of approach and scope in the regulation and oversight of national financial systems. Second, it has become clear that, alongside national regulation systems, there needs to be a global regulatory framework to establish minimum national standards and govern the global operations of systemically important financial institutions (Stiglitz Commission, 2009). A stronger international regulatory system with consistent standards in all countries is vitally important, not just as a way of preventing regulatory arbitrage but also to cope with systemic risks and provide financial stability at the global level.[7] This will require efforts to coordinate the regulation of financial systems between countries and stronger multilateral oversight arrangements for financial institutions deemed systemically important. There is a degree of consensus regarding the need to implement effective global early warning mechanisms, and this will require the combined experience and knowledge of a wide range of institutions and actors (IMF, 2009b; G20, 2009; European Union, 2009).[8]

The trend at both the national and global levels is towards far more comprehensive oversight and regulation in an effort to close the gaps which existed before the crisis. The coverage of regulation and oversight will be expanded as regards both the different financial instruments and the different market participants.[9] It has become clear that financial institutions often worked with excessive risk and with levels of leverage that were far higher than they should have been

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[7] A number of documents putting forward reform proposals for the international financial system agree on the need to increase coordinated efforts to incentivize economies that have inappropriate regulations or are unwilling to reform their practices and adhere to higher international regulatory standards. National and regional authorities should implement measures to protect the international financial system from untransparent or uncooperative jurisdictions (see, for example, G20, 2009; European Union, 2009; Stiglitz, 2009).

[8] In September 2009 the European Union approved the creation of a European Systemic Risk Council (ESRC) whose mission is precisely to oversee the solvency of the financial system as a whole by identifying potential risks and issuing early warnings.

[9] With regard to the former, there are proposals on the table for monitoring and supervising both the creation and the propagation of complex financial instruments, requiring the greatest transparency in the markets where they are traded. As for the latter, the idea will be to cover all market participants, be they banks, hedge funds or credit rating institutions. Similarly, a way will be found to bring the “shadow” banking system into the orbit of regulatory principles and oversight in the new regulatory landscape.

(Stiglitz Commission, 2009). Regulation should therefore have mechanisms to rein in both practices and to ensure that financial institutions have adequate capitalization and liquidity at all times.[10]

This process of new regulation will have important effects in shaping the type of financial system that will prevail in the post-crisis world. The expectation is that banking will move towards a model that is more transparent and has lower levels of risk and leverage.

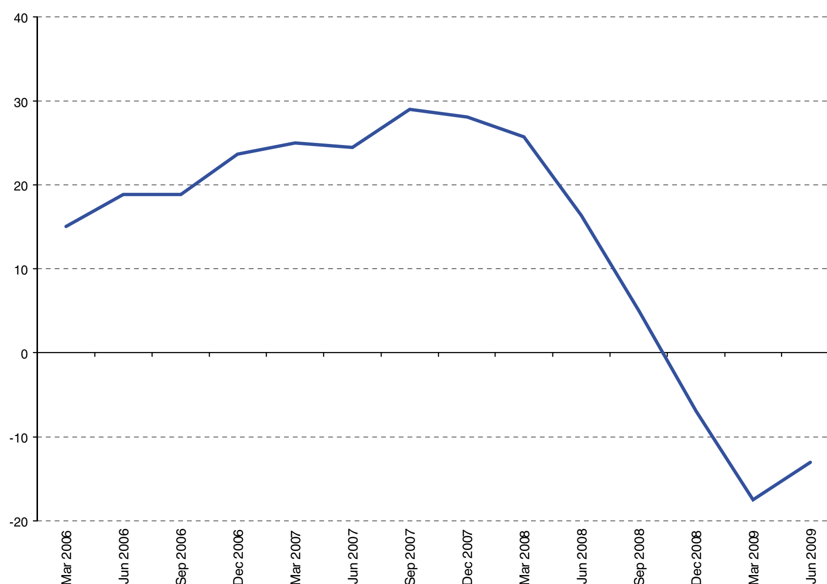
Meanwhile, the systemic impact of the crisis, combined with new regulations and the restructuring of the financial system, will have major implications for financial flows between regions. For example, there has been a renewed debate in a number of circles about the application of a tax on international financial transactions (a global Tobin tax) with a view to reducing speculative international transactions.[11]

More and wider-ranging regulation, fewer incentives for risk-taking and lower levels of leverage will bring with them a reduction in international financial flows and thus a partial reversal of the extraordinarily swift process of financial integration seen up until the crisis. The decline in private-sector financial flows to developing regions is due not only to higher uncertainty and a reduced appetite for risk (higher demand for safe assets on the part of international investors); it also reflects a reduction in the transnationalization of bank lending since early 2008. Financial systems began a process of deleveraging by reducing lending and, in particular, by shrinking their cross-border assets (see figure I.7).

Figure I.7

ANNUAL GROWTH IN EXTERNAL ASSETS REPORTED TO THE BANK FOR INTERNATIONAL SETTLEMENTS, MARCH 2006 TO JUNE 2009

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Bank for International Settlements (BIS), "BIS Quarterly Review" [online] http://www.bis.org/statistics/bankstats.htm, October 2009.

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[10] Countercyclical prudential regulation has been considered as an option. However, it has also been emphasized that regulation should not rely solely on capitalization standards (even if adjusted for risk and the cycle) but should take account of a range of broader aspects such as management incentives (Stiglitz Commission, 2009).

[11] Another reason for establishing a tax of this nature is that it would provide more resources to finance economic and social development policies.

This bias towards investment in local financial assets by the private sector could mean less integrated and dynamic financial markets at the international level. The same effect is produced by the demands of developed-country governments that their local banking systems channel the aid they have provided through lending to local agents and by a possible bias towards using the funds available to rescue local banks.

4. The need for a new multilateral global architecture

One of the main challenges for the coming years is to improve the ability of global institutions to respond to the economic, environmental and social challenges that will be thrown up by the new post-crisis context. This will require the new global architecture to return to the path of multilateralism and re-establish the right balance between global macrofinancial stability and the provision of resources and means to foster economic development.

Reform of the global architecture will have to arise from the virtuous combination of three elements. First, it must flow from and at the same time be a source of representative and politically legitimate leadership based on multilateralism so that the global development agenda can be defined and oriented. Second, it will need to consider a set of reforms to the system of reserves and to the global and regional specialized agencies that support implementation of the global agenda with technical and specialist input on rules, policies or programmes. Lastly, it will have to establish an accountability mechanism.

(a) Inclusive global governance based on multilateralism

Traditionally, the global development agenda has been controlled by the wishes of a small group of developed countries that possess the greatest powers of participation, voting and decision-making in international organizations.[12] Efforts have been made in recent years to integrate developing countries into these bodies through the creation of the G20.[13] However, this grouping needs to do more to fully incorporate the needs of developing economies into the global agenda.

In this context, one future requirement for global governance is the creation of broader and more inclusive platforms to coordinate the global development agenda (Stiglitz Commission, 2009). One option is to enhance the role now played by the Economic and Social Council of the United Nations, giving that body an institutional status analogous to that now possessed by the General Assembly or Security Council.[14] Its functions could include analysing and evaluating the latest economic, social and environmental events, promoting economic development, ensuring consistency in the policy objectives of the main international organizations and supporting efforts to reach consensus among the different governments of the world (Bárcena, 2009a). This would make it possible to arrive at better global governance solutions through greater dialogue between policymakers, the academic world and international organizations. The make-up of this global

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12 The Group of Seven (G7) is formed of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States, and has been enlarged by the addition of the Russian Federation to create the Group of Eight (G8). This group of countries wields a great deal of power in the decision-making processes of international bodies such as the United Nations Security Council, the World Bank, the International Monetary Fund and the World Trade Organization.

13 The G20 is a group of countries formed in 1999 by the eight most industrialized countries (G8), 11 recently industrialized countries from every region of the world and the European Union as a bloc. It is a forum for cooperation and consultation between the countries on issues related to the international financial system.

14 This forum would have similar characteristics to the global economic council proposed by the Commission of Experts of the President of the United Nations General Assembly on Reforms of the International Monetary and Financial System.

council could be based on a broadly representative system that included all continents and the world's leading economies. The forum should encourage participation by other major multilateral bodies such as the World Bank, the International Monetary Fund and the World Trade Organization.

(b) Reforms to the system of reserves and specialized institutions

In addition to reforming global governance, there is also a need for reform of the international financial architecture to increase its capacity to manage the business cycle. This reform should focus, first, on the reserves system and, second, on enhancing and strengthening international financial institutions.

In a context of growing financial integration, the international reserves system has shown itself to have major weaknesses when it comes to promoting financial stability and averting global imbalances. The current dollar-based reserves system places constraints on the ability of the global economy to adjust global imbalances, since correcting these imbalances entails major changes in the conditions of global dollar demand and supply. This can lead to large asset losses in countries which stock their international reserves in that currency. This loss of wealth could prove to be a deflationary (contractive) way of correcting global imbalances.

In view of this, it has been suggested that special drawing rights (SDRs) and the International Monetary Fund could play a stronger role in the new international reserves system. This would reduce the dependence of the reserve unit on political and economic conditions and decisions in any particular country, which in principle should increase stability and confidence in the international financial system. Some essential matters would have to be decided first, however, such as the criteria for issuing the new reserve currency and the mechanisms for determining the parity, convertibility and allocation of this new reserve unit.

Reform of the specialized institutions also needs to be part of the new global architecture. Prudent and appropriate management of economic crises requires countercyclical liquidity to be provided inclusively and on a global scale. This will mean increasing the resources of the financial institutions and easing the constraints on financing mechanisms and terms. This has been partially achieved in recent reforms to institutions such as the International Monetary Fund and the World Bank, which have increased their capitalization and changed the terms on which financing is provided. Progress is also needed at the regional level to recapitalize institutions such as the Inter-American Development Bank (IDB), the Central American Bank for Economic Integration (CABEI), the Caribbean Development Bank (CDB), the Bank of the South and the Andean Development Corporation (ADC).

A complementary requirement is for an increase in the financing base of loan agreements, as these still depend on countries' quota amounts. To supplement this, a multilateral framework should be established to deal with problems of over-borrowing by restructuring the amounts and repayment schedules of external obligations.

The developed economies should fulfil their commitment to devote 0.7% of gross national income to official development assistance, while in return developing economies should improve the efficiency with which they manage these resources. Equally, as foreshadowed in the reforms recently introduced in the case of the International Monetary Fund, the criteria for allocating and managing financial assistance resources need to be revised.

Crisis prevention requires a suitable system of regulation and supervision to oversee, monitor and distribute risk in the financial system. This means strengthening microprudential supervision and regulation and supplementing it with a macroprudential approach. Supervision and regulation need to help the financial system absorb shocks rather than amplifying them by countercyclical regulation. There is also a need to strengthen oversight mechanisms by activating an early warning system and promoting improvements in transparency and accountability practices.

Lastly, designing a more efficacious system of prevention requires effective coordination between multilateral institutions and between global and regional bodies. Regional institutions are a source of regional information and knowledge. Indeed, they can act as a link between national and global authorities and thereby enhance coordinated efforts to compile and synthesize macrofinancial information, develop early warning systems, adopt common regulatory mechanisms and support coordination efforts between countries in different subregions.

The governance of these institutions also requires major reform. In the case of the International Monetary Fund, decision-making power is largely monopolized by the industrialized countries, which hold 60% of the quotas. The result of this is a hegemonic role for the developed countries when it comes to setting Fund objectives and the criteria for allocating and distributing its financial resources. This imbalance should be corrected by a governance reform that goes further than that agreed at the G20 meeting of April 2009. This reform needs to be more inclusive and representative, with significant changes in the Fund voting structure to give developing countries a greater say and more decision-making power in international economic policymaking, in accordance with their economic size and development level.

The existing quota allocation system also limits developing countries' participation and decision-making power at the World Bank. The suggested governance reform centres on the allocation of quotas by countries' economic size, contribution levels and development needs. Likewise, developing countries have only recently secured a small degree of representation on the Basel Committee on Banking Supervision and until recently were unrepresented in the Financial Stability Forum too. The lack of representation for developing countries in these forums means that the latter's regulatory policy analyses and recommendations are incomplete and may lead to major errors and failures of regulation and oversight. Consequently, these institutions need the participation of all countries to draw up globally acceptable regulatory codes and standards.

The recent reform of the Financial Stability Forum (renamed the Financial Stability Board in 2009), increasing the number of members and including developing G20 countries such as China, India, Indonesia and the Republic of Korea, is a step in the right direction. Nonetheless, there is a need for mechanisms to ensure proper representation of different experiences and viewpoints with a view to establishing effective, consistent and appropriate regulatory legislation that applies at both the national and the international levels.

Inclusive governance needs to be supplemented by an accountability mechanism that is likewise inclusive. Accordingly, the accountability mechanism representing the international community needs to ensure that country preferences as articulated in the global agenda are respected and that the bodies responsible for implementing the global agenda have the necessary resources and capabilities. An appropriate accountability system can also improve transparency in the management of resources, thereby conferring legitimacy on the actions of international organizations.

5. The challenges of planetary climate security

There is no clarity about the duration in time of the consequences of the global economic crisis that broke out in 2008 and produced its severest effects in 2009. The analysis in the previous section allows a clearer estimate to be formed of the impact of the crisis and shows that the global dynamics of growth, trade and financing will not be the same over the decade now beginning as they were in the decade just ended. As it also notes, there is some consensus that the world will see a new economic and geopolitical configuration.

The previous section showed the need to reassess cooperation and negotiation criteria and procedures for market regulation and to have more effective international oversight and monitoring mechanisms in place to avert future financial crises. It highlighted the need for more and better multilateralism to build a global order with deliberative powers that offers greater representation for developing countries and a system of international cooperation characterized by greater solidarity and fairer financing. Multilateral institutions will need to develop the capacity to respond to the economic, environmental and social challenges of the new post-crisis context. This will require the new global architecture to re-establish a proper balance between the quest for global macrofinancial stability and the provision of means and resources to promote economic and social development.

There has been a financial crisis whose consequences transcend the present and suggest the need for new rules for the future; at the same time, great epochal changes are producing far-reaching alterations in the pattern of globalization, and their consequences cannot go unaddressed in the current agenda. Primarily, this means global warming and its main consequence: the demand —one the whole of humanity could justifiably make— for guarantees of planetary climate security. All this adds up to an epochal change that obliges us to act now in the face of a proliferation of alternatives. It is not the current financial crisis that is determining the future; rather, it is the inexorable working out of the future that is challenging the present. Furthermore, if global warming reaches critical levels, there will be no leeway for rescue measures. This is why it is urgent to act now to avert it or limit its impact.

The global climate has evolved since the very origin of the earth, driven essentially by natural causes. Since the nineteenth century, however, the generation of greenhouse gases as a result of human activities has increased so much that the average temperature of the planet is now the highest in 1,000 years.[15] Changes in precipitation, a higher sea level, the loss of ice sheets and alterations in patterns of extreme weather events are already discernible.

Climate change is most easily understood as a global public bad or loss of welfare due to atmospheric warming caused by a concentration of greenhouse gases unprecedented in human history. The scientific evidence available has shown that the main causes are anthropic and that their effects are globally distributed, irrespective of where these gases may have been generated.[16]

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[15] Greenhouse gases are so called because they retain heat and increase the temperature of the earth's surface, as happens in a greenhouse that heats the air near the ground. The most important gases are carbon dioxide (CO_2), methane (CH_4), nitrous oxide (N_2O) and sulphur hexafluoride (SF_6). Another very important group of gases are hydrofluorocarbons (HFC) and perfluorocarbons (PFC).

[16] The IPCC highlighted this anthropic character in its Fourth Assessment Report, published by the United Nations in May 2007.

The 2007 report of the Intergovernmental Panel on Climate Change (IPCC) reveals that 11 of the past 12 years have recorded the highest temperatures since 1850. Indeed, the Panel has revised upward its calculations for the rising trend of the global temperature over the past 100 years (1906-2005). The report concludes that the planet has warmed by an average of about 0.74°C (between 0.56°C and 0.92°C) in this period alone, although the problem has been building up since the beginning of the industrial era (1750), mainly because of high fossil fuel consumption.[17]

IPCC has also documented the correlation between rising temperature and intensification of the water cycle. First, the sea level rise caused by warming has averaged 1.8 mm/year (between 1.3 mm and 2.3 mm) since 1961. Since 1993, however, the increase has averaged 3.1 mm/year (between 2.4 mm and 3.8 mm). This is due to the thawing of glaciers and polar ice caps caused by the temperature rise. Satellite data obtained since 1978 indicate that the annual extent of Arctic sea ice has diminished by 2.7% on average (between 2.1% and 3.3%) per decade. Mountain glaciers and snow cover are estimated to have diminished in both hemispheres, although the figures are not so precise as for the Arctic. Meanwhile, climate change has influenced precipitation patterns, resulting in water shortages and droughts in certain areas and flooding in others. Between 1900 and 2005, precipitation increased greatly in eastern areas of northern South America and North America, northern Europe and northern and central Asia, although it diminished in the Sahel, the Mediterranean, southern Africa and some parts of southern Asia. Worldwide, the area affected by droughts has increased since 1970.

Observations also reveal a rise in intense tropical cyclone activity in the North Atlantic since about 1970, with little evidence of increases in other regions. Longer-term trends in cyclone activity, particularly before 1970, are difficult to identify because of a lack of suitable records.

The key messages from the four IPCC reports are:[18]

- The average temperature of the planet has been rising beyond what would be expected from normal trends over the past century owing to greenhouse gas emissions and the loss of natural sinks, chiefly as a result of anthropogenic activities.
- If this behaviour continues, the average global temperature will increase over the course of this century to levels unprecedented in the planet's geological history of the past million years, and this will have severe global consequences for ecosystems, the economy and human welfare.
- The longer effective measures to correct the situation are put off, the higher the costs will be.
- There is still a window of opportunity to implement mitigation measures which, while they will affect the global economy, can be applied using technology available today.
- Immediate adaptation measures will be required in the most vulnerable areas that have already been subjected to the effects of rising temperature and ocean levels.

The impact of climate change on ecosystems and economies has already been significant and will increase during this century, and it will be particularly severe in developing countries, small island States and communities with less social protection.

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[17] According to the 2007 IPCC report, global greenhouse gas emissions from human activity have increased by 70% since the pre-industrial era (1750), with most of the rise coming between 1970 and 2004. The main greenhouse gas-emitting activities are those related to energy, industrial processes, solvent use, agriculture, land use changes, deforestation and waste products.

[18] On the basis of information from the four IPCC assessment reports (1990, 1995, 2001 and 2007).

This explains the political haste to reach a binding multilateral agreement of global scope, especially since 2007 in view of both the Kyoto Protocol renegotiation process and the IPCC report. Global mitigation targets seek to stabilize total emissions at levels compatible with a rise of no more than 2°C, entailing a reduction of about 50% in total annual emissions up to 2050 (they currently stand at between 40 gigatons of carbon dioxide equivalent ($GtCO_2e$) and 45 $GtCO_2e$). With a global population of 6 billion, this translates into an average of about 7 tons of CO_2 per capita (Hepburn and Stern, 2008). A 50% reduction would mean cutting emissions to about 20 $GtCO_2e$ a year by 2050, giving a global average of just over 2 tons of emissions per capita for an estimated world population of 9 billion.

These long-term goals represent a huge challenge for developing countries, including those in Latin America and the Caribbean. Without international measures to mitigate the effects and support adaptation, the region could sustain major losses over the course of the twenty-first century in agriculture, water availability and biodiversity. It would experience intense pressure on infrastructure and an increase in the severity of disasters, adding up to large percentages of current GDP, with particularly severe effects on more deprived urban areas and the poorest sections of the region's population.[19]

From a global perspective, the greenhouse gas emissions of Latin America and the Caribbean currently account for a small proportion of world emissions, and they grew more slowly than global emissions between 1990 and 2000, but the consumption of fossil energy continues to increase in the region.[20] This path could be hard to sustain in a global setting where carbon emissions will be increasingly constrained in future.

Figure I.9 shows the positive relationship between per capita energy consumption and per capita income, and while there is a gradual decoupling of energy consumption as per capita GDP increases (see figure I.10), it is not enough to restrain the current vigour of energy consumption growth, which actually exceeds the world average (see figure I.11). This comes on top of other greenhouse gas emissions increasingly being generated by changes in land use (ECLAC, 2009d). From the standpoint of opportunities, the region has the potential to contribute to greenhouse gas emissions reductions by means of energy efficiency projects and measures, replacement mechanisms involving the generation of energy with renewable technologies, and the conservation and production of forests with a high carbon absorption capacity.

Unless prompt action is taken to alter the path the region is currently on, its economic underpinnings will alter in historically unprecedented ways over the coming decades, owing both to climate change and to pressure from developed countries to mitigate its effects at any cost if a worldwide multilateral agreement is not reached. One way or another, this will eventually mean a profound shift in modes of production and consumption, especially of energy (see chapter III).

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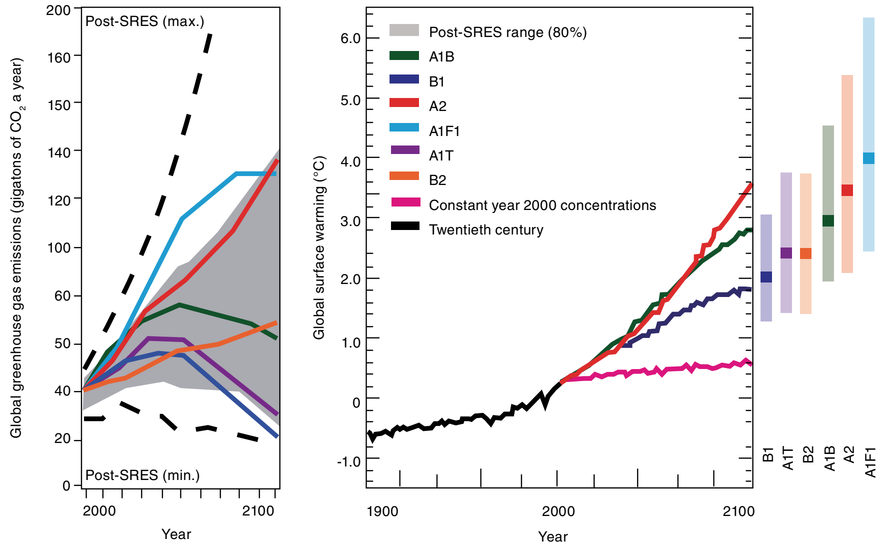
[19] In the twenty-first century, the average impact on Central American agriculture is estimated at between 14% and 19%, depending on the scenario chosen, with a discount rate of 0.5% in countries where this sector accounts for more than 5% of GDP (ECLAC, 2009d). Agriculture still plays a very important role in many Caribbean countries, whose geographical location leaves them particularly exposed to the impact of climate change on agriculture. The most vulnerable sections of society are those at the bottom of the income scale. In the case of agriculture, an inevitable effect will be higher prices as production falls and difficulty in maintaining supply, and the worst placed to cope will be those with the lowest income levels, just as they were during the food price crisis of 2008.

[20] The emissions database used is that of the World Resources Institute (WRI), which allows historical comparisons to be made between countries.

Figure I.8

SCENARIOS FOR GREENHOUSE GAS EMISSIONS FROM 2000 TO 2100 (IN THE ABSENCE OF ADDITIONAL CLIMATE POLICIES) AND PROJECTIONS OF SURFACE TEMPERATURES



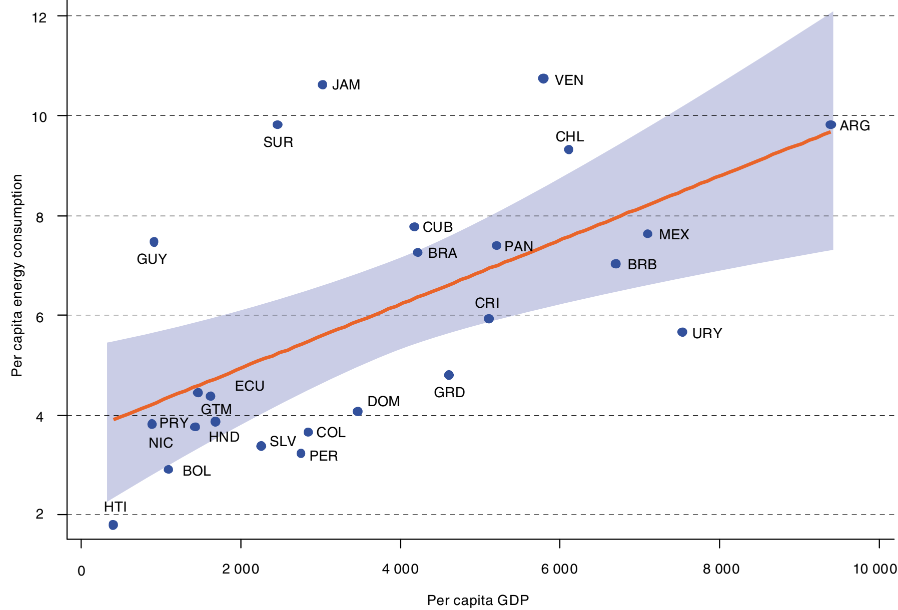
Source: Intergovernmental Panel on Climate Change (IPCC), *Climate Change 2007: The Physical Science Basis. Contribution of Working Group I to the Fourth Assessment Report of the Intergovernmental Panel on Climate Change*, Cambridge University Press, 2007.

Note: SRES = IPCC Special Report on Emissions Scenarios.

Figure I.9

LATIN AMERICA AND THE CARIBBEAN: RATIO OF PER CAPITA ENERGY CONSUMPTION TO PER CAPITA GDP, 2007

(Barrels of oil equivalent and dollars at constant 2000 prices)

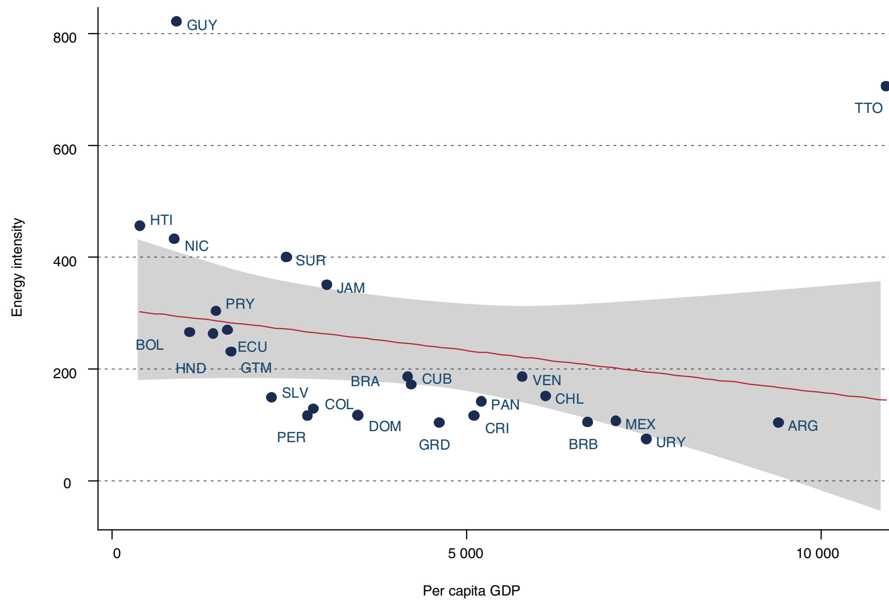


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the Latin American Energy Organization (OLADE), the Energy-Economic Information System (SIEE) for total energy consumption statistics, and the Economic Indicators and Statistics Database (BADECON) for data on per capita GDP at constant 2000 prices.

Figure I.10

LATIN AMERICA AND THE CARIBBEAN: PER CAPITA GDP AND ENERGY INTENSITY, 2007

(Barrels of oil equivalent and dollars at constant 2000 prices)

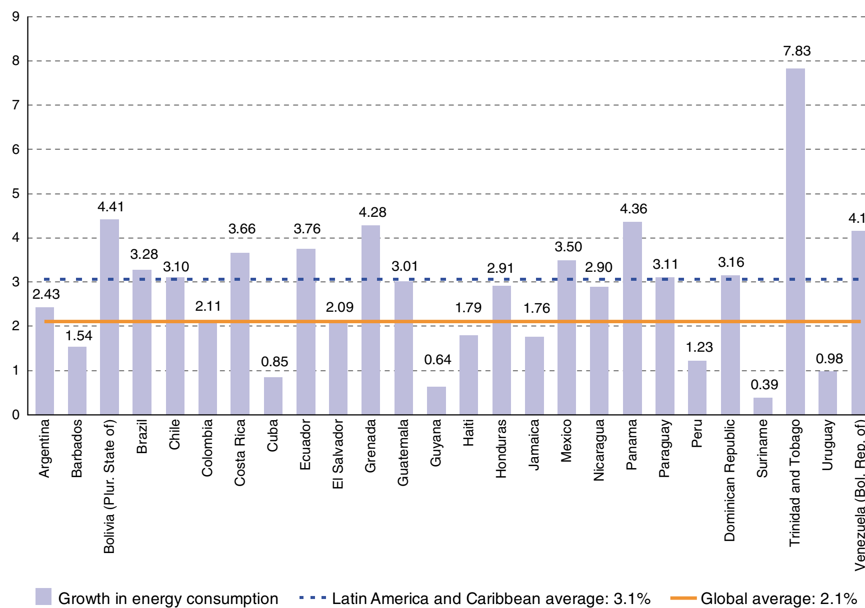


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the Latin American Energy Organization (OLADE), the Energy-Economic Information System (SIEE) for total energy consumption statistics, and the Economic Indicators and Statistics Database (BADECON) for data on per capita GDP at constant 2000 prices.

Figure I.11

LATIN AMERICA AND THE CARIBBEAN: ENERGY CONSUMPTION GROWTH, 1970-2007

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the Latin American Energy Organization (OLADE) and the Energy-Economic Information System (SIEE).

It is essential to find more effective multilateral means to halt global warming based on administration systems that recognize the interdependence between countries (and the differentiated role each of them has played in its gestation), between public, private and social actors, and between the different generations. These institutional and financial proposals will need to give full consideration to the principle of common but differentiated responsibilities and attach due importance to development priorities in a more equitable system of global governance. It is important for the region to participate actively in international negotiations and benefit from financial agreements based on competitive options for trading carbon emissions between developed and developing countries.

Progress towards effective and equitable multilateralism has not been very encouraging. The targets laid down in the Kyoto Protocol have been met only in part. Furthermore, the results of the fifteenth session of the Conference of the Parties to the United Nations Framework Convention on Climate Change (COP 15) held in Copenhagen in December 2009 were limited, precisely because no agreement could be reached on quantitative targets for additional emissions reductions by developed countries. Nor was there any success in achieving an agreement clearly embodying financial and technological support for developing countries wishing to commit to emissions mitigation. The Copenhagen Agreement was the outcome of an accord reached between the countries making up the so-called BASIC bloc (Brazil, South Africa, India and China) and the United States in the final hours of the meeting, from which no consensus emerged.

The agreement proposes to limit the global temperature rise to 2°C, which requires restricting the concentration of greenhouse gases in the atmosphere to 450 parts per million (ppm). This implies a considerable reduction in greenhouse gas emissions up to 2020 and a drop of 50% between 2020 and 2050. The document laid down some principles for the provision of financial resources by developed countries on the basis of the principle of common but differentiated responsibilities so that developing countries can contribute to emissions reduction on a voluntary basis and adapt to the immediate effects of climate change.

The Copenhagen meeting did not yield the results hoped for. Although the debate was carried forward, the Copenhagen Agreement, which is not binding, was called into question by many countries and will need to be reviewed and ratified by member States to increase countries' commitment to it, at the same time as a more transparent and inclusive negotiating process is developed.

Two international approaches to achieving climate security remain open in this confused post-Copenhagen scene. The first is to follow a negotiated path on the basis of shared values, agreed timetables and simultaneous efforts and criteria underpinned by the principle of common but differentiated responsibilities in the framework of multilateral negotiations. The second approach is to go along the route of unilateral initiatives that are applied indiscriminately, do not distinguish between relative development levels and are governed only by the laws of competition.

Among the main measures that will form part of the "new normal" of climate economics are the application of unilateral trade regulations and the imposition of international trade taxes based on the carbon content of goods exported to developed countries. This entails a serious risk that mitigation may end up being borne largely by developing economies, whether in this or other ways.

There have been a number of initiatives in this direction, among the furthest-reaching being the one that came out of stage 2 of the Grenelle process in France, which proposes retail product labelling containing information on the carbon content and estimated environmental effect of packaging. This is being closely followed in Japan, the United Kingdom and other of the region's export destination markets.[21] Developing countries will need to prepare themselves if they are to avert a potential export market loss owing to the appearance of competitors that have adapted better to cope with these requirements.

In summary, where Latin America and the Caribbean are concerned, climate change could become either a new constraint on economic growth or, if approached in a well-judged and integrated fashion, an opportunity to renew and improve infrastructure, upgrade production processes, create more efficient transport methods with lower emissions and gradually move towards a lower-carbon development pattern.

The ethical background and the economic dilemma in the discussion about climate issues is that climate change mitigation entails high present costs to generate benefits in the future. The singular problem now being faced at the global level is that climate change is cumulative and irreversible. Consequently, waiting before acting means accepting a great risk, which can perhaps be reduced at a lower cost now than in the future (Stern, 2007). State action is required in both the institutional and the economic spheres to bring about a realignment of prices and reorient markets towards long-term goals. Today's short-term mercantile logic is clearly inadequate.

Lastly, it needs to be made clear here that the implications of this transition to lower-carbon economies could be important from the standpoint of equality and convergence in the productive economy. Actors have contributed unequally to the problem and higher-income countries and groups have a greater responsibility for its causes and a greater capacity to mitigate the effects. The impacts of climate change are also unequal between and within countries. However, gradual mitigation can reduce inequities, for example through improvements in the quality of public services that are very important to the quality of life of the most disadvantaged sections of society.

B. The value of equality for the future

1. Taking the best of modern politics

The crisis and the new international scene referred to in previous pages have appeared at what is a special and, in some respects, a positive moment in the history of Latin America and the Caribbean. First, the region is dominated by democratic political regimes to an extent unprecedented in its republican history, and this has made citizenship a live issue on the public agenda in respect of both political and civil rights.

The playing out of democratic life in the region's countries has also positioned social and cultural rights as a subject for policies and politics. It is no coincidence that public expenditure is growing as a proportion of GDP and that social spending, which to a large extent is social investment, has been rising substantially. The implementation of more active policies of transfers towards the most vulnerable sectors, progress on the right to health care and on more universal

[21] See ECLAC (2009d) for the foremost initiatives up to 2009.

social security with solidarity components and greater policy recognition of gender, ethnic, cultural, territorial and age-related inequalities and differences are also connected with this.

This road is long and not necessarily straight, but the progress is undeniable. All the advances referred to have been the result of a hard but rewarding political and cultural learning process. Ideas that promote freedoms, environmental sustainability, non-discrimination in the most diverse areas and respect for the right to self-determination are taking root in the region.

Accordingly, the challenge thrown up by the crisis and the new international scene is to consolidate social gains and the agenda of inclusion and recognition rather than allow them to go into reverse. It is not easy when the effects of the crisis are eroding employment for the most vulnerable, the availability of fiscal resources for social protection and the conditions for greater economic dynamism. Nor is it easy when self-determination comes up against such uncontrollable outside factors as external shocks and global financial volatility. However, the lessons of history cannot be forgotten just because difficulties arise in an increasingly interdependent and unstable world. On the contrary, it is these lessons that must set the future agenda, particularly when it requires a great deal of political will in the present. The steps taken by the countries to maintain macroeconomic equilibria and contain the social costs of the crisis are evidence that this will exists.

It is against this background that we wish to argue for the key role of equality in development. Asserting the value of equality now means re-creating it in the light of the lessons of history and current conditions in the world, in other words, coming to terms with globalization in all its aspects. The value of equality, together with that of freedom, is the most humane way of taking on the tasks of modernity.

Equality is at the heart of modern politics and social struggles to change and improve society. For the past three centuries, equality has meant two things that, while complementary, are in a state of permanent tension. The first is the abolition of privilege and the firm establishment of equal rights for all individuals, irrespective of their origins and of their gender, nationality, age, territory and ethnicity. This dimension is enshrined in the declarations of human rights that began with the French Revolution and continued with those of the United Nations and the successive covenants signed up to by the international community. It crystallizes in an idea of citizenship that refers to the whole array of individuals' rights and obligations, to the political community of which these form part and to the existence of institutional and legal frameworks providing citizens' guarantees and of a public space where the rights and obligations constituting citizenship are exercised. This is the value of the equality proclaimed by democracy and given effect by universal suffrage. Without a doubt, the progress of political democracy in the region is a fulfilment of the mandate of modernity.

The second dimension is the distribution of resources in society in such a way as to allow all its members to exercise their rights effectively. This issue arises out of a particular weakness in the citizen equality dimension, a weakness that is of very long standing in Latin America and the Caribbean, namely the fact that political equality is undermined in its content if it does not acknowledge and seek to remedy inequalities in access to material and symbolic resources. What is postulated, then, is the principle of real or substantive equality in the different spheres of social life where universal rights are asserted. And while the first dimension of equality has to do with rights and the role of the judiciary in enforcing them, the second has to do with social justice and a socio-economic and political structure that promotes this. This is a great unmet challenge in the region, whose equity gaps are and have long been the world's widest.

The issue of equality in the socio-economic structure necessarily leads us to consider the production structure. By this we mainly mean the way people participate in the production system through work, which depends fundamentally on the situation in the economy, the production system, its territorial distribution and its ability to generate high-quality jobs. For this reason, the following four chapters are devoted to these structural aspects. Access to productive resources, capacity-building, access to financing and markets and the availability of infrastructure and technology are determinants of equality in this respect.

Equality needs to be considered from the standpoint of production and of social policy. In this context, social spending should be seen as social investment in human capabilities and production opportunities. This is the structural basis for equality and inequality, and this is where a more active role for the State is essential.

Throughout this document, we have opted to speak of human capabilities rather than human capital, precisely because equality is not resolved by way of a spontaneous meritocratic adjustment. Education and knowledge are certainly essential to give equality its rightful place at the intersection of productive capabilities and social development. For equality of rights, however, the redistributive role of the State is very important; people's "value" in the market cannot be the only consideration. As citizens, members of society cannot see their welfare subordinated to their "human capital" —the value placed on their capabilities in a labour supply and demand relationship— not just because access to education and knowledge is so unequal, but because we are making a political and moral choice to embrace inclusiveness as part of citizenship. We do not subscribe to the premise underlying human capital theory that inclusiveness comes about through meritocratic adjustment in the labour market rather than through a citizenship entailing the possession of rights.

2. Why now is the time for an equality agenda

The pattern of globalization in the two decades prior to the crisis, the effects of the crisis and the new global scene all invite a closer look at where we have come from, where we are going and where we want to go. These questions may seem very broad, but there can be no strategic orientation for development if they are not asked.

Our contention is that an equality agenda is now unavoidable for a number of reasons.

First, because greater equality of rights, opportunities and welfare creates a greater sense of belonging to society and thence greater social cohesion (ECLAC, 2007a). Without social cohesion it is difficult to confront the challenges of a more competitive and complex world as a community and as a country. Growth has a negative effect on social inclusion and cohesion when its benefits tend to be concentrated, which in turn undermines the future growth dynamic. As the expectations gap widens, social conflict increases and erodes the legitimacy of governments, thereby jeopardizing the sustainability of growth.

Second, a society must become more integrated before it can become more productive and more convergent in its production methods. "Genuine competitiveness" (Fajnzylber, 1990), based on increased human capabilities and improved participation in the production process for the whole of society (and not on low wages and overexploitation of natural resources), yields greater returns in terms of sustained long-term growth. A society that shares out educational opportunities and access to formal employment in a more egalitarian way will have a workforce

with greater capabilities and will optimize both the use of those capabilities to make progress with productivity and competitiveness and the use of fiscal resources for productive investment and social protection. A society that universalizes timely access to health care and nutrition will reduce the costs associated with disease and malnutrition, from lower productivity to sickness-related expenditure. A society with a higher level of equity will probably incur fewer costs related to public safety and the quality of democracy.

In the long term there is a virtuous circle between the narrowing of social divides, the closing of productivity gaps and more dynamic and sustained growth. There is conclusive evidence that economic development and social equality tend to go together. It suffices to contrast the distribution of income and other assets in poorer and less poor societies.

Third, greater equality in the sphere of social rights leads to greater equality of political visibility and influence. To put it another way, greater integration into decent work, high-quality education, information and knowledge and networks of social protection and interaction improves citizens' capacity for participation in political and union organizations, public debate, informed voting, the use of knowledge to enforce their rights, access to civil associations and cultural dialogue. Again, the more representative and open to public input decision-making systems are, the more influence perennially excluded groups will have on decisions about redistributing resources and universalizing benefits.

Fourth, the experience of earlier crises in Latin America and the Caribbean shows that they usually have a deeper and longer-lasting impact on poverty, welfare and social inclusion than on economic growth. Furthermore, the pattern of globalization that entered into crisis in 2008, heavily dominated by the financial world and relatively divorced from the real economy, proved not only very volatile but also very uninclusive; indeed, it had the unfortunate distinction of creating the most regressive distribution of the benefits of progress in modern history. The long-term effect is to make societies more unjust or leave large swathes of them vulnerable to poverty and indigence. In this context, greater equality is a benchmark that will guide public-sector action to reduce vulnerability and translate economic growth into wider access to well-being.

This discussion of equality is informed by a bitter experience of inequality. The evidence of the final two decades of the last century in the region shows it actually going backwards where equality was concerned. The new public-private alliance led to greater segmentation of service quality, information asymmetries and greater territorial segmentation, and did not correct inequalities of origin through life-path opportunities. Structural heterogeneity, beginning with segmentation in the world of productive work and thence multiplying inequalities in every sphere of society, has increased over the past three decades in most of the region's countries. Furthermore, two areas in which the arrangements between the State, the market and the family exacerbated segmentation were social protection and education. Instead of equalling out opportunities, they widened the gaps. Public policy efforts, redoubled in the decade now ending with a view to reducing poverty, expanding access to education and training and, more recently, mitigating social vulnerability, are undoubtedly a response to this critical evaluation.

The subject of equality forces us to consider degrees of proximity and distance in society as a whole. The aim is to narrow the distance between social groups in terms of power and wealth or, to put it another way, of access to instruments that determine people's capacity for self-realization. Furthermore, the transition from equality of opportunities to a lessening of gaps in terms of achievements, assets and appropriation of the benefits of progress is not automatic, given the deep

differences in power, possessions, recognition and social networks that have always marked our societies and, most importantly, the divides between people in the ways they participate in the production and employment structure of society, which reproduce so many other divides. This is why what ECLAC said a decade ago about equity (ECLAC, 2000) also applies to equality: “The sources of inequality are to be found in different areas of social and economic life, and action to further equity has to take (…) into account different aspects connected with equality of opportunities at the beginning and during the course of the educational and employment cycles, equality of access to material well-being but also to participation in decision-making and in public life, equality of access to systems of justice, citizen security and healthy lifestyles, and equality of access to numerous sources of knowledge and information and to social and other support networks.” In this context, equality of opportunities at the starting point requires a reasonable equality of outcomes if it is to be effective throughout people’s lives, and this brings us back to the principle of equality as a corrective principle over the whole of the life cycle.

3. Different but equal

Age-old differences between groups defined by gender, ethnicity, territory and age are becoming increasingly prominent in the political debate and on the public agenda. Membership of such groups is an increasingly valued source of diversity. Over and above demands for equality before the law, it is present in struggles for identity and for recognition of collective problems and aspirations, whether based on gender, ethnicity, age or other specific conditions. However, a history of discrimination and exclusion means that groups defined by these categories now experience the highest levels of vulnerability and exclusion precisely because of that belonging. That is the paradox.

This being the case, the equality agenda needs to be supplemented by an agenda of difference —not, by any means, to make difference a euphemism for inequality, but for the sake of progress towards greater equality between people who are unalike. Differences have to be taken into account if the universality of rights and equality before the law are to be made effective, not just because of the asymmetries they entail in terms of access to full political and social rights, but also because recognition of diversity calls in turn for affirmative action policies to ensure that everyone is a full citizen. This means extending the time-honoured concept of rights in pursuit of a more inclusive vision of equality, with consideration being given, for example, to the institutional resource of positive discrimination in favour of disadvantaged categories or parity in gender issues.

Ignoring these differences in the name of an abstract, generic equality passes over the fact that human beings and groups have different ways of experiencing their history. Thus, “generic” citizenship can be a source of real discrimination or inequality for specific groups if these factors are not considered. Citizenship or equal rights, social justice or substantive equality, recognition for diversity or equality in difference: these are three components of the concept of equality that cannot be subordinated to one another and that together form the concept of equality we are propounding.

Expanding the horizon of citizenship and policies to fields such as gender relations, the identity of ethnic groups and peoples, preservation of the environment, access to long-distance communication and local and regional administration requires major institutional changes. Failing to consider differences and these emerging areas of the equality agenda reinforces the traditional tendency for people to fall into first- and second-class categories of citizenship in the societies of Latin America and the Caribbean.

4. The interaction of unmet needs

Latin America and the Caribbean are rife with inequalities. The aggregate income distribution indicator is useful not just because it provides a telling picture of the divides that afflict the region, but also because income gaps are underlain by or embody other divides that have proved mutually reinforcing in a kind of vicious circle.

For one thing, education and knowledge gaps are human development gaps, which is why it is not only education that is vital, but also nutrition, preventive health care and training. Knowledge gaps are gaps in the positive exercise of freedom, understood as the set of capabilities needed to implement life plans. In the region, it is the norm for young people from the fifth quintile to complete secondary school and the exception for young people from the first quintile, as will be seen in chapter VI. If complete secondary education is required to gain access to employment options that can halt the intergenerational reproduction of poverty, this educational divide is perpetuating inequality throughout people's lives and between generations.

Productivity gaps, meanwhile, are gaps in welfare and self-realization in the workplace. People's socio-economic group of origin and educational level have a substantial effect on whether they ultimately do low- or high-productivity work, which implies the existence of divides in incomes, access to social networks, collective recognition of their own efforts and the quality of daily life. The so-called structural heterogeneity addressed in the third chapter entrenches mutually reinforcing inequalities in the areas of education, productivity, connection with markets, incorporation of technical progress, contractual stability and political negotiation. This heterogeneity cannot be overcome by means of redistributive policies such as direct transfers to households. Rather, such transfers need to be oriented so that they have a positive impact on people's productive capabilities, while investment in the production system is also needed to improve the jobs on offer.

Social protection gaps give rise to different forms of vulnerability, the main ones being the risks of poverty and indigence, sickness, unemployment and an income-less old age. Just as education and productivity gaps in the region are very acute, so social protection is highly segmented in terms of responsive networks and services. Only a small percentage of the economically active population pays into social security, while welfare pensions are still in their infancy. Health care has tended to be privatized and its quality fragmented by ability to pay, while the introduction of unemployment insurance remains an unmet need.

Inequalities in education, social protection and productivity are sustained by (and feed into) historical divides based on race and ethnicity, gender and territory. Gender inequalities are manifested, first, in different forms of discrimination in the labour market (lower incomes, more unemployment and less well-protected jobs) and, second, in the lack of remuneration and recognition for the care economy, which is vital to social reproduction and is shouldered largely by women. Indigenous people, Afro-descendants and the rural population are poorer and less educated, earn less, enjoy less social protection and have only restricted access to justice and politics. Territorial inequalities are reflected in urban segregation, as poor neighbourhoods have poor services and access restrictions (poor-quality schools, overcrowded environments, greater exposure to violence, fewer jobs, more inadequate health services, less social capital).

These unmet needs on the equality agenda will be addressed in chapters III, IV, V and VI, which refer to productivity, territory, employment, and social protection and education, respectively.

C. The issues before us

The analysis in this document is based on historical evidence in the context of the challenges raised by the new global scene and by the value of equality. Reflecting the change of era, it updates and recasts ECLAC thinking about the fiscal covenant, production development, social protection, territorial convergence, capacity-building through education and the creation of opportunities through employment. The equality agenda is also viewed in the light of various other dimensions and an attempt is made to forge a strategic vision of development in today's world, leading to a profound review of the role of the State in different spheres.

This strategic vision is based on six major pillars dealt with in the six chapters of this document. Chapter II looks more closely at the kind of macroeconomic environment needed to give economic growth a dynamic that is sustainable in the long term. Some of the things that stand out are the need to learn from experience in order to guard against global volatility, to generate suitable signals and incentives for productive investment and to close the gap between real and potential GDP. As will be seen, a great deal can be done with fiscal, monetary, exchange-rate and external capital market reform policies. By applying appropriate policies it is possible to boost growth and improve its quality, which will result in positive impacts on employment and greater fiscal leeway for public policies to stimulate production and provide social protection and advancement. Higher quality here also means growth with equity, by contrast with what has prevailed in earlier decades.

Chapter II highlights the importance of continuous, stable growth, as this is essential for restoring the conditions needed to redress the huge social lags that have been building up in Latin America and the Caribbean. Unfortunately, the global financial crisis and its effects on Latin America and the Caribbean have cut short an auspicious cycle of growth with stability in the region that began in 2003 and that reversed a two decades-long trend of high unemployment and increasingly informal and insecure working arrangements. All this means that there are new challenges to be met on top of the earlier ones in order to achieve economic and social development consistent with citizens' aspirations and rights.

The continuous, stable growth analysed in chapter II may contribute, through various mechanisms, not only to improvements in welfare but also to the reduction of inequality as discussed in chapters III to VI. Some of the most important points to bear in mind with regard to inequality are:

(i) The rate and stability of growth affect the degree of homogeneity achieved in the production system through the growth process and the corresponding convergence in the quality of the jobs created and in worker performance.

(ii) The rate and stability of growth determine how quickly the economic surplus increases and thus how much scope there is for society and the State to use public programmes and projects to reduce inequalities between territories that consolidate and heighten inequality in production conditions and employment.

(iii) The rate and stability of growth and the consequent increase in the economic surplus also give society and the State the fiscal leeway needed to gradually introduce the requisite social protection on a basis of universality. The result is a virtuous circle linking greater economic stability, greater convergence in production methods and employment and the spread of welfare throughout society, plus the assurance that the whole population will enter into possession of full citizenship through education, health care, social security and assistance for the poor, among other factors.

Chapter III shows how production has failed to converge in two senses. The first is that of structural heterogeneity —wide and persistent productivity gaps between and within sectors and in employment. These gaps, as is well known, form a hard core from which inequality spreads throughout society, exacerbating capability and opportunity gaps. The second type of convergence is the narrowing of productivity gaps between the Latin American and Caribbean economies on the one hand and more developed and more dynamic ones on the other. As will be seen, productivity shifts in the region's economies are very slow and require major efforts of public and private investment, appropriate stimuli and active public policies. This document argues that the two convergence challenges, inward and outward, are complementary and need to be addressed as such, with an energy pattern that is more consistent with future sustainability. More competitiveness, more equity and greater social inclusion all come together here. What is proposed, therefore, is development that is more sustainable in every respect.

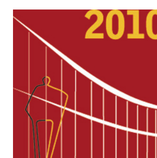
Chapter IV considers the challenges of economic convergence and social equality at the territorial level. It shows the acute territorial heterogeneity that exists in the dynamics of growth and industrial linkage, poverty and access to welfare. It also shows that territory matters and that it is subject to change, and that what is needed to characterize a territory is not a snapshot but a film of its evolution. The analysis carried out in this chapter gives an idea of the extent to which territorial divides reinforce and are reinforced by national divides in economic and social development. It also argues for the importance of activating synergies using a spatial linkage criterion, and the need to formulate fiscal reforms that level the playing field between different administrative and territorial units.

Chapter V links the world of work clearly to that of social inclusion and equality of opportunity. It does so by discussing the dynamics of both employment and labour institutions. There can be no doubt that employment is the link between productivity and equality, inasmuch as it is the main resource for generating household income and also a key area for social protection, lifelong learning and partnership with others in the effort to realize rights and aspirations. For this reason, the high proportion of the economically active population working in low-productivity jobs, large pay gaps, lower employment rates among the poor and indigent and the particularly disadvantageous situation of women and young people in the labour market are all detrimental to equality and overall productivity. This is why it is so important to develop active policies to improve employment quality and workforce capabilities and employability, minimum wage policies and coordination between labour institutions and social protection.

Chapter VI highlights the vital role of the State and social policies in providing the equality agenda with its social protection and advancement pillars. It also shows the dynamic of social inequalities in key areas such as household incomes and education. It emphasizes progress with social spending, which reveals the willingness of governments to give more of a leading role to the State in providing public goods, but also continuing shortcomings and the limited redistributive effect of this spending. Simulations are deployed to reveal social protection gaps in different areas, their importance for the equality agenda and their potential costs as percentages of GDP. This allows an estimate to be formed of the effort required to close major social protection gaps and the dilemmas involved in the question of how to increase and reorient public transfers. Lastly, it addresses the major educational challenges on the equality agenda, which include the need to narrow learning quality divides and the effort to consolidate universal pre-primary coverage and completion of secondary education.

The final chapter summarizes the major policy challenges identified in the earlier chapters and the new role of the State in meeting them. It emphasizes the growing consensus about the decisive role to be played by the State in guaranteeing public goods, dynamizing growth, stimulating production development, levelling the territorial playing field, coordinating the demographic transition with egalitarian policies from a life cycle perspective and building consensus around fiscal covenants that are clearly redistributive in their effects. The aim is to have a welfare State and not a subsidiary State, one that moves towards a tax structure and a system of redistributive transfers that establish social solidarity at the very heart of communal life, that does not seek to be maximalist or invasive but recognizes fiscal reform as vital for progress towards true equality of rights and opportunities, and that also recognizes growth as a necessary condition for development and seeks to supplement it with other conditions that are in turn both means and ends of development (high-quality employment, social cohesion and environmental sustainability).

The evidence of the crisis and effective responses to its eventual costs reinforce the importance of the State, of countercyclical policies and of social protection. In the face of financial volatility and the certainty that economic agents cannot solve everything or represent the common interest, we argue for the importance of politics as the supreme sphere of decision-making, the forging of broad consensus and the orientation of development. This is a politics that needs to improve its quality, transparency and effectiveness in response to the challenges of democracy in the twenty-first century, the new post-crisis global scene and the increasing complexity of our society. Fiscal and social covenants enshrined in laws, rules and collective behaviours are vital for the support they can give the policies put forward here in pursuit of the development we desire.



Chapter II

Macroeconomic policy for development: moving on from lessons learned and charting a new course

A. Introduction

The Latin American and Caribbean region has the capacity to achieve greater and better quality growth. The region's economic performance needs not only to be more robust but also to ensure greater levels of inclusion, social equality, productive investment and quality employment, and less exposure to the impact of external volatility.

This is no easy task. Sound policies must be adopted on various fronts, notably at the macroeconomic level. As demonstrated by recent events, which are reviewed in this chapter, this policy is not neutral vis-à-vis economic trends and social inclusion. On the contrary, there is a significant link between its thrust and the sparse and volatile pattern of development in the region, the limited flows of investment in productive enterprises and the scant increase in productivity.

Production and employment have been subject to the sharp cyclical fluctuations of global demand and exchange rates, which are key variables in the macroeconomic environment in which the producers of goods and services operate.

This environment is determined by the interaction between fiscal, monetary, exchange-rate and domestic market and balance-of-payments financial account policies, on the one hand, and external market forces, on the other. In turn, the macroeconomic context has an impact on the pace of economic growth and the distribution of its fruits, which have implications for the labour situation and the strength of social policy.

The current global crisis strengthens the arguments relating to the fundamental role of the style of macroeconomic policymaking and the importance of assessing the shifts that will need to be made in existing practices. A crucial leap forward needs to be made in macroeconomic policy

and the approach to be adopted must explicitly prioritize productive development and level upwards capacities and social opportunities. This will reduce productivity gaps, which should pave the way for a reduction of inequalities. For this to happen, stability must be seen as more than control of inflation; it must be conceived as functional for development, and the over-compartmentalized vision of micro- and macroeconomics must be replaced with a integrated approach that takes into account the interaction of the two.

These interactions have static and dynamic impacts. Among the former is the rate of utilization of available production capacity (both labour and capital), since fluctuations in this rate have frequently left large gaps between installed capacity—or potential GDP— and real GDP. These gaps and the volatility of variables such as the real exchange rate then generate dynamic effects through the multiple impacts of the macroeconomic environment: on the investment rate and how it determines future development, on the intensity of value added generated by exports and the way it interacts with the rest of domestic production; on innovation; on the development of small and medium-sized enterprises (SMEs); and on the formality or precariousness of the labour market. In short, the style of macroeconomic policy has a significant impact on all of these variables —which determine the momentum and quality of development— and is largely responsible for the modest growth in regional GDP in the period 1990-2008: 3.2% per year. To the extent that this lack of dynamism is also associated with a rigid pattern of diffusion of capacities and opportunities, it is also responsible for the enormous productivity gaps that have been reproduced between groups and persons and for the perpetuation of social disparities whose scale gives Latin America and the Caribbean the dubious honour of being the most inequitable geographic region in the world.

Although inflation has, to some extent, been brought under control and greater fiscal discipline has been introduced, steps must be taken to create a more favourable macroeconomic environment for the various agents of economic development, that is, those that generate GDP. Firms, employers and workers have had to cope with considerable instability in aggregate demand, access to credit and real exchange rates, and this has undermined capital formation, employment and productivity. In this regard, financial capital flows have played a central role.

Section B of this chapter reviews the various achievements and shortcomings of the Latin American and Caribbean economies since the early 1990s. On the one hand, it points to the successes in terms of control of inflation, fiscal discipline and export growth. On the other, it shows that GDP growth and productive investment have been insufficient and were hampered by macroeconomic policies that were poorly coordinated with each other and with the business cycle.

Section C examines the reasons for this poor performance. Clearly, outcomes were closely associated with the highly unstable aggregate demand and exchange rates that different agents had to contend with. This instability was due, above all, to recurrent external shocks, which restricted capital flows and, more recently, caused a deterioration in the terms of trade. Such shocks are not usually neutral in terms of the way costs are distributed over time and between different socio-economic groups. It has taken much longer to reverse the social deterioration caused by these shocks than it has for the economy to reverse the declines in per capita GDP. This was the case following the debt crisis of the 1980s. The result is a deterioration in income distribution and heightened social vulnerability.

Section D examines the effects of instability, in particular the generation of recessionary gaps between potential GDP —or the production frontier— and real GDP. As we shall see, these

gaps have an adverse effect on companies' balance sheets and expectations, as well as on employment. Particularly in the last few years, the instability of economic activity has been due mainly to underutilization of the capacity to produce for the domestic market, which now accounts for approximately 80% of regional GDP. This is the portion of GDP that is most dependent on the national macroeconomic performance, which is the subject of this chapter. The chapter then goes on to consider the impacts of frequent recessions, which result in lower rates of productive investment and fewer sources of employment. This not only leads to higher unemployment and, consequently, more widespread poverty, but also greater informality, which reaches very high rates among the economically active population of the countries of the region and accounts for the structural heterogeneity and the reproduction of inequalities. This heterogeneity is addressed in greater detail in chapter III.

Section E presents lessons and policy proposals for a macroeconomic approach to development, based on fiscal, monetary, exchange-rate and capital market policies, including the national financial system and the external financial account. The central message is the need for coordinated management of all these areas of economic policy so that the macroeconomic environment stimulates capital formation, innovation and robust creation of quality jobs.

B. Achievements and shortcomings of macroeconomic reforms since the 1990s

1. Achievements

The Latin American and Caribbean region has been the scene of spiralling inflation with clear episodes of hyperinflation, as in 1990 when the average rate of inflation stood at 1,667%.[1] In many cases, the excessively high inflation was due to huge fiscal disequilibria and the financing of deficits through money creation, which rapidly threw aggregate demand out of balance with production capacity. Hence, many countries in the region exhibited sharp macroeconomic disequilibria based on shortcomings in their internal management. These were compounded by terms-of-trade shocks: with exports limited to just a few resource-based commodities, whose prices were highly volatile, these countries faced sharp fluctuations in the availability of foreign exchange. In the absence of stabilization funds, this instability had a cyclical impact on aggregate demand and the exchange rate.

Macroeconomic instability, caused by short-termist policies and policies formulated in response to contingent pressures, whether economic or political, has tended to generate levels of uncertainty that undermine productive investment and growth (ECLAC, 2008b). One of the usual manifestations of this instability has been the volatility of relative prices associated with steep inflation, which, as demonstrated by experience in the region, tends to shorten hiring and decision-making horizons, hinders channelling of savings towards investment and impairs the quality of the information derived from the pricing system. In short, this volatility makes it well-nigh impossible to evaluate investment projects accurately.

[1] The regional average —taking into account 19 countries— weighted by the population is 1,667%, reflecting inflation of more than 2,000% in Argentina and Brazil and of 7,500% in Peru and Nicaragua. The simple average for the region in 1990 was 1,087%.

Directly related to this instability is the solvency of the public sector, which, as the region's past experience has demonstrated, is a crucial issue. Budgetary constraints experienced by the Government usually manifest themselves as pressures on the monetary authority. The economic policy objectives and modalities for action must be clearly defined in order to limit uncertainties, expand decision-making horizons and coordinate forecasts appropriately. This includes presenting a relatively foreseeable inflation panorama as a public good.

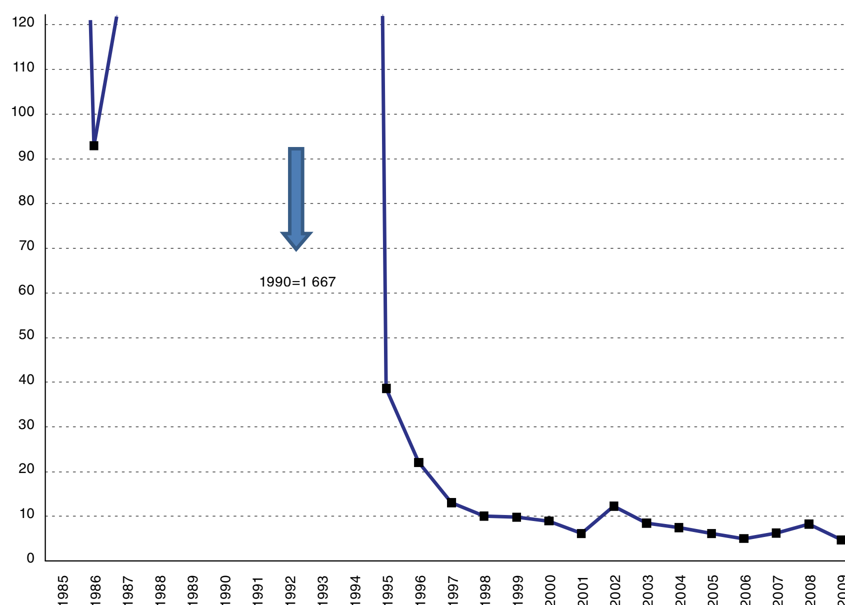
Conscious of the sources of macroeconomic instability, the reformists of the 1990s prioritized fighting inflation and imposing fiscal discipline at the same time as they sought to protect monetary management against pressures and direct it towards the pursuit of moderate, non-volatile inflation. Indeed, monetary policy would often operate independently of the other areas of macroeconomic policy and its sole or priority objective would be to bring inflation under control.

Towards the mid-1990s, the authorities had succeeded in reining in inflation and, since 1997, the annual rate has come down to single digits (see figure II.1).

Figure II.1

LATIN AMERICA (19 COUNTRIES): ANNUAL INFLATION RATES, 1985-2009 [a]

(Percentages, December to December)



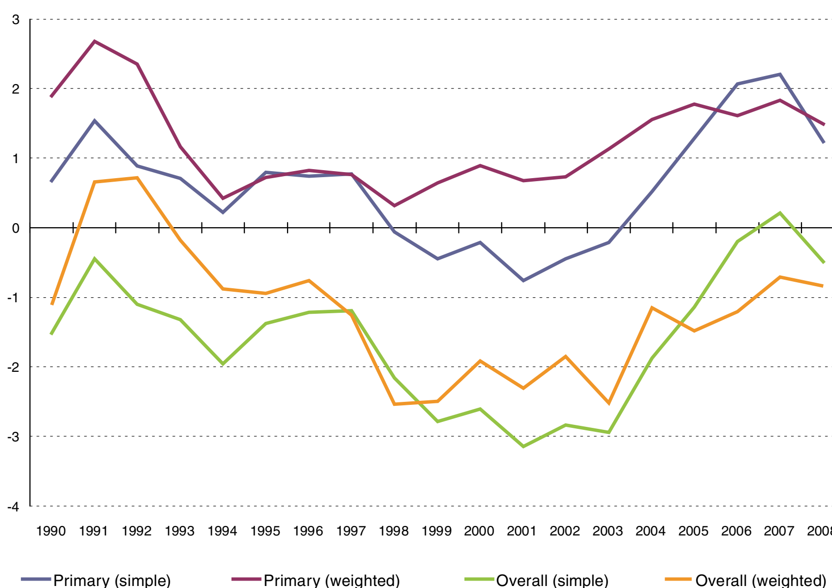
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The figures for 2009 are preliminary.

The control of inflation was associated with variables designed to stabilize price levels and correct market functioning. The substantive improvements in fiscal balances were instrumental in achieving this, especially in economies that had suffered from hyperinflation. Budget management and fiscal savings improved considerably: in the five-year period prior to the contagion caused by the 1998 Asian crisis, the fiscal deficit averaged only 1.5% of GDP —compared with 3.9% in the 1980s— and worsened as a result of the crisis, before returning to more manageable levels and continuing to improve since 2004 (see figure II.2). On average, the region maintained primary

surpluses for several years, which enabled some countries to use the unexpected fiscal revenue associated with rises in export earnings to set up stabilization funds. In turn, expansion of the money supply to finance the public deficit —a frequent cause of hyperinflation in the past— had almost ceased and the deficits, already much diminished, were financed through the financial market.

Figure II.2
LATIN AMERICA (19 COUNTRIES): CENTRAL GOVERNMENT PRIMARY AND OVERALL BALANCE, 1990-2008 [a]
(Simple and weighted averages as percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Simple averages of the 19 countries and averages weighted by real GDP. The coefficient of correlation between the two curves —the primary deficit and the overall deficit— is 67% and 71%, respectively.

Furthermore, since the 1980s, exports have expanded rapidly in volume terms —almost one and a third times as fast as global trade— and, in terms of products and destination markets, have become slightly more diversified, which has allowed a number of countries to build up substantial international reserves.

The proponents of an "orthodox" approach were confident that with these three significant achievements —control of inflation, improved fiscal balance and export promotion— economic growth would pick up spontaneously, while the degree of government intervention in the markets of the region would diminish (Burki and Perry, 1997; IDB, 1997). The strong moves to liberalize imports, domestic financial markets and financial accounts played a strategic role in promoting development in parallel with macroeconomic achievements.

2. Shortcomings from the development perspective

The vast majority of countries in the region complied with the requirements for macroeconomic equilibrium set out in what became known as the Washington Consensus. The results in terms of economic growth and social equity were paltry, however, although the upturn in 2004-2008 did

bring some improvement. Annual growth averaged barely 3.2% in 1990-2008 (see table II.1). Annual per capita GDP growth in this period was a meagre 1.7% in the region, well below the rate recorded in East Asia (4.1%) but the same as in the United States, where per capita income is five times as high as in Latin America and the Caribbean.[2]

The background to these unstable GDP results and their adverse effects are proof that the macroeconomic policy, which targeted the two above-mentioned pillars —low inflation and fiscal discipline— was unsatisfactory in developmental terms. As regards macroeconomic equilibria, the GDP growth rate has fluctuated sharply in most countries of the region, not so much because of sudden structural or microeconomic changes as because of other macroeconomic variables associated primarily with financial capital inflows and outflows, which are reflected in substantial variations in aggregate demand, the exchange rate and expectations or the sentiment of economic agents.

Indeed, the cyclical variations in these inflows and outflows of capital were the macroeconomic variable that contributed most to the recessionary gaps in the period 1990-2009. The resulting instability has a strong regressive impact on social conditions and equity. In this regard, volatility may be said to have had a punitive effect on the most vulnerable sectors and to have distributed costs and benefits in a highly uneven way.

Thus, in 2008, the average real wage barely exceeded the level observed just before the debt crisis in the early 1980s. The slight 0.7% yearly increase in GDP per worker in 1990-2008, as indicated in table II.1, does not seem to be reflected in any substantial rise in wage income, despite an appreciable increase during the period 2003-2008, which simply compensated for the previous declines. Furthermore, wages reflect developments in the formal segment of the labour market only. More serious is the extent of informal employment, which accounts for approximately half of the economically active population in urban areas. This attests to the precariousness of labour markets in the region. The informal sector expands during recessions and is associated with less secure employment conditions and a deterioration in labour income, as seen during the debt crisis and during the 1998-2003 recession (Tokman, 2004). The significant rally in employment and wages between 2003 and 2008 suggested that the average Gini coefficient in the region would decline by around 4%, compared with that of 2002. However, in 2008, before the outbreak of the global crisis, income distribution continued to be highly unequal (ECLAC, 2008a).

These averages include the recovery attained in the boom period following 2003. During the five-year period 2004-2008, GDP grew on average by 5.3% (a rate not seen since the 1970s), unemployment declined by more than three percentage points —from a regional average of 11% in 2003 to 7.4% in 2008— and wages picked up.[3]

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[2] From 1998 to 2008, GDP growth averaged 3.2%, a similar figure to that of the first few years after implementation of the Washington Consensus. In general, it is accepted that reforms require time to take full effect. Notwithstanding the greater maturity of the process during the most recent period, Latin America has not been able to improve on its poor economic or stability record or achieve any substantial improvement in the degree of equity resulting from the functioning of the market.

[3] As the boom was brought to an abrupt halt in 2009 by the global crisis, triggering a fall in production and employment (see table II.1), the present analysis ends in 2008 —when economic activity was at its peak— in order to centre the evaluation and its quantitative data on more structural factors, which reflects more accurately the structural situation up to the start of the crisis.

Table II.1

LATIN AMERICA AND THE CARIBBEAN (19 COUNTRIES): GDP GROWTH, 1971-2009

(Annual rates of variation)

	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Antigua and Barbuda	0.3 [a]	6.8	3.2	3.3	6.7	4.9	4.2	-6.6 [b]
Argentina	2.8	-1.0	5.0	-1.3	8.4	3.0	3.8	0.9
Bahamas	…	…	1.3	2.6	1.6	2.2	1.8	-3.9 [b]
Barbados	3.9 [c]	1.4	0.1	1.2	3.1	2.0	1.2	-3.6 [b]
Belize	5.1 [d]	4.9	2.0	7.3	3.5	5.6	4.1	-0.5 [b]
Bolivia (Plurinational State of)	3.9	-0.3	4.3	2.5	4.8	3.5	3.9	3.5 [b]
Brazil	8.6	2.3	2.0	1.5	4.6	2.9	2.5	-0.2
Chile	2.5	2.8	7.0	2.7	4.8	3.6	5.0	-1.5
Colombia	5.4	3.7	3.9	1.1	5.3	3.0	3.4	0.4
Costa Rica	5.7	2.4	4.7	4.8	5.9	5.3	5.0	-1.2 [b]
Cuba	…	…	-3.3	3.4	8.1	5.6	1.8	1.4
Dominica	…	4.2	3.3	-0.2	4.9	2.1	2.6	-1.5 [b]
Ecuador	9.1	2.1	2.8	2.0	5.4	3.5	3.2	0.4
El Salvador	2.4	-0.9	5.2	2.6	3.3	2.9	3.9	-3.5
Grenada	17.6 [e]	11.3	1.6	5.6	1.8	3.9	2.9	-5.0 [b]
Guatemala	5.7	0.7	4.0	3.5	4.4	3.9	4.0	0.6
Guyana	2.2	-3.1	5.8	0.4	2.6	1.4	3.3	0.9 [b]
Haiti	5.2	-1.0	-0.4	0.8	1.1	0.9	0.4	2.9
Honduras	5.5	2.7	3.3	3.0	5.8	4.3	3.9	-2.1
Jamaica	-0.7	3.1	1.7	1.0	1.2	1.1	1.3	-3.0 [b]
Mexico	6.5	1.4	3.1	2.9	3.5	3.1	3.1	-6.5
Nicaragua	1.0	-1.4	2.4	3.5	4.0	3.7	3.2	-1.5
Panama	5.6	0.9	5.6	3.5	9.2	6.1	5.9	2.4
Paraguay	8.8	3.1	3.2	0.3	4.8	2.3	2.7	-3.5
Peru	3.9	-0.7	3.9	2.0	7.6	4.5	4.3	0.9
Dominican Republic	7.2	3.3	4.5	4.5	7.0	5.6	5.2	3.5
Saint Kitts and Nevis	5.7 [e]	6.3	4.6	2.1	5.1	3.4	3.9	-8.5 [b]
Saint Vincent and the Grenadines	6.4 [f]	6.4	3.4	3.4	5.5	4.4	4.0	-0.2 [b]
Saint Lucia	4.4 [e]	7.4	2.9	1.5	3.8	2.5	2.7	-3.8 [b]
Suriname	2.1 [f]	0.6	-0.5	3.0	4.2	3.5	1.8	2.5 [b]
Trinidad and Tobago	5.3	-2.7	2.9	8.3	6.9	7.7	5.7	-0.5 [b]
Uruguay	2.7	0.4	3.9	-2.1	8.5	2.6	3.1	2.9
Venezuela (Bolivarian Republic of)	1.8	-0.3	3.8	-2.7	10.1	2.9	3.3	-3.3
Latin America (19)	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Total GDP	5.6	1.3	3.3	1.4	5.3	3.2	3.2	-1.8
Per capita GDP	3.0	-0.8	1.5	-0.1	4.0	1.8	1.7	-2.9
GDP per worker	1.7	-1.5	0.6	-1.1	3.1	0.8	0.7	-3.8
Per capita GDP	1971-1980	1981-1989	1990-1997	1998-2003	2004-2008	1998-2008	1990-2008	2009
Latin America (19)	3.0	-0.8	1.5	-0.1	4.0	1.8	1.7	-2.9
Asia (6)	-	5.6	5.8	2.2	3.9	3.0	4.1	-2.0
United States	-	2.4	1.6	2.0	1.4	1.8	1.7	-3.4
World [g]	-	1.6	0.6	2.0	3.3	2.6	2.0	-3.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official data from the respective countries and information from the International Monetary Fund (IMF).

[a] Refers to the average of the growth rates for the period 1974-1980.

[b] The figures for 2009 are the ECLAC estimates as published in the *Preliminary Overview* 2009 (ECLAC, 2009a).

[c] Refers to the average of the growth rates for the period 1975-1980.

[d] Refers to the average of the growth rates for the period 1977-1980.

[e] Refers to the average of the growth rates for the period 1978-1980.

[f] Refers to the average of the growth rates for the period 1976-1980.

[g] Weighted for each country's relative share at market prices.

The limited average growth meant that the gaps in productivity (see chapter III) and per capita GDP between the countries of the region and the developed countries remained very wide. The data presented in figure II.3 show that in 2008, per capita GDP in Latin America was equivalent to just 27% of that of the Group of Seven (G7) countries and 23% of that of the United States. A substantial social gap also persists, since the ratio of the income of the highest to that of the lowest quintile (Q5/Q1) in the countries in the region is well over double the corresponding ratio for the G7 countries (17, compared with 7). When deciles are used for this comparison, for example D10/D1, the gap is even wider (34 compared with 12) given that in the upper brackets, the income distribution curve is more vertical in Latin America and the Caribbean than in the developed countries. The region continues to be highly regressive compared with other world regions (De Ferranti and others, 2003), and this is linked to its production structures. The great structural heterogeneity between firms of different sizes and between workers with different skill levels builds inequalities into the structure of production and the operation of the markets. As described in chapter III, in order to achieve robust growth, steps must be taken to improve the productivity of the middle class and poor sectors, since inequality and poverty are a drain on economic development (Bourguignon and Walton, 2007). Consequently, the challenge that must be addressed is how to treat growth and the reduction of inequality as firmly complementary rather than contradictory objectives.

The extent of GDP growth depends on several factors, chief among them being the investment rate. Capital formation has been low compared with the rate observed in other successful emerging economies and with the rate achieved in the region in the 1970s. Figure II.4 shows that for much of the time when the Washington Consensus held sway, the investment rate was closer to the low level recorded in the lost decade of the 1980s than to the figure observed in the 1970s, when average GDP growth in Latin America was 5.6%.[4] In 1990-2008, the rate stood at 18.4%, compared with 23.5%, the figure observed in the 1970s. The exception was the period 2007-2008, when the investment rate approached, but did not quite reach, the average for the decade of the 1970s.

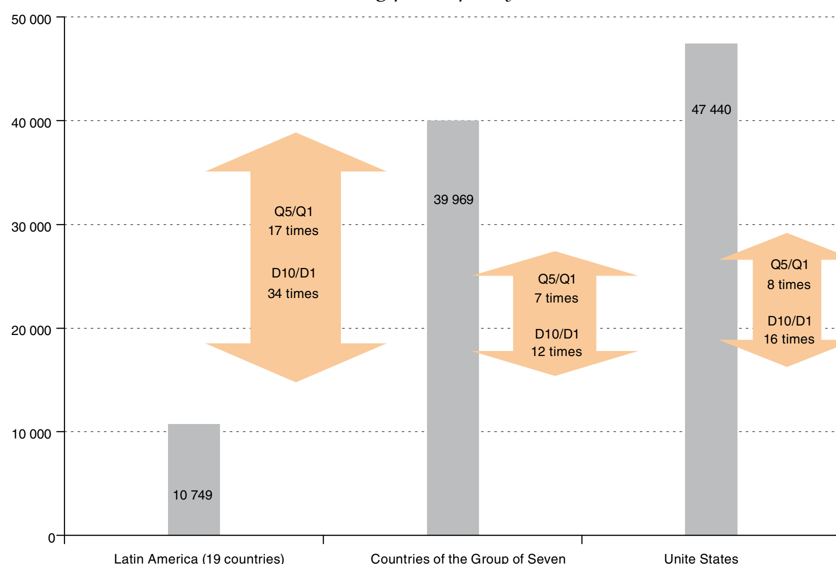
Figure II.4 illustrates clearly the importance of continuous recovery paths and sustainable equilibria in closing the recessionary gap. When economic recovery has lasted longer, the investment rate reaches higher levels and tends to be progressive: following the sustained recovery that started in 2003, the biennium 2007-2008 recorded the highest rates since the 1970s. This continuity is key for providing investors with an effective incentive to retain their investments in the country and for mobilizing the long-term credit required by the productive sector.

The global crisis triggered a two-percentage-point fall in the rate of gross fixed capital formation: from 22% of GDP in 2008 to 20% in 2009 and the challenge is now to achieve higher levels of capital formation than in 1990-2009, since this factor is indispensable for achieving growth with equality. Wage levels and income distribution are closely linked to the level of capital stock per worker as well as to the bargaining power of different social sectors, the quality of education and labour training (see chapters V and VI).[5]

[4] While the Washington Consensus was in force, the investment rate was at its lowest, despite the fact that foreign direct investment (FDI) flows were relatively higher in recent subperiods than in the 1970s. It may be inferred, therefore, that what decreased during that period was national saving and investment (see Ffrench-Davis (2005), table VI.1).

[5] In 2000, capital intensity per worker was US$ 16,000 in Latin America and US$ 111,000 in the United States (Ffrench-Davis, 2005, chapter V).

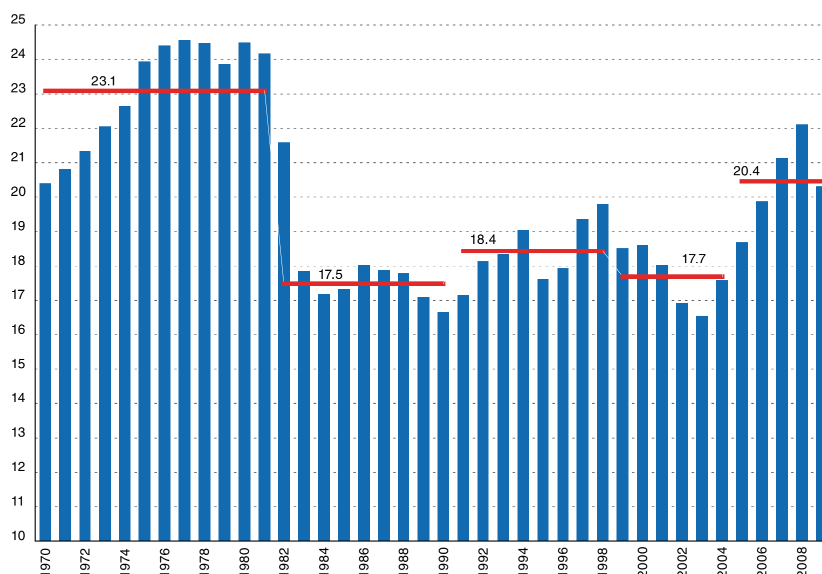
Figure II.3
LATIN AMERICA AND DEVELOPED COUNTRIES: PER CAPITA GDP AND INCOME DISTRIBUTION, 2008 [a]
(Purchasing power parity dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures for Latin American countries; International Monetary Fund (IMF), *World Economic Outlook* [online database] and World Bank, *World Development Indicators*, 2009, for the Group of Seven (G-7) and the United States.

[a] Q5/Q1 and D10/D1 are the ratio of the highest to lowest income quintiles and the highest to lowest income deciles of the population, respectively.

Figure II.4
LATIN AMERICA (19 COUNTRIES): GROSS FIXED CAPITAL FORMATION, 1970-2009 [a]
(Percentages of GDP)



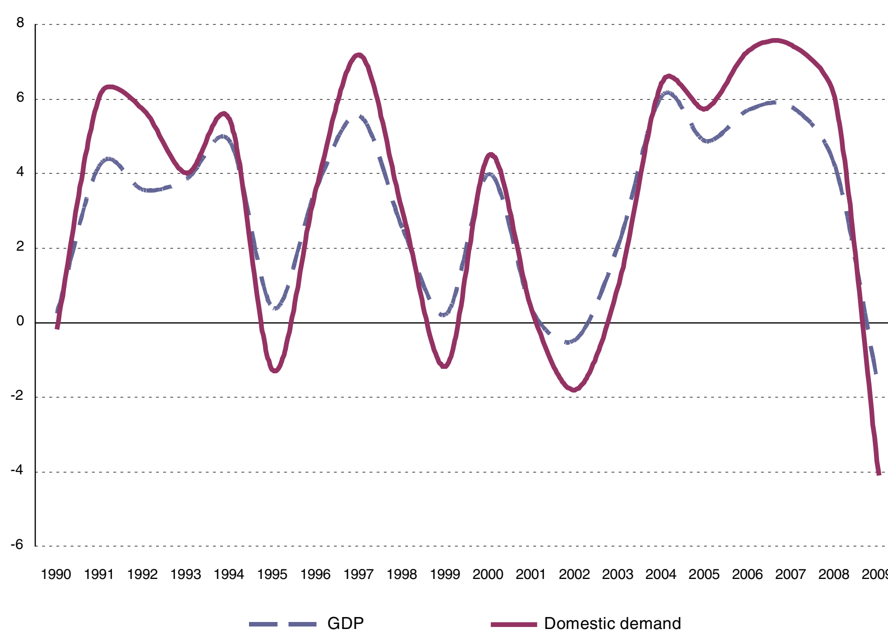
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The figures for 2009 a preliminary. The percentages shown on the horizontal lines are the annual averages for the relevant subperiods.

C. Causes of instability in the real economy

The remarkable success achieved in reining in inflation and improving fiscal responsibility was not sufficient, in itself, to consolidate stability. The performance of the countries of Latin America and the Caribbean gained impetus from a macroeconomic context whose main stakeholders —the State, entrepreneurs, workers and investors— faced considerable fluctuations in aggregate demand, economic activity and macroeconomic prices (ECLAC, 2000, chap. VI; Ffrench-Davis, 2005, chaps. I and II). In this regard, figure II.5 clearly illustrates the wild fluctuations in aggregate demand.

Figure II.5
LATIN AMERICA (19 COUNTRIES): ANNUAL VARIATION IN GDP AND AGGREGATE DEMAND, 1990-2009
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006.

Although economic growth is also influenced by the complex processes relating to micro and meso-economic structures, education, and labour and entrepreneurial training, during this period the volatility and limited growth of production were due, in no small measure, to the macroeconomic situation.

If the economy had been in macroeconomic equilibrium, with no major recessionary gap between real and potential GDP and steadily rising domestic demand —as occurred in 1990-1994, 1996-1997 and 2004-2007— then GDP in the following periods would have been relatively constant, with outbreaks of inflation and a proportional deterioration in the external accounts. On the whole, however, this is not what happened.[6] What did happen was that real GDP increased,

[6] A number of other variables interacted in parallel including currency appreciations, which, naturally, kept prices in check and bias domestic spending towards imports.

which is possible only if there is a gap between potential and real GDP. The conclusion, which has important implications, is that since the 1980s, the Latin American and Caribbean region has remained below the production frontier, with fluctuations that bring it closer to or further from potential GDP. This is tantamount to a serious macroeconomic disequilibrium.

Although fluctuations in aggregate demand in the past were often due to fiscal deficits financed through money creation, generally speaking, it may be stated that more recent variations have been due to external shocks, which have impacted especially the financial account and the terms of trade.

In the years prior to the eruption of the 1995 and 1999 crises, rising current account deficits generally involved surges in net private-sector spending. This was in response to the signals coming from the combination of a strong supply of external financing and lax, procyclical domestic macroeconomic policies (Kaminsky, Reinhart and Vegh, 2004), often lauded by financial markets and risk-rating agencies. The boom in 2004-2008 was associated, however, basically with terms-of-trade gains, but again the private-sector deficit increased. The improvement in terms of trade brought about higher government revenues, with a growing primary fiscal surplus between 2003 and 2007, which enabled Governments to reduce their liabilities and, in some cases, set up stabilization funds. This led the region overall to exhibit a significant surplus in the balance-of-payments current account, which suffered a sharp reversal in 2008-2009 with the outbreak of the global crisis. The pattern in the Caribbean was quite different (see box II.1).

Box II.1

GROWTH OF THE DEFICIT IN THE CARIBBEAN

The unweighted merchandise trade deficit of the Caribbean as a percentage of GDP was 22.3% in the period 1997-2000 and 23.4% in the period 2001-2006. In the case of the Organization of Eastern Caribbean States (OECS), the deficit for these two periods was 34.7% and 35% respectively, reflecting the continued decline in agricultural and manufacturing activity in these economies. In the Caribbean, the current account deficit was 10.7% of GDP in 1997-2000 and 12% in 2001-2006. In the OECS subregion, the percentages were 16.7% and 21.5%, respectively. The situation worsened in the latter period following the rise in food and fuel prices, since these products account for a substantial proportion of the import bill in most Caribbean countries.

In terms of the overall deficit/GDP ratio in the Caribbean, the simple average was 3.6% in 1997-2000 and 3.8% in 2001-2006. In OECS countries, the figures were even higher than the average: 4.1% in the first period and 4.3% in the second. The political responses to these deficits were varied and most spending cuts were made in the capital budget. A few countries had, for various reasons, seen an improvement in their fiscal position. The most notable of these exceptions was Trinidad and Tobago, which saw its surplus grow, but this was due to the increase in oil and gas revenues. Belize, Guyana and Suriname also experienced an improvement in their fiscal accounts due to buoyant commodity prices.

The difficulties indicated suggest the need to expand the fiscal space necessary for pursuing productive development strategies. With inflows of official development assistance (ODA) on the decline and with global demand for these economies' leading exports settling at more moderate levels, the prospects for robust growth in the short term are slim. A period of careful restructuring is needed in order to start to change production and boost corporate efficiency with a view to competing at the regional and international levels.

Source: ECLAC subregional headquarters for the Caribbean, on the basis of official figures and information provided by the World Bank and the International Monetary Fund.

As may be expected, following crises and the sudden drying up of financial flows, the recessionary impact adversely affects fiscal revenues. The larger fiscal deficit in the years following crisis periods is clearly one of the consequences of a crisis, and not one of the causes. What is more, deficits help to moderate the intensity of recessions, as was evident in the global context of 2008-2009. Fiscal policy acted countercyclically in this situation.

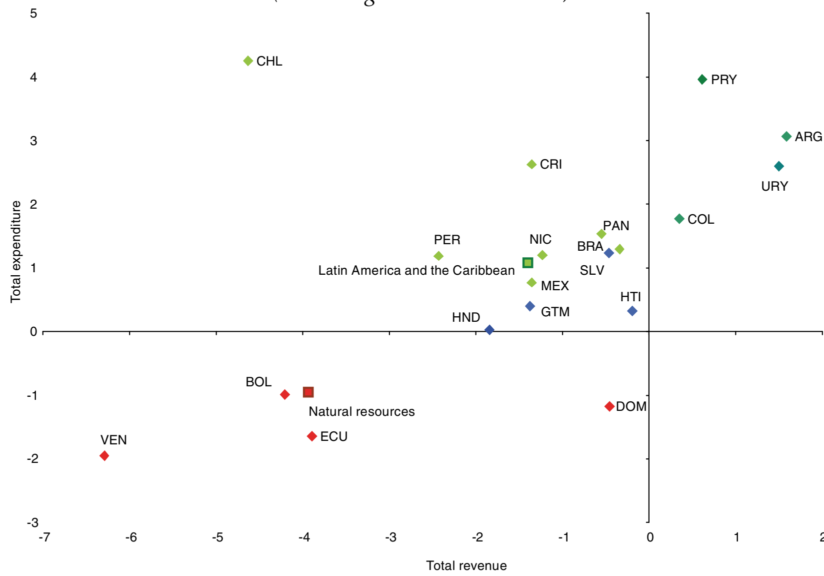
This widespread deterioration in public accounts was the result of differentiated performances in the countries of the region. The upper left quadrant of figure II.6 shows that most countries experienced a fall in their income and increased their expenditure. Only three —Argentina, Colombia and Uruguay— recorded increases in both income and expenditure, while four showed a decline in both categories —Bolivarian Republic of Venezuela, Dominican Republic, Ecuador and the Plurinational State of Bolivia— of which three derive most of their fiscal revenues from natural resources. As was to be expected, in this case, the "empty box" is the quadrant where revenues rise and expenditures fall.

Given the mixed performance of the financial account in the recent era of financial globalization, a distinction must be made between the behaviours and effects of its different components. New foreign investment and long-term loans associated with capital goods imports have been relatively stable during the cycle and are inextricably linked to production investment. The same has often occurred with credits from official regional multilateral agencies, such as the Andean Development Corporation and the Latin American Reserve Fund (FLAR), and from some developed countries; in many cases, these loans compensated partially —with a countercyclical effect— for the absence of private funds during recessions.[7] Conversely, net financial flows have been highly procyclical and, as a result of these very fluctuations, have seldom been used to finance gross fixed capital formation (Uthoff and Titelman, 1998). Indeed, instead of stabilizing the macroeconomy, the region’s inward and outward financial flows have destabilized it. Figure II.7 illustrates the external shocks sustained by the region and shows the fluctuations in the terms of trade and capital flows —net of service payments— as well as their relationship with the way in which aggregate demand has evolved.

In a context in which both supply and demand of capital have been managed by private agents, the volatility of capital flows is the fruit of the interaction between different factors, namely: (i) the nature of the local and foreign agents that handle the financial markets —short-termists by training and incentives; and (ii) a process of procyclical adjustment of the domestic economy, encouraged or permitted by the nature of macroeconomic policies. During the boom periods, the euphoria that pushes up asset prices —and fuels bubbles— results in contagion, which in turn stimulates additional flows of funds, since most influential financial brokers are concerned not with the long-term merits of an investment but rather with its returns in the short term. The procyclical behaviour of the risk-rating agencies deepened the disequilibria by influencing agents’ expectations. It is remarkable that the very risk-rating agencies which were supposed to safeguard sustainability and keep the evaluation of the agents and markets transparent tended to fuel imbalances with their evaluations. In fact, their assessments continued to have an extremely procyclical slant, just as they did when the Asian crisis was looming (Reisen, 2003).

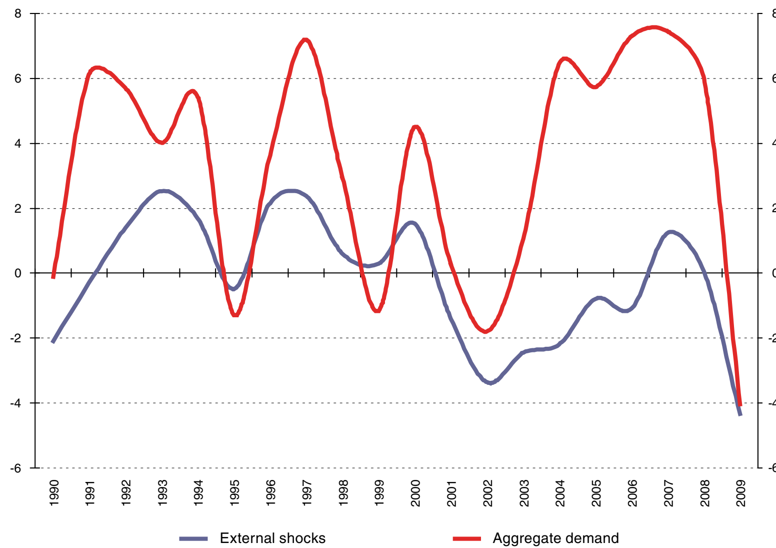
[7] Nevertheless, they have often entailed a procyclical conditionality. Some multilateral financial institutions, such as the International Monetary Fund, have contributed compensatory credits, which play a countercyclical role by easing liquidity restrictions, but they have frequently been subject to the application of procyclical policies, which has delayed the recovery in economic activity and increased social costs (CDP, 2009).

Figure II.6
LATIN AMERICA AND THE CARIBBEAN: FISCAL REVENUES AND EXPENDITURES, 2008-2009
(Percentage variation in GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

Figure II.7
LATIN AMERICA (19 COUNTRIES): EXTERNAL SHOCKS AND GROWTH IN AGGREGATE DEMAND, 1990-2009 [a]
(Annual variation as a percentage of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006.

[a] External shocks are net transfers of resources from abroad plus the terms of trade effect, both measured as percentages of GDP. Net transfers of resources are calculated as net capital flows (including errors and omissions) less net income balance (net factor payments) plus net current transfers, but excluding workers remittances from abroad.

Thus, it is the market itself which provides incentives for emerging economies to venture further into vulnerable territory during boom periods, as it stimulates macroeconomic variables (external liabilities and liquid components, current account deficits, real exchange rates, stock-exchange indices and real-estate prices, among others) to deviate from sustainable levels. The longer and deeper the economy's incursion into this territory, the greater the probability of its entering a crisis and the more serious that crisis will be.

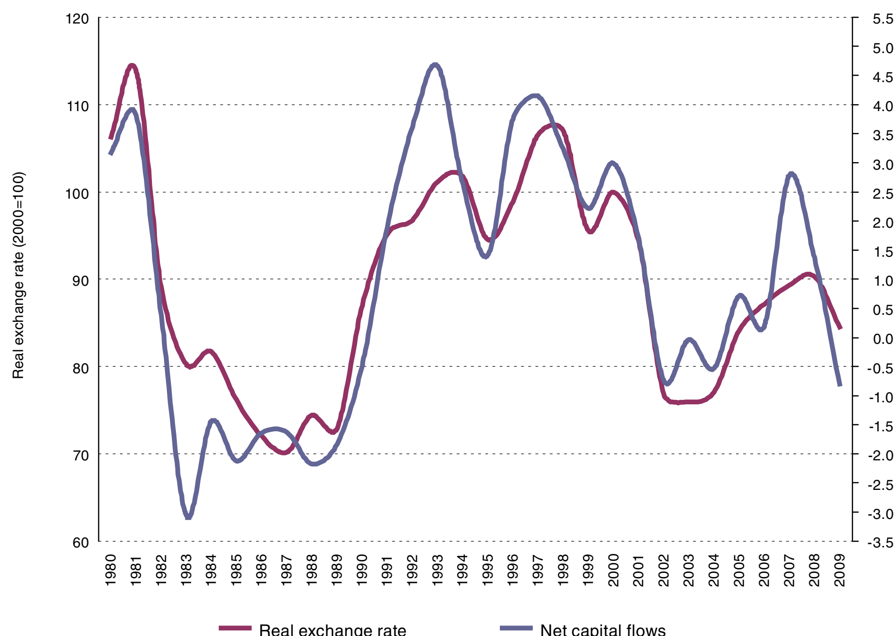
This underscores the need to implement effective regulations to ensure that capital flows boost productive investment and are consistent with a sustainable macroeconomic environment. The composition and volume of financial flows and their deviations from the trend are crucial variables for defining the level and pattern of growth and income distribution, as analysed in the following section.

In addition, in a market economy —the environment in which the region operates— relative prices are among the variables that most influence the decisions of economic agents. Aspiring to achieve an efficient market economy in a developing economy while ignoring such strategic macroeconomic prices as the real exchange rate amounts to a serious contradiction. In the region's experience, the real exchange rate —a fundamental macroeconomic prices when it comes to making decisions relating to production and spending on tradable goods— behaves in an extremely procyclical manner. Its evolution has been strongly correlated with capital flows, which, as already mentioned, are subject to cyclical variations. Figure II.8 shows the marked correlation between the real exchange rate and net capital flows for Latin America in average terms in the years dominated by the Washington Consensus. The procyclical behaviour of these flows is transmitted to the real exchange rate insofar as a boom has often caused sharp currency appreciations, which have repeatedly led to current account disequilibria through over- or undershooting in times of crisis. As shown in section D, this introduces a serious inefficiency through the impact of the real exchange rate on the quality of exports and the production of SMEs geared to the domestic market.

The fluctuations in aggregate demand and its composition and the evolution of the exchange rate have been overdependent on the capital account. The transmission of their procyclical impact to national economies is detrimental to productive development and equity. In order to advance towards sustained development, it is essential to control the transmission of globalized financial volatility. In responsible economies —and the countries of Latin America and the Caribbean have proved to be just that— a completely open capital account, instead of imposing macroeconomic discipline, has been a source of widespread macroeconomic imbalances which have been reproduced throughout the region in recent decades.[8]

[8] See Prasad and others (2003); Singh (2006); and Tytell and Wei (2004).

Figure II.8
LATIN AMERICA (19 COUNTRIES): NET CAPITAL FLOWS AND REAL EXCHANGE RATE, 1980-2009 [a]
(Flows as a percentage of GDP; real exchange rate: index: 2000=100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] The net capital flow includes net foreign direct investment, net portfolio investment flows and other investments (including errors and omissions). The exchange rate is defined as the amount of dollars per local currency and is the average for the region (19 countries) weighted by real GDP, that is, an overall increase represents an appreciation in the region's currencies. The data for 2009 are provisional.

D. Effects on growth and equity

One of the fundamental macroeconomic balances is related to the production capacity utilization rate. In economies with imperfect and incomplete markets—as those in the region tend to be—shocks lead to adjustments in prices and in the quantity of goods produced and traded, which add to the effects of the structural heterogeneity characteristic of these economies. Over time, the result is greater disparity between supply and aggregate demand, with the attendant gap between potential production capacity and the actual capacity used, particularly in the stop phases that follow the go phases. In some sectors, demand is paired with full capacity utilization, while in others it is subject to a marked deficiency. In stop-and-go conditions, unstable aggregate demand inevitably gives rise to an average net utilization rate that is lower than production capacity and real productivity that falls short of the production frontier, in comparison with a situation of stable proximity. Of course, greater instability leads to a wider negative output gap and a weaker labour market with higher levels of informality.

The link between real macroeconomic instability and inequality lies in the broad structural heterogeneity that characterizes developing economies. This heterogeneity refers to the varied capacity to act and react of the typical agents in the different markets —for example, large and small entrepreneurs, high- and low-skilled workers, productive investors or investors that

generate GDP, financial investors or asset-buyers, productive investors and consumers— and the asymmetries between their responses to unstable economic activity and macroeconomic prices. In periods of expansion —as opposed to a relatively stable trend— the elimination of liquidity constraints tends to manifest itself more rapidly among consumers than among productive investors, given the weakness of the long-term segments of the capital markets. Similarly, consumers are able to react more quickly than productive investors because investors must identify, design and develop new projects, which is a slow process. Given the irreversibility of investments, in a given moment, long-term investors have to believe that favourable prospects will be sustainable over time, which these agents seem to consider to be an essential condition for making new investments.

After a considerable increase in the level of informality in the 1980s due to the debt crisis, job creation between 1990 and 2002 was centred once more in the low-productivity sectors, which, based on the simple average of 13 countries, increased their participation in urban employment from 47.2% to 50.8% (see chapter V). As emphasized in chapter III, when growth began to accelerate in 2003, this trend reversed and most new jobs were created in the medium- and high-productivity sectors.

Latin America and the Caribbean have experienced volatile business cycles, with sharp and asymmetric contractions and expansions. Inasmuch as the production frontier imposes a limit on the recovery of real GDP, in a recessionary setting, real GDP can remain far below potential GDP for long periods of time. Naturally, real GDP can rise faster than potential GDP, but still remain below it. As long as the gap between the two levels—known as the recessionary gap—persists, so too will the depressive effects on productive investment, the labour market, and the situation of SMEs and the informal sector. Thus, it is important to orient macroeconomic policy to respond to the challenge of establishing greater convergence between the diverse sectors of production and employment, a key topic covered in the next chapter.

Accordingly, real instability is asymmetric and inevitably entails underutilization of productive potential and less real production. In fact, recovery increases the flow of production today to the maximum use of existing capacity, but production that did not occur yesterday cannot be recovered. The size of the gap between real demand and the production frontier has significant static and dynamic effects.

First, it affects the productivity and profitability of projects. Second, higher capital utilization rates tend to mean that the average level of employment is higher and the workforce is paired with a larger stock of physical capital in use. The resulting increase in productivity means that the well-being of the workers and the investors (wages and earnings) can increase immediately, by virtue of the higher average capacity utilization rate. Meanwhile, if wages and earnings rise, so too will fiscal revenues. Thus, workers, entrepreneurs and the government will be able to sustain an increase in consumption and investment, with a net positive impact on general economic well-being. Typically, poverty falls in these situations and income distribution is more likely to improve in the wake of the recovery. The boost to GDP stimulates investment and the growth of potential GDP. Thus, the sign of distributive impact depends on the micro- and meso-economic reforms that accompany the recovery. Growth per se can be progressive or regressive: the former tends to be sustainable and the latter reversible (Bourguignon and Walton, 2007).

With respect to the dynamic effects, the degree of stability has various effects on the construction of the future. The higher utilization rates and the resulting increase in average real

productivity will tend to stimulate investment in new capacity. In order for an increase in investment to materialize, investors must perceive a real improvement in the short term and be confident that the reduction in the recessionary output gap will endure.

The dynamic effect will be much more significant if solid expectations are generated among economic actors in the sense that public policies will maintain real demand near the production frontier and if, in addition, the authorities pursue reforms to complete the long-term capital markets and improve workforce training and productive innovation. Productivity gains are closely tied to greater productive investment in its various forms, given that it entails the introduction of technological improvements (De Long and Summers, 1991).

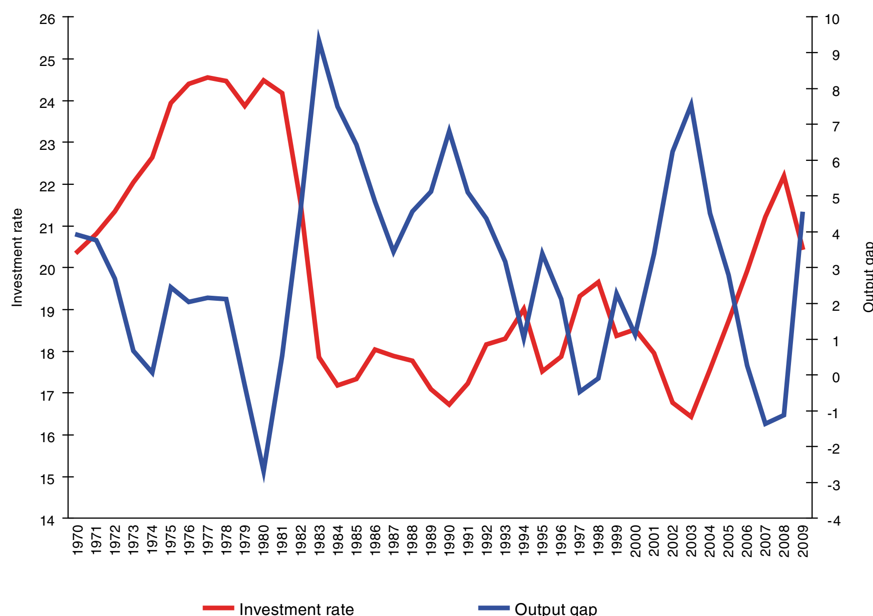
Figure II.9 shows the close association that has existed between the output gap—the recessionary gap—and the fixed capital investment rate in Latin America and the Caribbean; this relationship reflects one of the principal negative dynamic effects: the underutilization of production factors. There are various reasons for this relationship (Ffrench-Davis, 2005, chapter II): (i) where there is considerable idle capacity, there will be fewer incentives to invest in new production facilities; (ii) a volatile environment deters irreversible investment; (iii) underutilization means less earnings and a scarcity of own funds, which also tends to be associated with a reluctance in the capital market to finance firms with lack of liquidity in recessionary situations; (iv) the recessionary gap and its fluctuations tend to diminish the quality of project evaluation and innovation in production, and (v) intense recessionary fluctuations tend to depress public revenue, which leads to cuts in the public investment that rounds out private investment (Easterly and Servén, 2003). Thus, the capital formation rate has fluctuated as a function of the business cycles with much greater intensity than in response to the micro and meso-economic reforms introduced in the region to raise productivity and reduce structural heterogeneity.

Therefore, there is a clear connection between real volatility and long-term economic growth, which affects real total factor productivity, the volume of fixed capital investment, and structural total factor productivity (Ffrench-Davis, 2005).

In short, when conditions are unstable, the GDP level, productivity, the investment rate and employment and its degree of formality —all adversely affected by the recessionary gap— will be lower than in a context of greater real macroeconomic stability.

As regards the exchange rate, instability in the real exchange rate, associated with financial capital flows, has been detrimental to the performance of exports, their diversification and their degree of integration into the national economies (Agosin, 2007). Such widely fluctuating rates do not reflect changes in the levels of equilibrium, since these respond to changes in relative productivity levels between the countries of Latin America and the Caribbean and their trading partners, and to a level of net capital inflows in sustainable and efficiently absorbable volumes. These structural variables tend to experience gradual, not sudden, changes. Therefore, the fluctuations in the real exchange rate of many countries have generally reflected mismatches caused by volatile capital flows that distort project evaluations used for allocating resources, encourage speculative investment over productive investment, artificially relocate the domestic production of importable goods (many of which are produced by SMEs), discourage value-adding to traditional exports and help incentivize dollarization.

Figure II.9
LATIN AMERICA (19 COUNTRIES): OUTPUT GAP AND GROSS INVESTMENT RATE, 1970-2009 [a]
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures, R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and A. Hofman and H. Tapia, "Potential output in Latin America: a standard approach for the 1950-2002 period", *Estudios estadísticos y prospectivos series*, No. 25 (LC/L.2042-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), December 2003. United Nations publication, Sales No. E.03.II.G.205.

[a] Includes Argentina, the Bolivarian Republic of Venezuela , Brazil, Chile, Colombia, Costa Rica, Mexico, Peru, and the Plurinational State of Bolivia. The investment rate measures the ratio between gross fixed capital formation and actual GDP, while the output gap measures the difference between real GDP and potential GDP as a percentage of the latter.

Naturally, cyclical fluctuations in the real exchange rate act as a disincentive to acquiring new comparative advantages and adding value to traditional commodity exports. This failure of the exchange-rate policy places a heavy burden on a development strategy driven by exports, especially non-traditional exports and exports with high value added. If exports are not integrated into the national economy, do not transmit externalities, do not have value added and are produced with no input from SMEs, how can they become an efficient engine of economic growth? Managing exchange-rate policy is a key component of the variables required for that to happen (Rodrik, 2008; Williamson, 2000).[9]

In addition, due to the exchange-rate appreciation, especially after the significant liberalization of imports in the region (ECLAC, 1998a, chapter V), in each of the boom periods, the recovery of aggregate demand—both on the part of individuals and firms—became increasingly

[9] One effect that has at times tempted the authorities and analysts to defend and promote exchange-rate devaluations has been their downward impact on the prices of tradable goods. In several cases, success in lowering inflation has been associated with destabilizing revaluations of the exchange rate in an exchange-rate anchor regime. In fact, the vast majority of countries in Latin America revalued their currencies in real terms between 1990 and 1994, between 1995 and 1997, and in the boom period that began in late 2003. Access to external financing spurred the successive real revaluations.

import-intensive. Along with the positive increase in imports of capital goods, sharp increases in other imports have occurred, many of which competed with the savings rate and production by local SMEs. As a result, not only the level but also the quality of exports was affected. Thus, appreciation has a pronounced procyclical effect on the external sector and causes internal reverberations in the productive sectors that compete with imports.

Instability also tends to be asymmetric in terms of distribution because the sectors with higher income and access to markets take better advantage of the opportunities that arise during periods of expansion. Also, these sectors adjust more rapidly in periods of contraction, which leads to a widening of the gap between large companies and SMEs and an expansion of the informal sectors during recessions. The available data indicate that income distribution tends to deteriorate in recessions and to improve—although less significantly—in times of recovery.[10] The labour market is adversely affected because instability has a disincentivizing effect on investment and less-skilled workers are often discriminated against in times of rising unemployment. As noted, instability tends to increase the level of informality in the labour market. The more incomplete the financial markets and the lower the capital formation rate, the greater the likelihood that regressive effects will predominate.

The regressive impact on the labour market is also associated with the sectors most affected by cyclical adjustments. Table II.2 shows that most of the adjustment in GDP growth observed in 1990-1997 and 1998-2003 may be attributed to production for the domestic market, i.e., non-export GDP.[11] This reflects two facts, one at the microeconomic level and the other at the macroeconomic level. The first shows how difficult it is to reallocate resources from the production of non-tradable goods to exportable goods and import substitutes. In this regard, reallocation policies have been weakened by liberalization processes in the region's countries and institutional changes in international trade (Rodrik, 2001). As a result, the available instrument —the exchange rate— assumes considerable and greater importance. Declining to regulate it, i.e., allowing it to float without any intervention from the economic authority, is profoundly contradictory to an export-driven development strategy.[12]

The second point is macroeconomic in scope. Table II.2 shows that nearly 95% of the decline in GDP between the two periods of comparison occurred in the domestic economy.[13] As this depends on the local macroeconomy and exports depend more on the global macroeconomy, the data indicate that real instability has been more strongly localized in the domestic markets. In the countries of Latin America and the Caribbean, this relationship depends crucially on the quality of macroeconomic policy. The way in which it has been managed has been very procyclical and has exacerbated, instead of mitigating, the transmission of external trade and financial shocks.

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[10] For example, with the debt crisis, it took 14 years for per capita GDP to recover to pre-crisis levels (1980-1994), and 25 years—from 1980 to 2005—for the poverty rate to return to the original level (ECLAC, 2009c).

[11] As exports grew, so too did the share of gross exports in GDP, from 12% in 1990 to 23% in 2008 (from approximately 11% to 18% taking into account exports net of their imported content. Evidently, although the share of non-export production has been declining appreciably, it still accounts for most of GDP.

[12] In the region, there are economies that are strongly export-driven, such as Chile's. However, this is not the case in Brazil, where the relative weight of the domestic market is very strong.

[13] In order to achieve robust growth, non-export GDP must also undergo a rapid expansion. This is what happened in the emerging economies that had a successful export-driven productive development model, such as the Republic of Korea's, over several decades, and Chile's from 1990 to 1998, when annual non-export GDP growth was around 6.5%. Conversely, in Latin America, annual non-export GDP growth was just 2.7% in the period 1990-2008 (see table II.2).

Table II.2

LATIN AMERICA (19 COUNTRIES) AND THE WORLD: ANNUAL VARIATION IN GDP, EXPORTS AND NON-EXPORT GDP, 1990-2008

(Percentages)

	Latin America (19 countries)			World	
	GDP	Exports	Non-export GDP	GDP	Exports
1990-1997	3.3	8.3	2.7	2.9	6.2
		(0.9)[a]	(2.4)		
1998-2003	1.4	5.1	0.8	3.3	4.9
		(0.7)	(0.7)		
2004-2008	5.3	7.1	5.0	4.5	6.5
		(0.8)	(4.5)		
1990-2008	3.2	6.9	2.7	3.4	5.9
		(0.8)	(2.4)		

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of R. Ffrench-Davis, *Reforming Latin America's Economies: After Market Fundamentalism*, New York, Palgrave Macmillan, 2006, and data from the International Monetary Fund (IMF) and the World Trade Organization (WTO).

[a] The figures in parentheses denote the contributions to total growth of the economy of exports and non-export GDP, respectively. The value added of exports was estimated as gross exports of goods and services minus their imported content, which was considered equivalent to the share of imported and intermediate capital goods in total GDP. In the case of Mexico's maquila industry, real value added data were used.

A premature, indiscriminate and poorly sequenced liberalization of the capital account and the national financial markets has become a source of costly destabilizing shocks. As documented, the high costs created by the economic cycles in the countries of Latin America and the Caribbean are related to the close ties between the domestic financial markets and the procyclical segments of the global financial markets. At the same time, the more the flows fluctuate, the less likely they are to be allocated to finance capital formation (Uthoff and Titelman, 1998), and indeed, given the extent to which they have fluctuated, only a very small percentage of the flows was used to finance productive investments.

As liberalization has been pursued, financial savings have spiked without an increase in domestic savings, with a very low rate of gross fixed capital formation and intense volatility in the economy and employment (see section 4 of chapter IV). The main cause is a financial market dominated by agents specialized in the short term and not in productive investment. The financial agents with the greatest influence on cyclical fluctuations, which are not closely tied to productive investment, have played a key macroeconomic role. This weakness is exacerbated by the fact that their volatility has led to financial and exchange-rate crises, whose recessionary effects have discouraged the formation of domestic capital and employment.

E. The challenges of a macroeconomy for development

The objectives of comprehensive stability—including the level of prices, macroeconomic prices and aggregate demand consistent with potential GDP—are a prerequisite for locking in progress, correcting failures and accelerating progress towards development. As demonstrated, these are effective signs necessary for achieving economic growth, they play a role in combating poverty and they facilitate efforts to achieve sustainable equity.

The lack of overall stability has been closely tied to capital flows and their volatility. Volatile procyclical flows are part of the external funds that comprise the external savings needed, in addition to domestic savings, to finance a substantial increase in the investment rate. Accordingly, there is no valid "all or nothing" option. Consequently, a fundamental objective of macroeconomic policies and national financial market reforms should be to take advantage of the potential benefits of external savings for national productive development. These benefits should be utilized, above all, to supplement domestic savings, while reducing the intensity of financial-account cycles and their negative effects on domestic economic and social variables.

It is essential to formulate a coherent set of countercyclical fiscal, monetary, exchange-rate, domestic financial market and financial-account policies, accompanied by an effort to establish robust long-term segments and a stronger development banking system to complement capital markets.

1. Countercyclical fiscal policy

The global financial crisis has pointed up the central importance of fiscal policy as a tool for macroeconomic stabilization. Most industrialized countries have attempted to contain the crisis by means of a monetary policy with near-zero interest rates and comprehensive fiscal stimulus packages (Freedman and others, 2009) which combine infrastructure spending increases and specific measures to fight unemployment and lower taxes.

In 2009, most countries experienced severe recessions, which they tried to counteract with high fiscal deficits —generated by automatic stabilizers— or discretionary packages.[14] The few countries with positive growth rates —notably China, Egypt, India and Pakistan— also had high fiscal imbalances. As a result, the recent global crisis has led to a growing consensus on the importance of automatic stabilizers and the intensive use of budgetary instruments. The use of temporary fiscal deficits in periods of steep decline in private demand has been legitimized as an indispensable macroeconomic stabilization tool (Krugman, 2009).

However, once the emergency has ended, the post-crisis exit strategies should include, inter alia, fiscal responsibility and public debt sustainability targets consistent with the public investment and social policies required to accelerate progress towards sustainable development. Understood as such, fiscal responsibility is vulnerable to economic and social trends, national contingencies relating to governance and political commitments. In order to maintain solvency over the medium term, reaffirm the credibility of fiscal policy and prevent a pernicious trend towards excessive discretion, many analysts propose various alternatives, such as establishing numerical rules and creating independent fiscal councils.

Recent experience demonstrates that it is not possible to formulate rigid rules independent of the business cycle. Under normal circumstances, ECLAC (1998b) has recommended, as a guiding principle of fiscal policy, the use of a structural indicator of the public balance instead of the real balance. The creation of funds aimed at stabilizing fiscal revenue from exports, whose prices are characterized by instability, is part of an approach of this nature. In fact, a considerable

[14] The importance of automatic stabilizers depends on many factors, such as the weight of the public sector in the economy, the progressiveness of the tax system, the mechanisms for public employment and unemployment subsidies, and the sensitivity of unemployment and tax evasion to variations in GDP. These structural characteristics vary considerably by country and over time.

percentage of fiscal receipts comes from income associated with commodity exports, such as copper, oil, gas, sugar, coffee and soybeans. In order to moderate the elevated volatility that this reliance imposes on public finances, several countries have created stabilization funds. It should be noted that when well run, these funds are able to help stabilize normal fiscal expenditures, contribute financing in crisis situations such as the present one and stabilize the foreign exchange market by regulating the supply of foreign currency. For this, full coordination between the fiscal authority and the exchange-rate authority, which tend to reside with different institutions, is essential. Inadequate coordination can impede the alignment of the macroeconomic environment with sustained development, leading to an imbalance between diverse objectives, e.g., inflation, employment, export quality and growth.

Experience has shown that there are exceptional circumstances that warrant more active and discretionary policies. Any macro-fiscal rule should have the objective of achieving structural or public debt balance in the medium term—including the subnational governments—and exception and provisional clauses when there are significant macroeconomic fluctuations. Although fiscal rules are not a panacea that guarantees credibility and fiscal solvency, if enough flexibility is built in, they can become a powerful countercyclical tool.

Mechanisms must be developed at the level of the legislature, specialized agencies and citizen organizations to institutionalize countercyclical fiscal policies as a counterweight to potential fiscal discretionary excesses during boom periods. Optimal fiscal balance and public debt levels are not constant. Fiscal sustainability—measured, for example, as the stability over time of the ratio of public debt to GDP—depends on the differential between the rate of economic growth and the real interest rate at which the public sector borrows. For example, if the interest rate rises and growth is slow, the sustainability of fiscal policy is immediately impaired. As a result, the optimal public debt level will depend on the pace of growth and financing terms and conditions, which are largely subject to the credibility of domestic policies and progress in creating a new international financial architecture which will give low- and middle-income countries access to stable financing without recessive conditions.

It is also important to set a public debt target in the medium term, especially in the countries of Latin America and the Caribbean, which have enormous infrastructure gaps and urgent needs for greater physical and human capital. In recent decades, fiscal adjustments have severely dampened public investment, so establishing mechanisms to stimulate gross fixed capital formation in public goods will be key. One alternative is to keep separate budgets for current expenditures and investments, since in accrual basis accounting, investments are not a liability but rather an asset. Clearly, forging an economy based on infrastructure investment and productive development requires avoiding the traditional bias against public investment in the general government budgets.[15]

In any case, in Latin America and the Caribbean, the social evaluation of projects must be improved and national public investment systems must be strengthened institutionally. This is a key factor in promoting greater public investment, enhancing its complementarity with the private sector, raising productivity, and helping to improve the quality of the labour environment.

15 See the case of Latin America in Blanchard and Giavazzi (2004), Easterly and Servén (2003), Martner and Tromben (2005) and Lucioni (2004).

In a context of tight borrowing constraints, the public sector's social spending capacity must be maintained or strengthened. In Latin America and the Caribbean, the countercyclical strategy should focus on investments to support employment and on mitigation of the social costs of the crisis. From an equitable growth perspective, programme design must include an analysis of the programme's contribution to the acceleration of productive development and to the employability of the labour force in decent work.[16] The events that have taken place in the region clearly show that economic figures recover more rapidly than poverty and inequality indicators.

Significant and sustainable improvements in poverty reduction and income distribution in Latin America and the Caribbean will not be made without active fiscal policies that boost the quality and distributive potential of the markets. The transitory coexistence of budgetary imbalances and macroeconomic stabilization is part of a medium-term strategy keyed to the performance of social indicators and productive development and which in its decisions assigns greater weight to the targets related to structural balance than to the actual public balance.

Lastly, it is not only the composition of expenditure, but also its level and financing that is a key factor in the distribution of income and opportunities throughout society. Accordingly, there can be no further delay in establishing fiscal covenants that identify the magnitude of society's contribution to the financing of public policies and that determine how it will be collected, whether for investment or social expenditure (see chapter VII). In most countries in Latin America, it is clear that the present tax burden is insufficient and the tax structure is inadequate for modernizing the productive structures and achieving greater social equality. In this regard, there is no single formula that will work for every country. In a few countries, it may be that the tax burden should be raised, whether through new taxes or more efficient collection and a more decisive effort to combat tax evasion. In others, the priority may be to improve the quality of expenditure, both in terms of allocation and efficacy, with the goal of chipping away at the inequality of social and economic structures.

Strengthening the countercyclical role of fiscal policy is necessary, but it is not enough, given that fiscal expenditure in the region's countries is a small fraction of aggregate demand. Therefore, little progress will be made if the other policies depend on volatile flows and the opinions of procyclical agents. It is absolutely critical to ensure coordination of the various macroeconomic policies —fiscal, monetary, exchange-rate, and financial account policies— which will be addressed in the following sections.

2. Monetary policy

Domestic macroeconomic policies should attempt to create an environment of reduced real volatility, sustainable external and fiscal accounts and stable prices. This task is complex, since national authorities lost considerable latitude as a result of the liberalizing reforms of recent decades. So, although much fewer of the imbalances were of fiscal origin, the transmission to the national markets of externally generated cycles, especially those caused by the global financial markets, has been exacerbated.

[16] This concept was originally coined in the *Report of the Director-General: Decent Work*, at the eighty-seventh session of the International Labour Conference, held by the International Labour Organization (ILO) in 1999, in which decent work is defined as productive work in conditions of freedom, equity, security and human dignity, in which rights are protected and which generates an adequate income and adequate social protection. This definition subsequently incorporated the promotion of social dialogue and later came to address job quality.

In order to create more leeway for monetary policy and implement it in conjunction with exchange-rate policy, the capital account should be regulated. The principal variables of monetary policy are the interest rate and liquidity regulation. Experiences with financial liberalization have demonstrated that liberalized interest rates tend to be unstable and much higher than international rates, with much wider spreads over long periods of time (ECLAC, 1998a, chapter IX; Ffrench-Davis, 2008a, chapter IV; Stallings and Studart, 2005). From a macroeconomic sustainability perspective, it is significant that the spreads have been procyclical. The actual fact is that productive investments have been subject to considerable macroeconomic instability, with wide recessionary gaps in a very incomplete market, where investors have faced high, unstable average interest rates, particularly in the case of small firms.17 This had the effect of dampening investment and weakening employment and equity.

In Latin America, monetary policy has increasingly adopted inflation targets, that is, a single anchor approach where the explicit announcement of an inflation target is the monetary anchor of the economy. In general, this trend has been accompanied by freely floating exchange-rate regimes and financial-account deregulation. This new mix of policies imposes significant limitations on, or obstacles to, the countercyclical policies of the economic authorities.

In small open economies, such as those of most countries in Latin America and the Caribbean, the inflation targeting system has highly procyclical features for the real economy, especially in comparison with global financial markets. Given the important role of capital flows in driving the business cycles of emerging economies, the break points in periods of prosperity tend to be characterized by strong expectations of depreciation and a downward trend in aggregate demand and output, followed by expectations of appreciation and recovery after touching bottom in the lower part of the cycle.

Given that in more open economies the exchange rate has a stronger impact on the consumer price index (CPI), an economic environment marked by expectations of exchange-rate depreciation or appreciation is also characterized by expectations of deflationary or inflationary pressures. As a result, the incentives of a central bank with a policy focused exclusively or excessively on inflation will be biased towards implementing excessively contractionary monetary policies just when the economy is beginning to experience the downward part of the cycle, once excess aggregate demand has subsided, but with inflationary pressures stemming from exchange-rate devaluations. This drives the monetary authorities to intervene in the exchange-rate market to attain the inflation target, as described in the next section. In contrast, at the other end of the cycle and from the viewpoint of inflation targets, the bias tends to be toward applying expansionary monetary policies so that the recovery is led by capital inflows. The resulting exchange-rate appreciation trend, driven by capital inflows, acts as an artificial brake on increases in the CPI. The data, which show that the economies have functioned chiefly below the production frontier, seem to indicate that the recessionary bias has been stronger than the expansionary bias, inasmuch as the prevailing trend is real exchange-rate appreciation.

In a context of asymmetries in capacity utilization, the procyclical trend assumes average real GDP far below average potential GDP. Thus, a first challenge in the implementation of monetary policy based on inflation targets should be to eliminate this procyclical bias. There are a number of possible solutions for dealing with this problem. One is to use price indices of

[17] Some central bank data indicate that the high averages mask significant differences between the costs paid to the formal financial sector by large companies and by small firms, most of which do not even have access to the formal market.

non-tradable goods instead of the general price index to set the inflation target (Parrado and Velasco, 2002) and take into account the movement of asset prices and potential bubbles in those markets. Another option is to set the target based on a long-term horizon to filter the transitory effects of the exchange rate and their impact on the general price index.

Even more importantly, the full complement of objectives of any macroeconomic policy oriented towards economic growth and equity should be considered. Other proposed solutions include setting targets on external deficits as a way to mitigate the transmission of volatility from capital flows to domestic output (Marfán, 2005). Another option is to implement or strengthen targets in the real sector, such as those designed to reduce unemployment or make real GDP consistent with potential GDP.

A key point is the weight or relative importance of each variable in the central bank's response capacity and coordination with the rest of the economic authorities. It is important to recall that recent years have been characterized by low or moderate inflation in both developed countries and emerging economies. Against this backdrop, the additional effort required to bring down already low inflation tends to involve diminishing returns and rising costs. A central bank with considerable autonomy from the national political and economic authorities and clear anti-inflation preferences makes the target more credible in the preliminary stages of the fight against inflation, in the wake of high prices. However, in a region that has generally held annual rates in the single digits, and particularly in countries that have managed to keep inflation low and stationary, the excessive autonomy of the central banks and inattention to other macroeconomic goals have lost the validity acquired during times of fiscal irresponsibility and high inflation. Excesses tend to be inefficient, including the replacement of one excess by another. The mediocre result seen in growth and equity has its correlation in the imbalances between targets and coordination failures.

In a context of moderate inflation, more complex mechanisms must be designed that enable the central banks to respond and make a moderate and relatively stable inflation rate compatible with a GDP growth rate that is sustainable and consistent with the expansion of potential capacity and aggregate demand. The purpose of a stable, low inflation rate is to improve market information, incentivize innovation and value adding and spur investments and their degree of efficiency. This leads to more dynamic growth with a positive impact on equity. In contrast, an imbalance in the objectives is detrimental to development.

However, even if the more modal approach is resumed and an attempt is made to eliminate the procyclical bias of inflation targets by adopting a series of objectives —that is, a multi-anchor approach— a second problem may arise: a monetary policy with limited effectiveness, whether because it acts as a drag on domestic demand, produces insufficient results or has offsetting effects on other macroeconomic variables, such as the exchange rate.

During an expansionary phase, if monetary policy is managed to regulate aggregate demand by raising interest rates, local agents will turn to more external financing and short-term external funds will be attracted by a higher differential between the international interest rate and the domestic interest rate, an incentive that can be further accentuated by expectations of exchange-rate appreciation. In this context, higher interest rates tend to coexist with a tradable goods sector adversely affected by exchange-rate appreciation and with an increase in aggregate demand and the production of non-tradable goods financed by external savings—which tend to

displace domestic savings. The policy failure becomes evident and costly when output nears a slow moving production frontier.

The capacity of monetary policy to absorb shocks during the contractionary phase is more restricted, especially if the economy has already entered vulnerability territory. The textbook says that, given a specific external rate, a drop in the domestic interest rate will lead to capital outflows, causing the exchange rate to depreciate. Depreciation, in turn, will tend to favour recovery of the production of tradable goods and stimulate GDP growth. However, in practice, the negative effects of depreciation on consumption and short-term balances are usually stronger than the positive impact on the production of these goods. In contrast, if monetary policy is used to try to halt capital flight, the interest rate can be used to restrict aggregate demand —thus exacerbating a recession— but may be useless with respect to the capital outflows if there are strong expectations of depreciation and contagion of pessimism.

In summary, the effectiveness of countercyclical monetary policy in an open financial account and freely floating exchange rate context is much more limited than assumed in the standard theories. Consequently, the main policy implication of our analysis is that it is crucial to regulate capital flows to make room simultaneously for complementary countercyclical exchange-rate and monetary policies. It is dangerous and very naive to think that an excessive flow of capital meant only to generate income will never again appear, especially given the financial nature of the current global crisis.

3. Exchange-rate policy, productive development and sustainable stability

The exchange rate is a key macroeconomic variable for the sustainability of macroeconomic balances and the allocation of resources. Naturally, the relevant macroeconomic price refers to the basket of exchange and inflation rates of a country's trading partners, which vary according to the trade structures of the different countries.[18] The conventional approach, which maintains that the only exchange-rate option is a fixed nominal rate or a fully flexible rate, presupposes that the market will benignly set a sustainable equilibrium real exchange rate. This implicitly means levels and movements that involve a correct price for allocating resources among tradable and non-tradable goods and for attracting additional physical capital resources and labour. Aside from an effective allocation of existing resources, economic growth is chiefly characterized by a vigorous expansion of the stock of factors and their productivity.

The present modal exchange-rate policy supports a freely floating exchange rate. Several countries in Latin America and the Caribbean adopted freely floating exchange-rate regimes after the contagion of the Asian crisis in 1998. The problem caused by the new regime was that the exchange rate became extremely sensitive to temporary adjustments in the supply of external funds, accompanied by an inefficient allocation of resources. In times of scarcity of funds, the real exchange rate reflects a strong devaluation, as can be seen in figure II.8, but in the present context of recession and liquidity constraints, producers have a hard time taking full advantage of the rate incentive. In the next stage, when external constraints disappear thanks to a greater supply of external funds, new revaluations soon occur. In this regard, another asymmetry should be noted:

[18] ECLAC periodically calculates the real exchange rate of each country in the region, taking into account matrixes of nominal exchange rate and price level ratios, weighted by the relative contribution of the various trading partners. In contrast to the trade-weighted real exchange rate —relevant in the world of production— the real exchange rate relevant for financial flows tends to refer exclusively or predominantly to the dollar.

during periods of expansion, the financial markets are willing to finance larger investments, but exchange-rate appreciation discourages capital formation in the production of tradable goods. As a result of this procyclical behaviour of the real exchange rate, the business cycle shows a bias against tradable goods. Paradoxically, import liberalization reforms sought to position tradable goods centre stage, on the assumption that the exchange rate would come to play a key role in international competitiveness. However, the two exchange-rate options offered by the Washington Consensus—which are extremes—counteract that objective.

There has been a growing body of literature which discusses the nexus between exchange-rate policy and development in recent years. In addition to the invaluable studies of John Williamson, particularly his 2000 paper on intermediate regimes and the financial account, Rodrik (2008) discussed the impact of the real exchange rate on the production impulses supported by a depreciated real exchange rate. Eichengreen (2008) also looks at this topic, but emphasizes the need to limit the extension of periods of exchange-rate incentives. Meanwhile, Agosin (2007) analyses the issue of the quality, value-added and externalities of exports and compares the experiences of the Latin American and Caribbean countries with those of the Asian economies.

The aforementioned failures of the modal exchange-rate regimes regarding the distributive role of the real exchange rate also have implications for macroeconomic balances, as presented in the section on monetary policy. The boom and bust cycles of the global financial markets generate demand for flexible macroeconomic variables that are able to offset or absorb positive and negative impacts in the short term. Given the limited effectiveness of some traditional policy instruments, mainly the monetary policy implemented in response to the financial shocks, the exchange rate can play a central role in buffering the after-effects. In fact, the freely floating exchange-rate option, which eliminates the monetary effects of foreign exchange operations and restores equilibrium to the balance of payments on a sustainable basis, is key to making room for monetary policy. However, this objective is usually contradictory to the trade-related goals of exchange-rate policy, inasmuch as it tends to throw the current account out of balance.

Intermediate regimes of managed exchange-rate flexibility—such as crawling pegs and different types of moving bands or dirty floating—are a serious pragmatic attempt to reconcile these competing demands (Williamson, 2000). The typical neoliberal position is that any exchange-rate intervention is tantamount to going against the market and is destined to fail. On the contrary, the point is that real market forces—importers and producers of exportable and importable goods, which are important in terms of productive development and equity, should take the lead in determining the exchange rate. This is the market that should gain ground, not the market of the short-term operators.

Currency board regimes certainly build in automatic institutional systems for imposing fiscal and monetary discipline but they reduce manoeuvring room for monetary and exchange-rate stabilization policies, which are needed both to prevent crises and to stimulate post-crisis recovery. Currency boards facilitate the domestic transmission of destabilizing shocks originating in the global capital markets and cause wide swings in economic activity and asset prices, leading to costly domestic financial vulnerability.

The volatility characteristic of freely floating exchange-rate regimes is not a serious problem when fluctuations in the financial and commodity markets are short-lived, because they are resolved with the derivatives markets—if they exist in the local market—or they quickly even out

given the continuous reversibility of fluctuations. However, it is a significant problem in terms of the allocation of resources when the waves last for several years, such as those that have characterized the access of emerging economies to capital markets in recent decades. In such cases, sharp fluctuations in the real exchange rate tend to generate misinformation about the equilibrium exchange rate, with adverse effects on the allocation of resources.

Exchange-rate fluctuations caused by the cyclical movements of financial capital are exacerbated when countercyclical monetary or credit policies are adopted under freely floating exchange-rate regimes and open financial accounts. As explained in the section on monetary policy, this results in the classic problem in which a countercyclical monetary policy causes procyclical fluctuations in the exchange rate. For example, this happens when the monetary policy seeks to contain domestic demand by raising the interest rate, attracting financial capital and causing the real exchange rate to appreciate. The capital inflows boost demand, but exchange-rate appreciation halts inflation and introduces an expenditure bias towards imports.

Thus, the ability of a flexible exchange-rate regime to smooth out the effects of externally induced boom and bust cycles depends on the capacity to effectively implement a countercyclical monetary policy without encouraging procyclical exchange-rate movements. This is possible only systematically under actively managed intermediate exchange-rate regimes combined with some of the various types of countercyclical prudential regulation, which can be applied to the financial account as explained in section 4. These intermediate regimes with managed flexibility represent the best possible option for addressing the two demands that exchange-rate policy must meet.

Intermediate regimes with actively managed flexibility can entail costs and restrictions. First, these regimes will be subject to speculative pressures if they do not have the confidence of the respective market, so the cost of defending the exchange rate is very high. In critical moments, such as when there is a loss of confidence, it can be advisable to move, for a period of time, to full flexibility. Second, the accumulation of sterilized reserves during periods of expansion tends to involve financial costs. Therefore, countercyclical regulations on flows lower these costs by reducing excess inflows. Lastly, regulation of the financial account—necessary for effectively managing intermediate exchange-rate regimes—tends to experience rising losses that must be dealt with through ongoing monitoring of sources. However, if a countercyclical prudential approach is not adopted, the result will be severe volatility with high social and economic costs.

In summary, exchange-rate policy must be radically corrected so that it aligns with a development strategy that gives a central role to exports. That would also help bring about systemic competitiveness, that is, develop productive capacity not only for the external markets but also for the domestic market, where the vast majority of workers and firms are located. As will be discussed in the next chapter, greater systemic competitiveness helps to close output gaps with more developed countries and reduce internal structural heterogeneity, creating more egalitarian conditions in the labour and business market.

4. Capital market reform

As this chapter has shown, capital markets have major repercussions on macroeconomic balances and powerfully influence other variables that are critical for capital formation and the distribution of opportunities and income among economic stakeholders. This is associated with two particular features of this region's developing economies. First, capital markets are incomplete, with certain

segments either weak or lacking. To a greater or lesser degree, this problem can be found in every country of Latin America and the Caribbean. Second, the impact of this shortcoming in the region is exacerbated by the extreme structural heterogeneity among economic agents. Close ties with the most volatile international financial markets in recent decades also explain in part the shortage of productive investment and the precarious nature of labour markets.

This section will examine the direction that reforms of the national capital market need to take if they are to contribute effectively to the development of production. The discussion will then focus on reforms for managing the capital account with other countries so as to tap its potential to contribute to national development more fully while minimizing the economic and social costs involved.

(a) Domestic markets and development financing

The 1980s and 1990s saw widespread reforms on domestic capital markets. This was triggered by unsatisfactory earlier experiences in previous decades with increasingly interventionist policies and highly distorted real interest rates, which in countries with high inflation were frequently tantamount to negative real rates. Very often, reform meant the liberalization of interest rates, transaction terms and credit allocation and the relaxation of regulations and prudential oversight of financial institutions.

Reformers expected impressive growth in national savings and to achieve equilibrium interest rates that would result in a more efficient allocation of funds into investment in the most productive sectors. In terms of savings volumes, the overall impact was a significant increase in financial savings in the short-term segment of the capital market. Parallel to this increase, however, development banking has tended to weaken and the long-term segment to lose momentum, without there being an increase in domestic savings or productive investment (see figure II.4).[19] Clearly, the contrast between the rise in financial savings and the stagnation of domestic savings meant that the reform channeled savings into consumption and the purchase of already existing assets instead of encouraging capital formation.[20]

Nor did interest rates respond in such a way as to ensure growth or equality. Interest rates are a highly significant variable both for resource allocation and at the macroeconomic level. When domestic rates were liberalized in the countries of the region, they frequently proved to be unstable and far higher than international rates, with much greater and longer-lasting spreads. This has meant that systems with high financial costs and segmented markets continue to be the rule.[21] In short, investors in production activities have been faced with a real economy that is

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[19] For the most part, capital markets have remained underdeveloped, with nearly 70% of financial resources still being channeled through the banking system. The rest is characterized by stunted capitalization rates, too few shares being traded, minimal new stock issues on the markets and highly concentrated transactions with few shares.

[20] Over the last two decades, gross domestic savings in Latin America hovered around 20% of GDP, significantly less than in other developing regions, such as southern Asia and the Pacific (40%) or the Middle East and northern Africa (30%).

[21] For example, the book value of general bank expenditures in 2007, expressed as a share of total assets, exceeded 5% in Latin America, more than in Southeast Asia (2%), the Middle East and northern Africa (2.3%) and Asia and the Pacific (3%). Significantly, Chile applied similar reforms in the 1970s and obtained similar results: from 1973 until the 1981 peak, prior to the 1982 recession, average annual GDP growth of barely 2.9%; from 1975 to 1982, active interest rates that were too high, averaging 38% annually in real terms; low rates of capital formation, deteriorating conditions for labour and income distribution, and finally in 1982 and 1983, a severe banking and exchange-rate crisis (Ffrench-Davis, 2008a, chapters IV and V).

clearly unstable in a very incomplete financial market and were hit with extremely high average interest rates, especially for holders of non-preferential debt.[22]

With the onset of the current global downturn, the financial institutions of the region's countries have displayed considerable progress inasmuch as they have successfully managed to avert banking crises. They are also now on a more solid footing, less exposed to risk and covered by stricter oversight, but they have clearly failed to provide broader financing to current economic activities. An overview of financial system reforms shows that these institutions have not developed enough to tackle structural heterogeneity or provide financing for the production sector. A proactive relationship among financial institutions still needs to be forged, and the degree of heterogeneity needs to be lessened for them to have a more inclusive effect on society (see the following section and chapter III). Still pending is the implementation of the Monterrey Consensus of the International Conference on Financing for Development which would boost the resources for financing economic, social and environmental development in the region and design them to be countercyclical.

The reorganization of the financial system must therefore aim to channel resources into savings and investment, which calls for a more fully developed capital market rather than reforms that focus on the short term. The countries need institutions able to serve a vigorous long-term segment so that savings are funneled into financing for productive investment, along with prudential and countercyclical regulations. Similarly, institutions should grant public and private development banks an active role in the process as this is the best way to guarantee the vitality of the long-term segment.

The handling of institutional savings, such as pension funds, merits high-priority attention to ensure that these long-term funds are channeled into productive development in the domestic economy (see the following section). This is critical to guarantee sustainable welfare for savers given their dual status as both workers and future retirees.

(b) Toward more equitable access to financing

When access to financing is heterogeneous, inequalities in production capacity become more marked and the ability to enter large markets turns more segmented. This creates a vicious cycle that condemns lower-capital sectors and production units to a permanent state of vulnerability and feeble growth. Unequal access to financing and unequal conditions of financing are a centrepiece in perpetuating social inequality.

Above all, small-and medium-sized enterprises and low-and middle-income sectors need greater access, as these groups generally feel the impact of social segmentation in the capital market. This is important, not necessarily because SMEs are leading the pack at the technological forefront, but because they have an enormous impact on social inclusion, on buffering structural heterogeneity and, accordingly, on bringing about greater social equality (see chapter III). Appropriate supply- and demand-side resources and instruments must be made available to ensure that SMEs obtain the loans they need, as guarantee mechanisms alone are not enough. SMEs need the capital market in order to cope with emergencies, invest in education and training, carry out production activities and modernize.

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[22] In the countries of the region, bank financing for the production sector targets mainly large companies and is much more costly for SMEs than for larger businesses.

This means that specialized credit entities and guarantee mechanisms should be created to accomplish what the market is generally unable to do spontaneously. The top priority in this field should be to offer favourable access to long-term financing, at normal interest rates, and to the other resources currently lacking among these underserved sectors: technology, certain inputs and associated services, marketing channels and infrastructure. It is equally crucial, if these units with their more limited resources are to thrive, for the production process to take place in a real economy that enjoys relative stability.

The development of SMEs is critical if countries hope to overcome the deep inequality between the few large companies and the majority of other, smaller ones and advance towards labour markets that are able to create more and more high-quality jobs. Improved access for SMEs to financing will have a direct impact as it will generate more and better employment and thus making a substantial contribution towards narrowing the considerable labour productivity gaps. This is a cornerstone for achieving greater social equality, an issue that will be discussed in further detail in chapter III.

Designing and constructing an inclusive financial system specifically to finance production requires the expansion and development of the set of instruments to control risks, diversify access and lengthen repayment periods. These objectives can be met only in the presence of a strong push to finance SMEs and reinvigorate the role of microfinance at different scales and in a variety of institutional settings.

Microfinance plays a key role in improving access to financial services and employment for low-income households and microbusinesses. The scope of action of microfinance is highly heterogeneous. For example, one objective could be to provide microenterprises with financing to purchase simple equipment or to incorporate inactive members of the labour force —especially women— into production activities. This would help generate GDP, improve household welfare and consolidate personal dignity.[23] Given the newfound importance of resources mobilized through the remittances of migrants, microfinance institutions in some countries have also experimented with financing production development for people who receive these resources from abroad. Microfinance institutions in a number of the region's countries, as one of their basic activities, provide technical and strategic support to loan recipients. In certain cases, such as Ecuador, they have helped groups of clients set up production clusters to lower production and distribution costs. In others, such as the Plurinational State of Bolivia, Honduras and Nicaragua, they have helped borrowers of microcredit identify new markets for their products. Such experiences need to be strengthened and instituted in other countries.

To encourage the development of microfinance in the region, public policies must be designed for the following objectives: (i) improve the capacity of relevant institutions to channel market resources and develop new products; (ii) tackle management and regulatory challenges so as to facilitate risk monitoring and management; (iii) apply low-cost technologies that are affordable for institutions of this kind; and (iv) move towards the creation of instruments that facilitate more effective evaluation of the impact of microfinance.

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[23] At present, microfinance institutions in countries including the Bolivarian Republic of Venezuela, Colombia, Guatemala, Nicaragua and the Plurinational State of Bolivia also offer a variety of insurance programmes to their clients. At first the focus was essentially on basic medical and funeral services, but in recent years the coverage has expanded and now covers crops and capital goods financed through microcredit, as in the case of the Plurinational State of Bolivia.

The countries need to develop a financial system that will reduce the great structural heterogeneity in the region's economies. As chapter III suggests, this system should target sustained productivity increases in small- and medium-sized enterprises. Today's incomplete capital markets have posed an insurmountable barrier that has prevented many SMEs from stepping up their development. This is an essential ingredient for bringing about growth with equality. Reform of the capital markets therefore means strengthening public banking, particularly development banking, as an instrument to boost and democratize access to credit, especially long-term credit oriented towards financing of productive investment.

Financial markets are typically hampered by problems of information, making it difficult for SMEs to gain access to credit and dampening innovative activities in general. These problems are compounded by the impact of the maturity mismatch between obligations that financial intermediaries acquire to obtain resources, and the needs of potential borrowers, especially when resources are to be allocated for investment. These difficulties tend to be more acute in volatile, unstable economies, such as those of Latin America, where depositors have a high preference for liquidity.

Private banks, which are generally subject to strict regulation and supervision, operate with a shorter horizon in terms of profits and use market criteria for their risk management programmes. Thus they tend either to favour enterprises that are relatively larger and well-established or are able to offer real high-value guarantees, or else to focus mostly on short-term credit —to the detriment of long-term financing— for small companies or new ventures or projects whose potential profitability is more uncertain. It is these new ventures or projects, which lack timely access to financing from private banks, that are most likely to introduce new products or new ways of producing them and to seek out new markets. These biases in the private banking sector are not good for investment or growth because they fail to encourage innovation, long-term productivity or the narrowing of production and social gaps.

The introduction and development of instruments such as leasing with an option to buy, factorization, guarantee systems or venture capital is a move in the right direction, but not enough to eliminate the problem of credit rationing. That goal requires the strengthening of public development banking. Public banks operate under different criteria than private banks in terms of profitability, risk management and funding of resources and are therefore in a better position to focus on financing investment and working capital for companies that do not have ready access to credit. This would not only have a positive distributive effect, but would also increase the overall growth potential in the economy by allowing more production units to join the process.

Moreover, development banking can play an essential role in providing countercyclical financing. For example, the Government of Brazil recently responded to the global crisis by boosting the capital of the National Bank for Economic and Social Development (BNDES) by 3.5% of GDP in order to augment its credit potential and partially offset the decline in private credit: in 2009, public credit made up 41% of total credit. This institution played a leading role in reactivating the Brazilian economy.

Given the extreme heterogeneity in today's economies, financial development must boost access to credit for micro-, small- and medium-sized enterprises. This is consistent with commitments acquired under the Monterrey Consensus (United Nations, 2002 and 2007). Development that produces more equitable markets and a dynamic economy requires a financial infrastructure that is able to provide microenterprises and SMEs with access to a diverse range of sustainable products and services that will strengthen weaker segments over the long term. It also needs diversified financial instruments that make it possible to adopt countercyclical measures.

In short, a reform of the reforms of the Washington consensus must attach top priority to linking the financial system up with the domestic investment process and the domestic economy rather than with external financial markets. It must also contribute to greater economic stability, which means avoiding exchange rates that are out of alignment and regulating interest rates in order to temper the frequency and aggressiveness of cyclical fluctuations and avoid real interest rates that are either negative or too high. Finally, the reform should seek to decentralize economic power by using inclusive financing mechanisms that give preferential access to SMEs (Ffrench-Davis, 2005).

(c) The balance-of-payments financial account and development financing

Reforms of domestic capital markets went hand in hand with liberalization of the balance-of-payments financial account. Total external financial opening, as occurred in the 1990s and during this decade, generally leads to integration into the most speculative sectors of the developed world. Consequently, the most buoyant segment of the capital market has been short-term financial inflows and outflows characterized by procyclical volatility and having little connection to productive investment. Even so, it is now clear that the original objective of liberalization —financing more investment and higher productivity to boost economic growth— remains elusive. Instead, the process has opened the way to intense cyclical instability imported through the financial account. Effective regulation of the financial account is now understood as an indispensable condition for moving towards a development-oriented macroeconomic scenario framed by monetary independence and exchange-rate sustainability.

Regulations on the financial account can serve as a prudential macroeconomic policy instrument as they target volatile flows, which are the direct source of boom and bust cycles. If they are effective, they relieve the pressure for exchange-rate appreciation and make it possible to adopt contractive monetary policies during periods of financial euphoria. Similarly, regulations tend to reduce the quasi-fiscal costs of sterilized international reserve accumulation. If such regulations are in place, during the down cycle (marked by active external restriction), expansive monetary and fiscal policies can be adopted to tackle the recession, which is extremely useful in situations such as today's global crisis.

Experience has generally confirmed the benefits of imposing volume or price restrictions on the entrance of liquid or short-term capital as they facilitate the adoption of countercyclical macroeconomic policies and improve the maturity profiles of external liabilities (Ocampo, 2007; Williamson, 2003). Regulations of this kind are designed to create a more stable macroeconomic environment in boom times and minimize the costly recessionary adjustments needed when the economy descends from disequilibria caused by overheating. An environment with regulations is better adapted to the market and more equipped to meet the following goals: (i) make irreversible investment decisions; (ii) avoid major gaps between real GDP and potential GDP; (iii) prevent macroeconomic prices —exchange rates and interest rates— from falling too far out of alignment; and (iv) warding off disequilibria in other key macroeconomic ratios associated with the appearance of areas of vulnerability (unsustainable current account deficits, price/earnings ratios on the stock market and ratios between liquid and short-term liabilities and international reserves).

The debate over capital controls was intensified in response to the well-publicized measures adopted by Malaysia in 1998. The Government imposed tight quantitative restrictions on the outflow of capital (Kaplan and Rodrik, 2001), which turned out to be crucial for applying the active monetary and fiscal policies that reactivated the economy in 1999.

Knowing how to move on from a crisis after having been through it is not enough. Averting a crisis altogether or drastically mitigating its costs is as important if not more so. This is one goal of the regulation of capital flows that aims to achieve sustainable equilibria in the real economy. In recent years, there have been several noteworthy attempts in the region, such as in Argentina, Brazil, Colombia and Peru (see box II.2), to regulate capital flows to achieve these equilibria, mostly to prevent excessive exchange-rate appreciations (ECLAC, 2009a).

A significant development at the beginning of the 1990s was the Chilean experience with countercyclical regulation of capital income. Faced with high levels of external financing (in relation to GDP) that could have had a destabilizing effect, Chile introduced a reserve requirement on capital income other than foreign direct investment. During the five years from 1991 through 1995, exchange-rate appreciation and the current-account deficit as a share of GDP were below the average for the region as a whole and for other countries of Latin America that received huge capital injections at that time.[24] The disincentives on short-term inflows made room for active exchange-rate and monetary policies. Chile successfully controlled the composition of income by engineering a significant drop-off in liquid and short-term flows (Larraín, Reisen and von Maltzan, 2000).

Multiple econometric tests confirm that foreign direct investment is much less volatile than short-term indebtedness and portfolio flows and that it makes sense to adopt prudential policies for macroeconomic regulation —such as reserve requirements— that target short-term or volatile flows (Agosin and Ffrench-Davis, 2001, table 4). As this chapter has shown repeatedly, persistent flows generally go into productive investment rather than consumption, while the likelihood of a crisis and the seriousness of its consequences seem to be closely associated with greater liquidity of net external liabilities (Rodrik and Velasco, 1999). The Chilean regulations, together with sterilized intervention in foreign-exchange and money markets, staved off excessive exchange-rate appreciation and prevented a consumption boom, thus holding the current account deficit within reasonable limits until the mid-1990s (Le Fort and Lehmann, 2003; Williamson, 2003). Thus, Chile's economy persistently operated near its production frontier, which during that period produced a virtuous circle of high productive investment, high GDP growth —averaging more than 7%— and declining inflation.

These are examples of positive experiences with regulation of capital income. Other measures are associated with the outflow of domestic capital. The Republic of Korea, for example, maintained strict controls on capital for several decades: following the liberalization of capital income, which culminated with the 1998 crisis (Agosin and Ffrench-Davis, 2001), controls were imposed on external monetary transfers by residents (Mahani, Shin and Wang, 2005). In some countries of Latin America and the Caribbean, reforms and the transformation of pension systems into private capitalization funds have created significant long-term sources with growing volumes that have given rise to steadily expanding institutional savings. The neoliberal approach has exerted pressure to liberalize the management of these funds and to allow them to be moved overseas freely. Naturally, if the room for manoeuvre is too ample, they can become a source of macroeconomic instability.[25] These are large-volume funds of a very long-term nature. As a result, any reform of the reforms must grant them a critical role as a factor for real macroeconomic stability (Zahler, 2005) and as a key element for gradually restructuring the capital market to achieve capital formation and productive development.

[24] See quantitative background in Ffrench-Davis (2005, chapter VI and 2008a, chapter VIII). Agosin and Ffrench-Davis (2001) and Le Fort and Lehmann (2003) examine numerous features of the reserve requirement, its application and effects, and analyse the critical literature.

[25] Authorities in Singapore took a very different approach, using a semi-public pension fund as an effective instrument for stabilization.

Box II.2

CAPITAL CONTROL: AN OUNCE OF PREVENTION

Several important economic policy lessons can be learned from the absence of prudential macroeconomic regulation of capital inflows. With their predominantly passive positions, national economies were left vulnerable to external shocks, lending tremendous volatility to key domestic macroeconomic prices —exchange rates and interest rates— and to macroeconomic aggregates, especially the gap between effective demand and potential GDP, and the external balance. As investments dip, these fluctuations exert an adverse effect on long-term growth, productive employment and equality. In more recent years, several countries of the region have intervened in the financial account to ward off excessive volatility in capital flows or exchange-rate values.

In the 1990s, Chile and Colombia began systematically applying non-remunerated reserve requirements on financial capital income; one of the objectives was to keep exchange rates competitive for the production of tradable goods, create space for monetary policy and regulate domestic demand and the external balance.

Starting in June 2005, Argentina required anyone bringing in foreign currency to deposit in dollars an amount equivalent to 30% of the total value of the operation. This mandatory deposit is applied, with certain exceptions, to different types of capital flows, such as debts of the financial and private non-financial sector, primary stock issues of resident companies that are not publicly traded and trading in self-regulated markets. It also applies to portfolio investments by nonresidents in local-currency stocks and foreign-currency income earned on the local exchange market through the sale by residents of external assets amounting to more than US$ 2 million per calendar month, as well as other operations intended to prevent tax evasion and leakage. A minimum repayment period of 365 days is required for overseas debts and debt turnovers by residents; such debts cannot be paid off before this term lapses.

In Colombia, from May 2007 through October 2008, international investors were required to make a non-remunerated deposit for stock portfolio investment from abroad, and foreign direct investment required a minimum stay of two years. At first the required deposit was 40% of the total amount, rising to 50% in May 2008. These requirements were removed in response to the international crisis, specifically for new overseas investments in stocks or mandatory convertibles and for the acquisition of portions of collective portfolios consisting of stocks only. Nevertheless, the deposit requirement remained in effect for other portfolio investments from abroad, especially fixed-income assets.

In Peru, in addition to direct intervention in the foreign exchange market, the central bank adjusted dollar reserve requirements as a tool to manage domestic liquidity in foreign currency. In early 2008, in response to surging capital inflows, the Government stepped up intervention in the foreign-exchange market, increasing the reserve requirements in new soles and dollars as a way to lessen the need for sterilization. In order to further limit capital inflows, the central bank temporarily stopped issuing certificates of deposit, replacing them with auctions of nontransferable deposits and non-negotiable certificates of deposit, which could be acquired only by national financial entities, so that in effect, they served more as instruments for controlling liquidity and less as investment assets that would attract international investors. The bank also began charging a commission for transferring ownership of Central Reserve Bank of Peru (BCRP) certificates to nonresidents. Nonetheless, under the terms of its recent free trade agreement, Peru now has a more restricted capacity to impose measures that discriminate against investors from the United States.

In October 2009, Brazil introduced a 2% tax on capital flows for acquisition of stocks and bonds, excluding foreign direct investment. Shortly thereafter, a 1.5% tax was placed on American Depositary Receipts (ADRs) for Brazilian firms trading on the New York exchange. Significantly, during the earlier period of significant nominal appreciation of the real, Brazil had charged a 1.5% tax on foreign investment in fixed-income assets, which was eliminated in October 2008 following the onset of the international financial crisis.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Preliminary Overview of the Economies of Latin America and the Caribbean, 2009* (LC/G-2424-P), Santiago, Chile, 2009. United Nations publication, Sales No. E.09.II.G.149.

Other more traditional controls are also available. For example, China and India introduced bans on short-term financial debt, placed quotas on stock investments and controlled capital outflows. These have proven to be a very effective means for achieving the macroeconomic policy objective of minimizing the close associations between the domestic economy and volatility on international markets. Both countries successfully withstood the current crisis, blocking the transmission of external recessionary shocks that have struck nearly all the world's economies, whether developed, emerging or in transition. With these controls, they were able to implement the impressive reactivation programmes now under way.

The effective countercyclical regulation of capital account inflows and outflows can provide the financial system with the room it needs to reorganize its operations and channel resources into savings and investment in direct association with the needs of the productive apparatus. In practice, however, the procyclical and volatile nature of external financial flows has conspired against achieving more financial intermediation to facilitate development in the region. This means the countries must develop a greater capacity to attract external savings and direct them into financing production, supporting growth and employment, working to integrate their societies and lessening the structural heterogeneity among the various production sectors.

(d) The great macroeconomic challenge in short: managing capital flows

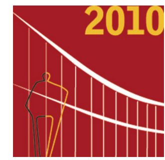
The low rate of investment over the past two decades reveals persistent structural flaws in domestic capital markets and their linkage with international markets. The negative impact of these flaws has been worsened by weaknesses in the national macroeconomic environment.

Nonetheless, a number of important lessons have been learned. The effects of the recent financial crisis, which threatened to be as dramatic as the Great Depression of the 1930s, were tempered not by feats of magic or by self-adjustment of the markets, but by deliberate public action to salvage the macroeconomic environment of the world economy following the financial erosion that occurred in the second half of 2008. The correction required actions that ran counter to the prevailing paradigm of a passive State and an essentially neutral economic policy. It overcame any opposition to using available instruments, especially fiscal policy, for countercyclical purposes. The world's major economies responded with a robust countercyclical fiscal policy. Now that collapse had been averted, the corrections need to be strengthened. This does not mean the crisis is over or that recessionary conditions have ended; but it is reasonable to hope that economic activity has begun to rebound in the region and in the rest of the world.

Today's major challenge is to see that recovery from the crisis is sustainable, especially if, as this chapter suggests, the goal is to create an environment for work and productive capital that fosters dynamic development. The preceding pages have shown how different macroeconomic approaches have a decisive influence on the degree of stability and on the ways in which stability determines the direction and pace of growth and the fairness of domestic markets. The financial system must play a vital and fundamental role in attracting savings and channeling them into investment. Foreign capital can play a valuable part as a supplement to domestic savings, for which purpose the composition and stability of flows is crucial. Indiscriminate financial liberalization did not engender productive development or bring about real macroeconomic stability and in fact was counterproductive for meeting objectives associated with reducing

inequality. In the countries of this region, the global crisis —an illustration of the risks of unregulated financialism— has opened the way to more pragmatic policies for countercyclical regulation of the capital account.

Sustainable development requires public policies that are conducive to social inclusion, and it calls for countries to be engaged with the international economy based on growing domestic integration and less social disintegration. Decisions must therefore be made about how to reform domestic capital markets and how to develop the link with international financial capital markets. This is the critical challenge for achieving a macroeconomic context that sets the region on a sustainable course of economic and social development.



Chapter III

Structural heterogeneity and productivity gaps: from fragmentation to convergence

A. Introduction

In terms of productivity, two traits clearly set the economies of Latin America and the Caribbean apart from developed economies. The first trait is the region's technology gap with regard to developed regions, that is, the external gap —that reflects the asymmetries between the technological capabilities of the region and those found on the international frontier. Developed economies innovate in technology and disseminate it throughout their productive system more quickly than the countries of Latin America and the Caribbean are able to absorb, imitate, adapt and innovate in technology following international best practices.

The second distinctive trait is the internal gap, that is, the large productivity differences —much larger than those found in developed countries— among sectors, within sectors and among companies within a given country. This is known as structural heterogeneity, which refers to marked asymmetries among segments of enterprises and workers and the concentration of employment in strata characterized by very low relative productivity.

Most countries of Latin America and the Caribbean are known to suffer from a considerable degree of social inequality, which reflects the strong concentration of ownership and the sharp productive heterogeneity they display.

That is, segments with very low labour productivity exist alongside others whose labour productivity is in the middle or high ranges, as will be seen in this chapter. Social gaps, then, cannot be understood without a grasp of the uneven quality and productivity of jobs among (and within) economic sectors, which translates into highly uneven performances among workers, and disparate yields between capital and labour.

The interconnections between growth and social and production heterogeneity are complex and vary considerably depending on a country's historical experiences. For example, the process currently under way in China and India appears to illustrate the argument of Kuznets (1955) that, for a certain time during a country's development, inequality increases because a growing part of the peasantry, which was once "homogenously poor", migrates to the city and finds higher-productivity employment in the modern sectors that are emerging during industrialization. That is, for a time the productivity gap between occupations in the modern urban sectors and those in rural areas widens, intensifying occupational and productive disparities, at least until the proportion of occupations in the modern segments rises enough to produce an inflexion on the Kuznets curve.

In Latin America and the Caribbean, such disparities grew in the period from 1950 to 1980 and were examined early on by several classic ECLAC authors of (Furtado, 1961; Pinto, 1965; Sunkel, 1970). In the Latin American model of "social and productive heterogeneity" described by these authors, a small segment of the population appropriated a substantial portion of the gains from higher productivity in the economy overall; nevertheless, the rise in productivity that later accompanied industrialization underpinned a gradual improvement in the output of workers, who were increasingly absorbed by ever-expanding modern sectors.

Rather different dynamics, however, marked, the growing heterogeneity seen in most of the region's countries between the beginning of the lost decade (the 1980s) and the early 2000s, which marked beginning of the period of growth that lasted until the 2008 crisis. During that period (1980-2002), overall productivity in many Latin American and Caribbean countries remained more or less unchanged. The greatest changes took place in several segments of the urban services sector, in which average productivity declined sharply, especially during the 1980s, leading to the bloating of the informal services sector. This gave rise to a vicious cycle of spatial segregation in the cities (with high levels of urban marginalization) and productive segregation, with high percentages of the urban economically active population (EAP) in very-low-productivity sectors. Hence, spatial and productive heterogeneity mirror one another.

Structural heterogeneity largely explains acute social inequality in Latin America and the Caribbean, because gaps in productivity reflect, as well as reinforce, gaps in capabilities, in the incorporation of technical progress, in bargaining power, in access to social safety nets and in options for upward occupational mobility throughout working life. At the same time, the wider internal gap reinforces and, to a certain extent, depends on the external gap, as this chapter will discuss. To the extent that low-productivity sectors find it extremely difficult to innovate, adopt technology and promote learning processes, internal disparities aggravate systemic competitiveness problems. This creates vicious cycles not only of poverty and low growth but also of slow learning and weak structural change. As a result, both gaps must be addressed simultaneously in order to support stronger and more inclusive growth.

Recent ECLAC studies identify the conditions for narrowing the external gap, and thus carry on an analytical tradition that focuses on the relationship between technology, equity and transformation of the production structure.[1] In open economies, the lack of technology convergence

[1] See the studies by Fajnzylber (1990) and ECLAC documents (2008a, 2007, 2006a, 2004a, 2001, 1998, 1992 and 1990) cited in the bibliography. From this perspective, Infante (2009) argued that convergence depends on the relative speed at which technical progress is introduced into and spread within the region's production structures by means of fixed capital and know-how, compared with developments in the rest of the world.

with the international frontier results in a pattern of specialization that involves hardly any technology-intensive activities. This has two important implications. The first is a structure that is heavily biased towards activities in which little is spent on research and development, resulting in a slow learning process and scant productivity gains. This is because technology-intensive activities generate externalities —technology spillovers— and a range of incentives for innovation and learning that underpin the long-term accumulation of technological capabilities.

The second consequence is that a production structure with smaller technology-intensive sectors is poorly equipped to adapt to changes in demand. Indeed, the ability to innovate and imitate quickly is a key for entering markets in which demand grows more quickly. In the most dynamic markets, competitiveness depends on technological proficiency, and demand patterns (in both consumption and investment) shift frequently. The technological disadvantages of the region prevent it from responding quickly and powerfully enough to avoid losing its share of those markets. Consequently, exports are less dynamic than imports, which leads to external constraints on growth and concomitant foreign-exchange crises, while growth tends to be more volatile and dependent on a fluctuating international liquidity supply.[2]

Just as the external gap reflects the limited spread of international best practices to Latin America and the Caribbean, the internal gap results from difficulties with disseminating them among agents within each country. Infante (2009) noted that early theories of structural heterogeneity had argued that technical progress was not a generalized process that penetrated all economic sectors or branches to greater or lesser extents in most Latin American economies. On that contrary, it had been assimilated almost exclusively by certain activities, generally those linked to the export sector, leaving large swathes of the economy excluded from the process of technical progress.[3]

In every country, technical progress occurs at different rates in the various sectors and technology and opportunities for innovation are unevenly distributed. But in Latin America, these differences are much greater than in developed economies, and the most heavily lagging sectors and agents tend not to catch up with the “leaders”.[4] Even within sectors that, in the aggregate, could be considered medium- or high-productivity, there remain strata of firms and jobs whose productivity is extremely low. The high rates of underemployment and informality in the region are the most visible, but not the only, sign of disparities, as well as a major source of inequity.

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[2] On this point, see also chapter II.

[3] Classic references in ECLAC literature may be found in Pinto 1965, 1970 and 1976. The topic is discussed in detail in Rodríguez (2007).

[4] Schumpeter (1934) described the business cycle as being based on a wave of secondary innovations and the vigorous entry of imitators who erode the oligopolistic advantages of the leaders. Although major innovations are what initially drives economic growth, their most important impact on aggregate performance derives from the investments made by new entrants, drawn by the windfall profits of the pioneers. In the Latin American case, this wave of investments is cut short and rapidly weakens, and the advantages of the pioneers (who are often merely followers, in international terms) are not contested by the mass entry of imitators.

B. Heterogeneity among sectors and agents: external and internal convergence

1. Production structure and productivity dispersion

From a historical perspective, the most notable development has been the change in the nature of the main productivity gaps in the region. From 1950 to 1980 there was a large productivity gap between agriculture and secondary and tertiary activities, especially those conducted in urban areas. The predominance of large-scale ranch-style (*latifundista)* farming, which is not geared towards raising output, and a campesino economy with scant resources hampered the development of the relative productivity of agriculture and led Governments to introduce agrarian reforms and policies to modernize the sector.

The picture has changed in recent decades. Although in many countries the peasant economy continues to suffer from low productivity and a lack of access to the production resources needed to bring about a profound transformation, average labour productivity in the agricultural sector has increased substantially thanks to countryside-city migration, the emergence of non-agricultural rural activities and the modernization of agri-business. Low labour demand during the 1980s debt crisis and the subsequent crises in the late 1990s and early 2000s, together with supply-side pressures at a time when the working age population in many countries as growing at a high rate, meant that informal employment in urban areas surged. Average labour productivity in the tertiary sector consequently dropped sharply during the 1980s and remained low from then on.

This section presents an overview of the structure of production in Latin America and highlights the wage and production asymmetries, which are directly related to poverty and social exclusion in the region. An analysis of labour productivity (value added per worker) reveals that performance varies from one sector to the next. Changes in this variable are observed using two points of reference: (a) differences among sectors within the region (the productivity of each sector compared with average productivity for the economy); (b) the productivity of each sector in Latin America compared with that of the same sector in the United States, which can be considered to represent the international technological frontier (external gap).[5]

The fact that productivity gaps are larger in Latin America than in the developed countries means that the region also suffers from wider wage gaps and worse income distribution. A convergence of sectoral productivity (internal convergence) should therefore lead to better income distribution and less social exclusion. In addition, by narrowing its wage gap with the United States (external convergence), the region would raise its competitiveness level and be better positioned to reduce per capita income differences with the developed world. This would also create synergies in knowledge dissemination (complementary improvements in productive capabilities and the social distribution of capabilities) and, by raising competitiveness, prolong economic growth, boost fiscal revenue and enhance the State's ability to transfer resources and services to the most vulnerable sectors.

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5 The internal gap has two dimensions: differences between sectors and differences between agents or activities within a given sector.

Table III.1 presents labour productivity for each sector in Latin America as a percentage of average productivity throughout the economy. There are notable differences between sectors: mining productivity is seven times higher than average productivity; productivity in the electricity sector is four times higher; and productivity in the financial sector is twice as high. At the other end of the spectrum are agriculture, commerce and construction.[6] Productivity in sectors such as industry and transport is very close to the average for the economy. The unevenness of sectoral productivity increased between 1990 and 2008.

Table III.1
LATIN AMERICA (SELECTED COUNTRIES): PRODUCTIVITY INDICES [a]
(Total GDP=100)

	1990	1998	2003	2008
Agriculture	28.4	27.7	30.9	31.0
Mining	608.4	1045.5	932.8	767.4
Industry	99.3	112.7	115.5	114.2
Electricity	225.9	353.6	434.6	483.2
Construction	91.3	94.4	84.7	77.5
Commerce	76.1	63.3	56.2	59.5
Transport	118.7	134.4	148.4	146.1
Financial establishments	279.0	282.5	279.7	252.1
Community, social and personal services	84.5	74.4	78.9	75.8
Total GDP	100.0	100.0	100.0	100.0
Period		1990-1998	1998-2003	2003-2008
Average annual rate of productivity growth		1.9	-0.4	0.7

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

[a] Calculation based on the economically active population, broken down by sector as indicated by the International Labour Organisation (ILO), and corrected for the sectoral unemployment rates given by ILO. The figure given for Latin America is the simple average of 11 countries: Argentina, Bolivarian Republic of Venezuela, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Peru and Uruguay.

By contrast, an examination of sectoral productivity in the United States reveals smaller differences among sectors in that country (see table III.2). Productivity in the leading sectors (electricity and finance) is twice the average for the economy overall —a much smaller difference than that found in Latin America and the Caribbean— and the disparities narrowed from 1990 to 2008, whereas in Latin America they increased during the same period.

[6] Agricultural productivity is particularly low when viewed in terms of simple averages for the region as a whole (as is done here) owing to the extremely low output of the peasant economies in the less developed countries in which rural populations make up large proportions of the total population. When viewed in terms of weighted averages, the agricultural productivity of the region increases on account of the more buoyant agribusiness sectors of countries with relatively larger populations (such as Argentina and Brazil) but is still relatively low in comparison with that of other sectors.

Table III.2
UNITED STATES: PRODUCTIVITY INDICES
(Total GDP=100)

	1990	1998	2003	2008
Agriculture	36.9	35.3	44.6	71.2
Mining	273.6	299.7	278.9	176.8
Industry	73.3	92.6	110.1	126.2
Electricity	177.9	174.4	216.0	224.4
Construction	80.0	72.2	54.9	37.5
Commerce	51.1	62.8	65.6	66.9
Transport	114.0	125.4	165.2	210.1
Financial establishments	284.4	268.2	219.0	185.0
Community, social and personal services	84.1	69.8	66.7	65.1
Total GDP	100.0	100.0	100.0	100.0

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

Note: Calculation based on the economically active population, broken down by sector as indicated by the International Labour Organisation (ILO), and corrected for the sectoral unemployment rates given by ILO.

The coefficient of variation of productivity constitutes a more precise measure of the degree of divergence between Latin America's internal production structure and that of the United States.[7] Table III.3 confirms that the coefficient of variation is higher ("sectoral inequality" is greater) in Latin America than in the United States, and that in the latter sectoral productivity levels have converged (that is, the coefficient of variation has narrowed) since 1998.[8] In Latin America, sectoral dispersion of productivity increased sharply during the years of trade liberalization (the coefficient of variation widened between 1990 and 1998), and, although the coefficient of variation trended downwards thereafter, it remained above the levels seen in the early 1990s. Lastly, the relative dispersion, that is, the ratio of the coefficient of variation in Latin America to that in the United States, increased in the years in question. This indicates that the distance between the sectoral dispersion of productivity in Latin America and that of the United States increased: in 2009, the dispersion in Latin America was 101% greater than that in the United States, compared with 40% in 1990.

7 The coefficient of variation is the ratio of the standard deviation to the arithmetic mean.

8 The comparison with the United States is particularly instructive, not only because that country's economy is on the technological frontier but also because its regulatory framework favours market competition. Hence, productivity differentials originating in the unequal pace of technical progress can be assumed to be more clearly manifest in the United States.

Table III.3
LATIN AMERICA (SELECTED COUNTRIES) AND THE UNITED STATES: INTERNAL CONVERGENCE AND RELATIVE PRODUCTIVITY

	1990	1998	2003	2008
Dispersion index of productivity in Latin America	0.94	1.24	1.14	1.05
Dispersion index of productivity in the United States	0.67	0.67	0.60	0.52
Ratio between productivity in Latin America and in the United States	1.40	1.85	1.89	2.01

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

In addition, a sector-by-sector comparison of productivity in Latin America and in the United States shows that, for most sectors, productivity is much lower in Latin America (see table III.4). The exception is the mining sector, in which productivity in Latin America is 70% of that in the United States.

Table III.4
LATIN AMERICA (SELECTED COUNTRIES): RELATIVE PRODUCTIVITY WITH RESPECT TO THE UNITED STATES [a]
(Percentages)

	1990	1998	2003	2008
Agriculture, hunting, forestry and fishing	14.2	13.3	10.7	7.0
Mining and quarrying	40.9	59.2	51.5	70.2
Manufacturing	25.0	20.7	16.1	14.6
Electricity, gas and water	23.4	34.4	31.0	34.8
Construction	21.0	22.2	23.7	33.5
Commerce, restaurants and hotels	27.4	17.1	13.2	14.4
Transport	19.2	18.2	13.8	11.2
Financial establishments	18.1	17.9	19.7	22.0
Community, social and personal services	18.5	18.1	18.2	18.8
Total	18.4	17.0	15.4	16.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

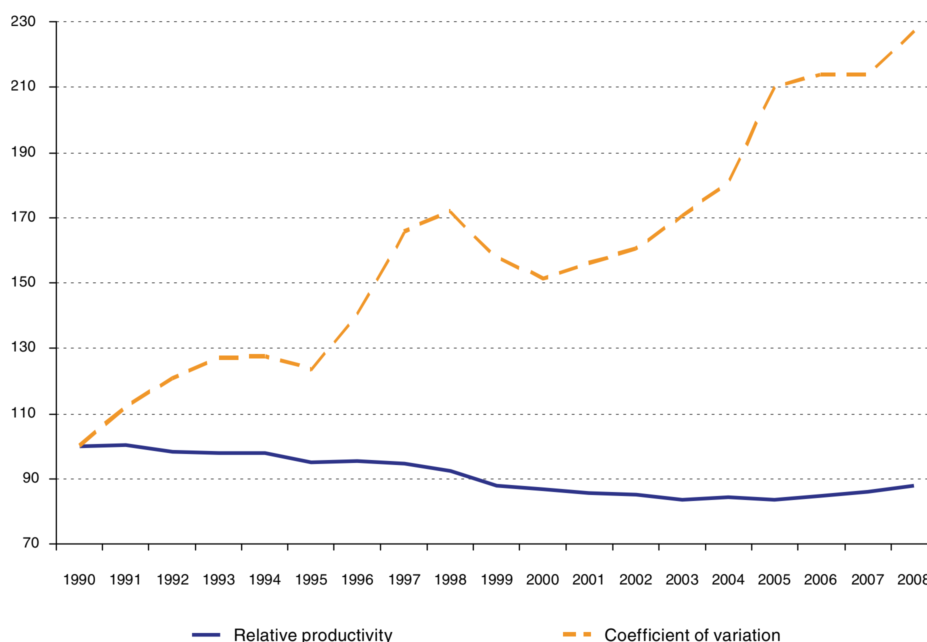
[a] Calculation based on the economically active population, broken down by sectors, indicated by the International Labour Organisation (ILO), and corrected for the sectoral unemployment rates given by ILO.

In high-productivity sectors (mining, electricity and financial establishments), the productivity gap between Latin America and the United States narrowed between 1990 and 2008. In most medium- and low-productivity sectors, such as agriculture, industry, transport and commerce, the gap widened, however. The only exception was the construction sector, where, despite the low productivity that characterizes the Latin American building industry, the gap narrowed, mainly because of the decline in construction productivity in the United States.

The performance of high-productivity sectors has slightly narrowed the productivity gap between the United States' economy and that of Latin America as a whole in recent years. Slow growth in the remaining sectors, however, has led to a sharp increase in the coefficient of variation of relative productivity. In other words, a small percentage of enterprises and workers in Latin America are approaching the international frontier while the rest are moving away from it, which reinforces the structural disparities and acute inequalities in the region.

Figure III.1 shows changes in relative productivity and its dispersion. The increase in dispersion indicates that within Latin America the distance between the sectors in which the external gap is narrowing and those in which it is widening is growing. This comparison reveals sectors' different capacities to utilize their potential to absorb cutting-edge technology. A higher coefficient of variation is an indicator of problems with competitiveness and with linkages within the production structure, which have an adverse impact on economic growth.

Figure III.1
LATIN AMERICA (SELECTED COUNTRIES) AND THE UNITED STATES: RELATIVE PRODUCTIVITY AND COEFFICIENT OF VARIATION
(1990=100)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

From 1990 to 2008, both the dispersion of relative productivity (the broken line in figure III.1) and the average external gap for the economy overall (the solid line) increased. This highlights the widening of the gap between a small group of sectors (and therefore of enterprises and workers) that are approaching the external production frontier and the rest of the economy, which is lagging further behind international standards. It should be noted, however, that the

decline in relative productivity from 2003 to 2008 was interrupted —it stood at 15.4% in 2003 but at 16.2% in 2008— within a very particular context of growth recovery associated with a favourable trend in prices for commodities and raw materials.

The economies of the Caribbean have adopted models of structural heterogeneity based on an abundance of natural resources and the specialization of trade which, until recently, depended on non-reciprocal preferential agreements with the European Union and North American markets. Some countries, especially those belonging to the Organisation of Eastern Caribbean States (OECS), have emerged as economies that largely depend on tourism and financial services. For example, in 2006, services exports as a share of all exports from Antigua and Barbuda, Bahamas, Barbados, Dominica, Grenada, Saint Kitts and Nevis, Saint Lucia and Saint Vincent and the Grenadines stood at between 67% and 86%, and the OECS average was 77.2%. By contrast, the corresponding proportions for Belize, Dominican Republic, Guyana, Haiti, Jamaica, Suriname and Trinidad and Tobago ranged between 8.5% and 55%. Within the latter group, the economies of the Dominican Republic, Haiti, Jamaica and, to a certain extent, Barbados are based on a combination of basic-services and goods-producing sectors.

The fundamental problem for both services-based and goods-based economies is the limited range of goods and services produced and sold in the area and the effect that this factor has on growth.[9] A measurement of total factor productivity underscores the magnitude of the problems that arose in the late 1990s when trading regimes in the Caribbean and throughout the world were undergoing changes.[10] Kida (2005) notes that, in the 1980s, total factor productivity was positive in most Caribbean countries, accounting for nearly half of the growth in output.[11] Nevertheless, the findings suggest that, in the 1990s, total factor productivity, as well as competitiveness declined, except in Belize, Guyana and Trinidad and Tobago. In addition, a World Bank study (2008) shows that growth in total factor productivity in several OECS countries tapered off in the 1990s, although not in Saint Kitts and Nevis. Machado (2009) arrived at a similar conclusion for the Caribbean overall.

While there are various explanations for lower productivity growth, including overvalued exchange rates and rising Government investment —which may have crowded out private investment— manufacturing, agriculture, and services grew at a slower pace in this period. The structural changes are borne out in OECS data. For example, in the 1990s, average yearly banana output fell by 4.8% in volume terms, while in value terms it decreased by 3.9%, and in 2000 the two indicators decreased by 11.3% and 14.7%, respectively. At the same time, tourism receipts climbed by 17.6% in the 1980s, by 4.1% in the 1990s and by 4% in the 2000s.

2. Productivity gaps and employment

Data on the production structure must be examined in conjunction with data on employment. If the sectors in which productivity rises account for a small proportion of total employment, then only a few workers will benefit from higher wages, while the rest will continue to be employed in

[9] There was an attempt to diversify the range of tourism products and to create specialized markets, such as ecological tourism, community tourism, cultural tourism, tourist centres for couples and special events, including jazz festivals.

[10] Because of the limitations in the measurement of total factor productivity, these results are merely illustrative.

[11] The countries included were Antigua and Barbuda, Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Saint Kitts and Nevis, Saint Lucia, Saint Vincent and the Grenadines, Suriname and Trinidad and Tobago.

sectors where wages and productivity are lower. This relationship is examined briefly below and is analysed in greater depth in Chapter V, which focuses specifically on employment.

High-productivity sectors account for a rather small portion of all employment (8.1% in 2008), as shown in table III.5. From 1990 to 2008, employment in high-productivity sectors as a proportion of total employment remained nearly constant, increasing by only 0.2 percentage points from the beginning to the end of the period, while the ratio of employment in medium-productivity sectors to all employment decreased sharply (by three percentage points) and employment in low-productivity sectors as a share of all employment increased by 2.9 percentage points. The long-term trend from 1990 to 2008 was for the number of workers (and, probably, of enterprises) to increase in low-productivity sectors, at the expense of the medium-productivity ones. In other words, heterogeneity increased. Importantly, the expansion of the proportion of employment in low-productivity sectors was interrupted during the economic upturn from 2003 to 2008, although (as in the case of the external gap) not sufficiently for this proportion to return to its 1990 level.

Table III.5

LATIN AMERICA (SELECTED COUNTRIES): STRUCTURE OF EMPLOYMENT, 1990-2008 [a]

(Percentages)

	1990	1998	2003	2008
High-productivity sectors [b]	7.9	7.0	7.3	8.1
Medium-productivity sectors [c]	23.1	20.7	19.7	20.0
Low-productivity sectors [d]	69.0	72.3	73.0	71.9
Total	100.0	100.0	100.0	100.0

Source: Economic Commission for Latin America and the Caribbean (ECLAC), "América Latina y el Caribe. Series históricas de estadísticas económicas 1950-2008", *Cuadernos estadísticos*, No. 37 (LC/G.2415-P), Santiago, Chile, 2009. United Nations publication, Sales No. S.09.II. G.72 and International Labour Organization (ILO), LABORSTA [online database] http://laborsta.ilo.org/, 2009.

[a] Calculation based on the economically active population, broken down by sectors, indicated by the International Labour Organisation (ILO), and corrected for the sectoral unemployment rates given by ILO.

[b] Mining, energy and finance.

[c] Industry and transport.

[d] Agriculture, construction, commerce and community and personal services.

A rise in the proportion of workers in low-productivity sectors has an impact on social equity as it leads to a more unequal distribution of wages in favour of a small group of workers with more advanced skills who are more securely engaged in high-productivity activities. Recent trends in employment and its relationship with productivity are examined further in Chapter V, which focuses specifically on this topic.

3. Heterogeneity among agents: employment, wages and performance

Disparities are found both among sectors and among agents within different sectors. As noted above, there are enormous productivity gaps in the agricultural sector between the traditional peasant economies and the fastest-growing agro-industrial niches. In urban areas, large numbers of workers entered the informal sector over the last three decades as a sizeable population of low-

productivity economically active persons found work that requires little specialization in sectors such as commerce and services. This exacerbated existing disparities.

One way to quantify productive heterogeneity is to classify companies by size. More than 90% of the companies of the region are micro-, small and medium-sized enterprises, which account for a considerable proportion of employment, a much smaller share of output and a negligible share of exports. Recent, in-depth research by ECLAC on the magnitude of the differences in productivity among enterprises of varying sizes has confirmed the extent to which the region is heterogeneous and the relationship between heterogeneity and indicators of growth and inequality (Infante, 2009). Moreover, the lack of linkages in the production structure means that even the export sector is heterogeneous and offers only weak stimuli for small enterprises to grow (Infante and Sunkel, 2009). Hence, during certain stages, heterogeneity may curb economic growth. Table III.6 shows the share of total employment, GDP and exports for different types of agents.

Table III.6
LATIN AMERICA (SELECTED COUNTRIES): SHARE OF EMPLOYMENT, GDP AND EXPORTS FOR DIFFERENT TYPES OF ENTERPRISES [a]
(Percentages)

	Microenterprises	Small enterprises	Medium-sized enterprises	Large enterprises
Employment	30.4	16.7	14.2	38.7
GDP	7.3	9.8	11.4	71.5
Exports	0.2	1.8	6.4	91.6

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

[a] The table indicates employment, GDP and exports for each type of enterprise as a ratio of the total for the formal sector. A simple average, based on official data from Argentina, Brazil, Chile and Mexico, was used. The criterion for classifying enterprises by size is in keeping with the definitions used by the development institutions in each country (see Ferraro and Stumpo, 2009).

Relatively smaller agents constitute a highly heterogeneous group, ranging from subsistence microenterprises to somewhat fast-growing medium-sized exporters. A comparison of the performance of these enterprises in the region (their productivity versus that of large enterprises within each country) with the performance of similar-sized companies in developed countries sheds light on two important points:

First, differences in relative productivity within each country (between large enterprises and others) are much greater in Latin America than in developed countries. Whereas microenterprise productivity in Chile is just 3% that of a large company, the equivalent figure in France is 71%.

Second, as shown in table III.7 —again with regard only to relatively small enterprises— the differences between microenterprises, small enterprises and medium-sized enterprises are greater in the region than in the developed countries under consideration. In Brazil, the productivity of a microenterprise is 25% that of a medium-sized firm and 37% that of a small enterprise, while in Spain the respective ratios are 60% and 73%.

Table III.7
RELATIVE PRODUCTIVITY OF VARIOUS AGENTS COMPARED WITH THAT OF LARGE ENTERPRISES [a]
(Percentages)

	Microenterprises	Small enterprises	Medium-sized enterprises	Large enterprises
Argentina	24	36	47	100
Brazil	10	27	40	100
Chile	3	26	46	100
Mexico	16	35	60	100
Peru	6	16	50	100
Germany	67	70	83	100
Spain	46	63	77	100
France	71	75	80	100
Italy	42	64	82	100

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

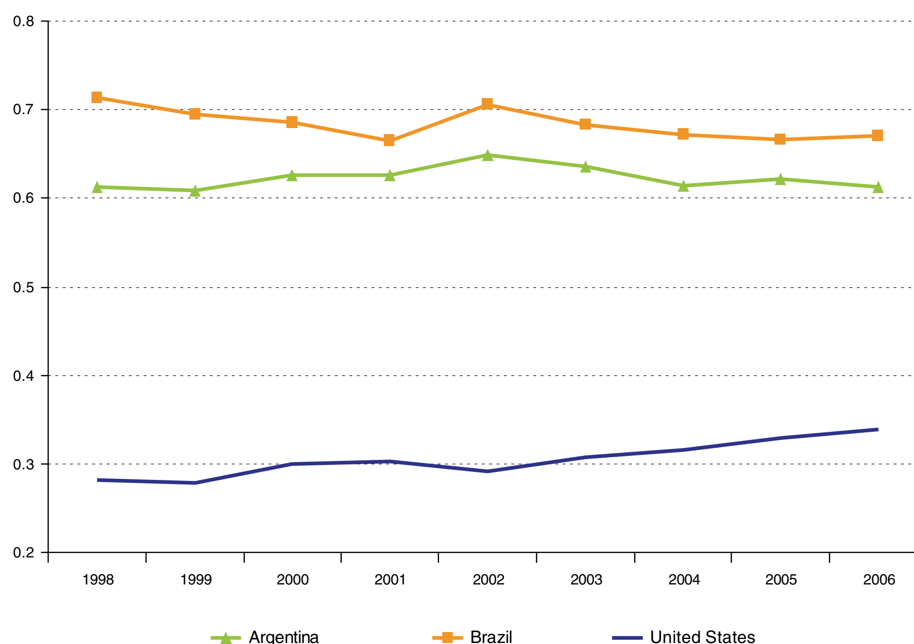
[a] The figures in the table correspond to the productivity for each type of enterprise as a percentage of that of their larger counterpart. The productivity data and the classification of enterprises by size comprise only the formal sector of the economy and are based on information released by the development institutions in each country (see Ferraro and Stumpo, 2009).

These data underscore the high degree of heterogeneity among relatively small enterprises. This has important policy consequences, given that different programmes, instruments and methodologies will be need to be implemented to take account of the differences among this highly diverse group of agents.

Because of the degree of heterogeneity, considerable wage differences can be assumed to exist both among sectors and among enterprises. To verify the validity of this assumption, information on the unit wages of different types of enterprises in the nine economic sectors of Argentina, Brazil and the United States were examined. A dispersion index was constructed for each country using data on the wages of workers in micro-, small and medium-sized enterprises, in the nine sectors. The index reflects wage differences both among sectors and among agents. As shown in figure III.2, wage dispersion levels are indeed much higher in Argentina and Brazil than in the United States.

Labour policies may help narrow wage differences and therefore influence the degree of dispersion of unit wages. Indeed, figure III.2 shows a reduction in the coefficient of dispersion starting in 2002-2003 both in Argentina and Brazil, just as more proactive labour policies were being implemented. Yet these policies failed to substantively reduce wage dispersion, because it is rooted in the very high degree of heterogeneity among sectors and among agents characteristic of Latin American economies. Hence the importance of production convergence policies, which are the focus of section D of this chapter.

Figure III.2
ARGENTINA, BRAZIL AND THE UNITED STATES: WAGE VARIATION COEFFICIENTS



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

C. Heterogeneity in the manufacturing sector: variations in the productivity gap and specialization

A more detailed analysis of the trends in the productivity gap and in the heterogeneity in the manufacturing sector is provided in this section. A study of the various segments of this sector reveals that asymmetries in the pace of technological change had an impact not only on productivity but also on productive specialization.

Manufacturing was highly protected for many years, which spurred strong growth in this sector, particularly in the largest economies of the region, namely Argentina, Brazil and Mexico. Still, the debt crisis and the low levels of investment during the "lost decade" of the 1980s dealt a severe blow to the sector. The downturn in industry was even sharper than that of the economies as a whole, and industrial output as a share of GDP declined. In the 1990s, however, when the economy began to overcome the crisis as a result of stabilization policies and the return of foreign capital, Latin America's manufacturing industry showed signs of recovery. Though, by then, its structure had changed.

Indeed, in the 1990s Latin America's policies and the growth model changed substantially, in association with sweeping trade liberalization and the abandonment of previous technology policies (Stalling and Peres, 2000). The coefficient of openness for the region rose significantly between 1990 and 2008, while the mesh of intersectoral ties and linkages became more diffuse.[12]

[12] The coefficient of openness is the ratio of the sum of imports and exports to GDP.

Under the new growth model, the input-output matrix contains fewer sectors overall, and there are more empty spaces in the production matrix and fewer production- and technology-related linkages (Infante and Sunkel, 2009).

There were two phases of rapid industrial growth, one in the 1990s and the other during the boom from 2003 to 2008 that was driven by a strong surge in raw materials prices. Both phases slowed the downward trend in the coefficient of industrialization that had characterized the region since the 1970s. In several of the countries considered in this document —Argentina, Colombia, Costa Rica, Ecuador, Nicaragua, Peru, Plurinational State of Bolivia and Uruguay— industrial output as a share of domestic value added actually increased.

Although the technology-intensive sectors of several countries of the region have grown at rates higher than those of other industrial segments, they have not recovered the relative weight they had in previous periods. Technological capabilities and production linkages diminished throughout the 1980s and 1990s while, at the same time, research and development expenditures were cut and high-technology-content goods imports climbed.

This loss of technological capabilities was accompanied by a considerable loss of institutional capabilities within the public sector (Katz and Stumpo, 2001). Consequently, the industrial plant responsible for the growth recorded in 2003-2008 was qualitatively very different from the productive system that had existed in the region in previous decades, just as the institutional framework within which production was promoted, and which set guidelines for growth, was also quite different. In recent years, the erosion of institutional capacity has meant that several countries of the region ran into serious difficulties in the design stage and encountered insurmountable obstacles in implementation when they attempted to carry out industrial promotion plans.

The near-complete absence of proactive industrial promotion policies in the 2003-2008 growth period, along with the profound transformation of the industrial sector in the preceding decades, meant that although there was a basically quantitative increase in output in technology-intensive sectors (and, in general, in the manufacturing sector as a whole), no concomitant build-up was recorded in technological capabilities.[13] The consequences can be seen in two aspects: the first is related to the region's position in external markets and its industrial trade balance, while the second is associated with changes in productivity.

The growing importance of the external sector can be seen in the rise in the industrial import and export coefficients. In particular, the sharper increase in the coefficients for industrial imports from 2003 to 2008 underscores the productive system's difficulty in competing in most sectors. This is particularly clear for technology-intensive sectors, although it also applies to labour-intensive ones which face competition from new producers, especially from Asia. As a result of this weakness and given the sustained increase in domestic demand, industrial trade balances are either running higher deficits or posting waning surpluses (table III.8).[14]

During the same years, the deficit was offset by high prices for the region's agricultural and mining exports. Over the medium and long terms, this situation is unlikely to be sustainable,

13 The exception in this case is Brazil.

14 In the English-speaking Caribbean, high-technology manufactures accounted for 6% of exports in 1985, compared with only 1.4% in 2000 (ECLAC, 2003).

given the degree of openness of the economies of the region and the volatility of raw materials prices (which has been confirmed by the current international crisis).

Table III.8
LATIN AMERICA: TRADE BALANCE
(Thousands of current dollars)

	1970	1980	1990	1998	2003	2008
Agriculture	1 302 191	3 229 446	8 053 713	12 045 198	14 048 738	28 384 653
Mining	2 594 776	15 345 835	18 048 226	17 696 919	40 372 224	150 455 987
Industry	-3 585 818	-22 486 471	-6 810 511	-60 463 927	-30 168 729	-148 563 691
Engineering-intensive industrial sectors	-4 974 309	-24 229 565	-20 033 217	-43 815 418	-19 375 174	-102 246 840
Natural-resource-intensive industrial sectors	1 958 858	2 759 600	12 702 086	-7 918 827	-676 687	-10 028 422
Labour-intensive industrial sectors	-570 367	-1 016 507	520 620	-8 729 681	-10 116 868	-36 288 428
Overall total	311 149	-3 911 191	19 291 428	-30 721 810	24 252 233	30 276 949

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the External Trade Data Bank for Latin America and the Caribbean (BADECEL).

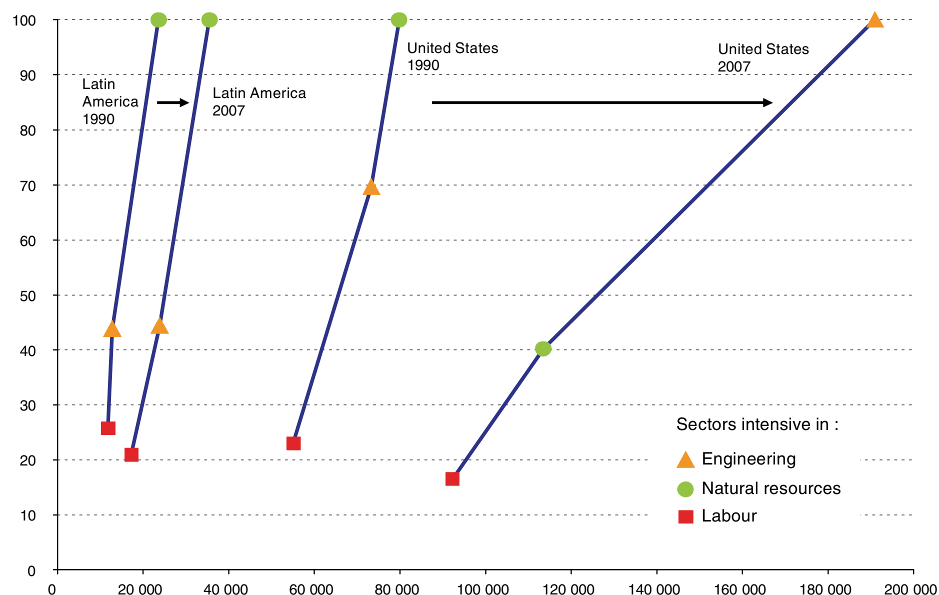
An analysis of the trends in the most technology-intensive sectors requires an examination not only of the external balance, but also of the transformations that have taken place within manufacturing, in terms of changing composition and rising productivity. Two indicators are used to evaluate these trends: (a) the share of industrial value added corresponding to the three categories into which industry has been broken down (high-technology-intensive, natural-resource-intensive and labour-intensive), and (b) the productivity of these three groups. As in the preceding sections, changes in some of the countries of the region from 1990 to 2007 have been compared with changes in the production structure in the United States during the same period. This comparison is presented in figure III.3 below, in which the square corresponds to labour-intensive sectors; the circle, to natural-resource-intensive sectors; and the triangle, to engineering-intensive sectors.

The vertical axis represents the total share of industrial GDP that these groups of sectors account for. As shown in the figure, in 1990 labour-intensive sectors in Latin America accounted for 25.7% of industrial GDP, compared with 18.2%[15] for technology-intensive sectors and 56.1%[16] for natural-resource-intensive sectors. The horizontal axis represents labour productivity (in 1985-constant dollars) for these groups of sectors. In Latin America in 1990, natural-resource sectors had the highest productivity, followed by technology-intensive sectors, while labour-intensive sectors had the lowest productivity. Thus, in the same year, natural-resource-intensive sectors, as a group, had the highest share of industrial GDP in the region as well as the highest productivity. In 2007, natural-resource-intensive sectors continued to have the highest share of GDP (55.6%[17]) and the

[15] The vertical distance between the triangle and the square on the first curve in figure III.3.
[16] The vertical distance between the circle and the triangle on the first curve in figure III.3.
[17] The vertical distance between the circle and the triangle on the second curve in figure III.3.

highest productivity. Moreover, the share of industrial GDP corresponding to engineering-intensive sectors rose, to 23.4%,[18] although productivity in these sectors is considerably lower than that of natural-resource-intensive sectors.[19]

Figure III.3
LATIN AMERICA (SELECTED COUNTRIES) AND THE UNITED STATES: PRODUCTIVITY AND BREAKDOWN OF INDUSTRIAL VALUE ADDED
(Percentages of industrial GDP and 1985 dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of the Industrial Performance Analysis Program.

A comparison with trends in the United States shows that productivity increased much more in this country than in the region. The horizontal axis in figure III.3 measures productivity, with a rightward shift in a curve indicating an increase in productivity between the two years in question. The curve corresponding to the United States for 2007 shifted much further to the right than did the curve for Latin America. This is the case for all sectors under consideration, and in particular for technology-intensive ones.

However, the differences are not limited to productivity; they also include the composition of the production structure. In the United States, the share of industrial GDP corresponding to technology-intensive sectors rose from 46.7%[20] in 1990 to 60% in 2007.[21] In 1990, productivity in these sectors was lower than in natural-resource-intensive sectors, but by 2007 productivity in

[18] The vertical distance between the triangle and the square on the second curve in figure III.3.

[19] As can been seen from the horizontal axis of figure III.3, in 2007, productivity in natural-resource-intensive sectors was equivalent to US$ 35.51, compared with US$ 28.81 for engineering-intensive sectors.

[20] The vertical distance between the triangle and the square on the third curve in figure III.3.

[21] The vertical distance between the triangle and the circle on the fourth curve in figure III.3.

technology-intensive sectors was considerably higher that that of the latter group.[22] Hence, between 1990 and 2007, the production structure of the United States underwent a transformation, led by technology-intensive activities.

Technology-based segments generate knowledge spillover effects that encourage productivity increases throughout the industrial structure; hence, the structural transformation of the United States is accompanied by a generalized increase in productivity in the overall economy. By contrast, in Latin America, both in 1990 and 2007 the highest-productivity sectors and those that added the most manufacturing value were natural-resource intensive. The expansion of these sectors (especially in the absence of relevant policies) has few positive effects on overall technological capabilities, and their high productivity stems above all from the availability of natural resources. These sectors undoubtedly adopt technology, but mainly imported technology, and their lack of an endogenous capacity to innovate minimizes the catalytic role of learning. These sectors are characterized by continuous-production processes, which, by definition, are more difficult to break down into discrete spatial and temporal phases. Hence, they offer a much smaller number of opportunities for generating subcontracting linkages with other firms and therefore for transferring know-how and technology to other activities and enterprises (for example, to SMEs). Natural-resource-intensive sectors also have less capacity to generate backward and forward linkages, owing to the "technological strangeness" between existing activity and the new activities that are to be generated.[23]

Unlike that of the United States, Latin America's manufacturing sector did not undergo a structural change between 1990 and 2007 (see figure III.3). In Latin America, the sectors whose share of GDP and whose productivity make them the engines of economic growth have been the natural-resource-intensive sectors. This has brought about a modest increase in total output, but the associated increase in productivity has been far from sufficient to close the gap with the more developed countries. In the meantime, developed countries have succeeded in shifting their production structure in favour of technology-intensive sectors, and enterprises in these countries have transformed their business model, incorporating, among other things, new technological paradigms, such as information and communication technologies (ICT).

In terms of investments in research and development (R&D), not even the most advanced countries of the region have reached the level of European countries, Japan or the United States, where spending on R&D is between 2% and 3.6% of GDP (ECLAC, 2008b). In many countries of Latin America (Bolivarian Republic of Venezuela, Colombia, Costa Rica, Panama, Plurinational State of Bolivia and Uruguay), R&D outlays are, at most, 0.5% of GDP, and in others, spending is very close to that level (Argentina and Mexico). Only two countries (Brazil and Chile) spend substantially more. Brazil is an exception in the region, in that its R&D expenses have increased since the late 1990s and now stand at close to 1% of GDP, making it the regional leader in R&D investment (see table III.9).

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[22] As can been seen in figure III.3, in 1990, output of natural-resource-intensive sectors was equivalent to approximately US$ 80,000, compared with US$ 73,000 for engineering-intensive sectors. In contrast, by 2007, there was a reversal in this situation, and productivity in engineering-intensive sectors stood at of US$ 190,000, whereas in natural-resource-intensive sectors it had risen to US$ 113,000.

[23] This refers to Hirschman's idea of technological strangeness. Sometime the technologies used in an existing sector are of a complexity and have characteristics that make them very different from those used in the potential linkage (whether forward or backward). This will require a technological leap that is very unlikely to be made (Hirschman, 1977).

R&D investment functions according to a different logic in Latin America than in most developed economies, both in terms of funding sources and of the sectors that make investments for this purpose. The public sector continues to be the largest funder of R&D in the region, accounting on average for more than 50% of the total. By contrast, in more developed economies, the private sector funds and carries out most science and technology activities (with over 65% of the total in the United States) (ECLAC, 2008).

Table III.9
RESEARCH AND DEVELOPMENT EXPENDITURES
(Percentages of GDP)

	1998-2002	2002-2006	2007
Argentina	0.42	0.44	0.49
Bolivia (Plurinational State of)	0.29	…	0.28 (2002)
Brazil	0.56	0.92	1.02
Chile	0.55	0.67	0.67
Colombia	0.17	0.17	0.18
Costa Rica	0.36	0.41	0.41 (2004)
Cuba	0.51	0.51	0.41
Ecuador	0.07	0.09	0.15
Guatemala	…	0.04	0.05
Honduras	0.06	0.06	0.06 (2004)
Jamaica	0.06	…	0.07 (2002)
Mexico	0.40	0.44	0.46 (2005)
Panama	0.37	0.30	0.25 (2005)
Paraguay	0.10	0.09	0.09 (2005)
Peru	0.10	0.13	0.15 (2005)
Trinidad and Tobago	0.12	0.12	0.09
Uruguay	0.24	0.31	0.36
Venezuela (Bolivarian Republic of)	0.41	0.62	…
Latin America	0.54	0.57	0.63
Spain	0.91	1.09	1.20
Portugal	0.74	0.78	0.83
United States	2.65	2.62	2.60

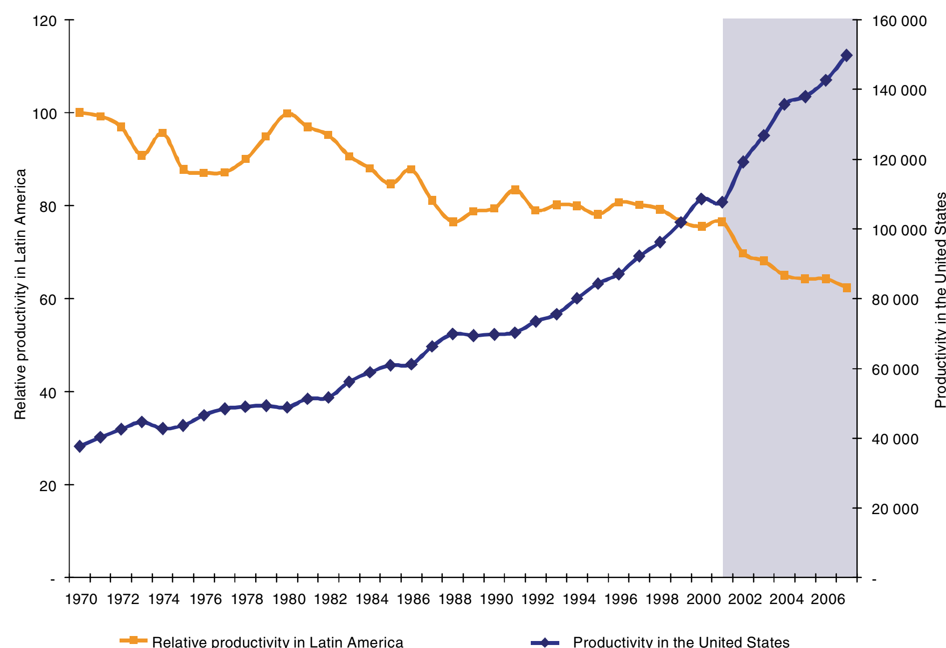
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from UNESCO International Institute for Statistics (UIS) and Ibero American Network of Science and Technology Indicators (RICYT).

It is clear that technological change in Latin American industry has been limited and inadequate in light of the challenges posed by a production structure that is more open and more integrated into international trade. The situation may become even more difficult in an international context in which, for several years, technologies and production processes have been changing in response to increased ICT use.

A comparison of productivity in the countries of the region with that of the United States shows just how large a challenge the region faces in terms of technological convergence. The

trends in the relative labour productivity index for Latin America's industrial sector reveal that the gap has not been narrowed during the period under consideration (see figure III.4).[24]

Figure III.4
RELATIVE PRODUCTIVITY INDEX OF LATIN AMERICA (SELECTED COUNTRIES) AND PRODUCTIVITY IN THE UNITED STATES
(1970=100 and 1985 dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of the Industrial Performance Analysis Program.

In the 1980s, the productivity gap began to widen, until the first half of the 1990s, when it started to narrow. In the mid-1990s, however, the relative productivity index for Latin America once again began to decline, with which the productivity gap widened. There were two reasons for this decline, which was particularly sharp in the last six years of the decade: (a) industrial labour productivity in the countries of the region increased by only 2% a year from 2003 to 2007, the worse performance for this indicator in 37 years (except for the "lost decade" of the 1980s); (b) beginning in the mid-1990s, the pace of productivity growth in the United States, which for 20 years had stood at approximately 3% per year, rose to about 5% per year. This higher rate of productivity growth resulted from changes in production processes based on the increased incorporation of ICT (Oliner, Sichel and Stiroh, 2007). The "acceleration" in the rate of increase of productivity in the United States therefore stemmed above all from the transformation of the industrial structure and the incorporation of new technological paradigms (in particular, ICT) into that structure.

[24] The index (base year 1970=100) is equal to the quotient of labour productivity in Latin America to labour productivity in the United States. A value of less than 100 indicates than the distance between productivity in the United States and productivity in Latin America has widened, and, therefore, that the productivity gap has also widened.

Figure III.4 also shows the effects of the various crises, with a drastic fall in relative productivity during the 1980s' debt crisis, a modest recovery starting in the early 1990s and a new decline starting in the second half of that decade (known as the "tequila crisis"). Each price- or real-exchange-rate-induced crisis was followed by a decline in productivity during the ensuing adjustment. If technological capabilities were destroyed, productivity increased more slowly after the shock, at least for a certain time. That is, under certain conditions, such as the destruction of know-how, each shock lowered the rate of post-adjustment productivity growth that could be attained. During the period of reforms, policymakers of the countries of the region were guided by the overarching assumption that companies and sectors adapted better and produced more efficiently when markets were liberalized and resources could shift freely to more competitive activities. This assumption proved mistaken as the loss of capacities in high- and medium-technology sectors was not offset by the symmetrical construction of new capabilities in natural-resource-intensive ones (Cimoli and others, 2009).

D. Productivity gap and energy gap

The energy sector plays a particularly important role in the productivity gap, for several reasons. The sector is strategic for international competitiveness, since energy is a key resource for raising output and lowering costs. The energy sector also affects the purchasing power of the most disadvantaged groups, given that in many countries of the region, energy sources and costs, as well as access to energy, vary considerably across income groups (ECLAC/SEGIB, 2009). Lastly, the energy sector accounts, both directly and indirectly, for a substantial proportion of the planet's greenhouse gas emissions.

There is growing consensus within societies and Governments regarding the need for environmentally sustainable growth models and, especially, for a shift towards low-carbon economies, and these issues will become increasingly important for future domestic- and foreign-policy agendas. A prime challenge for coming years is to discover and promote more sustainable paths for growth and, in particular, models for structural change in which progress in wealth distribution goes hand in hand with progress in sustainability. The evidence given below on the energy gap and structural change suggests that advances can be achieved with regard to learning, technological externalities and sustainability at one and the same time within the development process.

The industrial sector consumes large amounts of energy: around 30% of total energy consumption, both in the United States and in Latin America. On the other hand, as noted in this section, industry's traditional role in generating technical progress and passing it on to other areas of the economy means that industry is also crucial for generating the innovations needed to lower energy consumption and carbon emissions.

Given the importance of the industrial sector, the correlation between energy consumption and higher industrial value added has received close attention, since it underscores trends in energy. This correlation, widely discussed in the literature on the stages of industrialization processes in developed countries, has once again become pivotal for developing economies as the economies on the periphery move ahead with their industrialization.[25] There is no single, universal correlation between a society's energy consumption and its level of development: the

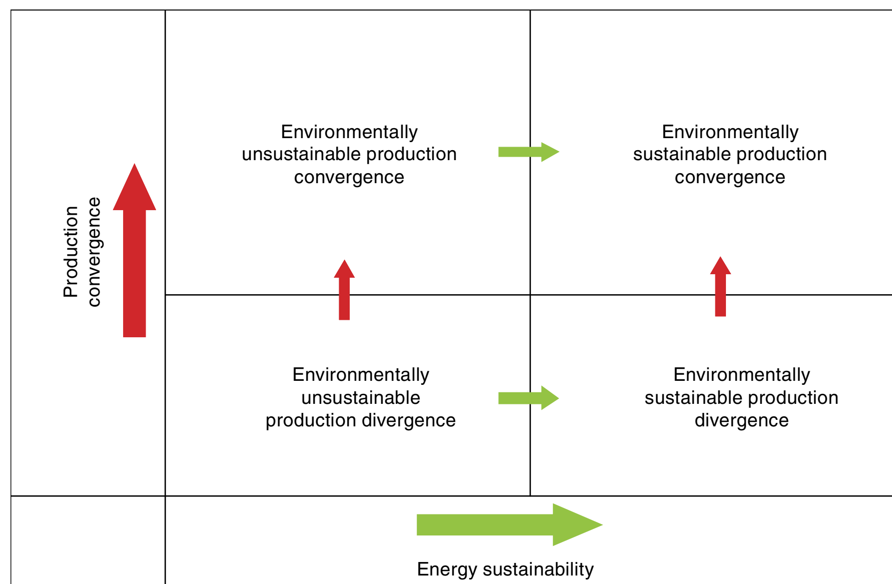
[25] See Cole, Rayner and Bates (1997); De Bruyn, van den Bergh and Opschoor (1998); and Pasche (2002).

disparities over time and in different areas of production appear to be associated, on the one hand, with technology choices, and, on the other, with resource use. Technology choices made by the agents of production affect energy consumption, as well as the productivity and competitiveness achieved with the energy consumed. This poses a twofold challenge for economic policy, given that countries must make technology choices that encourage efficiency, in terms of both production and energy consumption.

A commonly used indicator of efficiency is energy intensity, or the ratio of the quantity of energy consumed to industrial value added. This indicator can also be used to construct a measure of Latin America's energy intensity relative to that of the United States.[26] If labour productivity, as an indicator of the efficiency of production, is also considered, four different situations can be identified (see diagram III.1).

Diagram III.1

MATRIX OF PRODUCTION DEVELOPMENT AND ENERGY SUSTAINABILITY



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

To attain a virtuous, sustainable development pattern (upper-right quadrant of diagram III.1) Latin America will need to introduce structural changes and reduce its productivity differences with the most developed countries (that is, it will need a production convergence) while also lowering energy consumption per unit of output (environmental sustainability). This scenario might be called "sustainable convergence". The opposite of this virtuous pattern occurs when the least technologically dynamic sectors play a central role within the production structure, which widens the productivity gap, and when consumption patterns are adopted that cause energy consumption to be higher than is the case in developed economies (lower-left quadrant, unsustainable divergence). This type of growth pattern is often associated with natural-resource-

[26] This is the quotient of the energy intensity of a given country to the energy intensity in the United States. Hence, the energy gap is equal to: 1 – relative energy intensity.

intensive sectors, which are mature and are slower to incorporate technological change. Moreover, greater natural-resource use entails higher energy consumption.

In the remaining two scenarios, either efforts are focused on raising energy efficiency, but with less production efficiency (lower-right quadrant, sustainable divergence), or a more technology-intensive specialization pattern is adopted, narrowing the productivity gap but increasing energy consumption per unit of value added (upper-left quadrant, unsustainable convergence). The latter pattern heavily emphasizes production objectives, at the expense of energy objectives.

This section now analyses, on the basis of available information, the industrial sector in four countries of Latin America, Brazil, Chile, Colombia and Mexico, and compares energy consumption and productivity between these countries and the United States from 1996-1997 to 2006.[27]

In figure III.5 below, the square corresponds to labour-intensive sectors; the circle, to natural-resource-intensive sectors; and the triangle, to engineering-intensive sectors. The vertical axis represents the cumulative share of industrial energy consumption that these groups of sectors account for. In 1996, labour-intensive sectors in Latin America accounted for 17.4% of industrial energy consumption, compared with 8.8%[28] for technology-intensive sectors and 73.8%[29] for natural-resource-intensive sectors, as shown in the figure. The horizontal axis represents labour productivity (in 1985-constant dollars) for these groups of sectors. In Latin America in 1996, the group of sectors with the highest productivity were natural-resource-intensive sectors, followed by technology-intensive segments, while labour-intensive sectors had the lowest productivity. In 2006, natural-resource-intensive sectors continued to be the group with the highest productivity in the region, while their share of industrial energy consumption rose (to 76.6%).[30]

By contrast, in the United States, the highest-productivity sectors are engineering-intensive, and these sectors' share of total energy consumption declined from 28.4%[31] to 24.1%[32] between 1997 and 2006. Importantly, both in the United States and in the four Latin American countries, natural-resource-intensive sectors account for the largest share of industrial energy consumption and, therefore, their intensive use of energy per unit of output must not be overlooked. Given the specialization and the composition of industrial production in Latin America (described in the previous section), the region consumes an increasingly high amount of energy per unit of output, with lower levels of relative productivity. The opposite is true of the United States, as a result of that country's productive specialization.

The different patterns of development of countries or regions are determined by the closure of energy and productivity gaps, which, in turn, determines their position in the matrix of productive development and energy sustainability. Thus, it can be posited that even if the analysis were to include groups of sectors, the four countries of Latin America are far from closing the energy and productivity gaps, since for the most part they are located in the quadrant corresponding to a development pattern of unsustainable divergence (see diagram III.2).

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27 This sampling was selected on the basis of available data, given that only some countries give information on energy consumption with a breakdown by manufacturing sectors in their industrial surveys. The paucity of data also narrowed the study period, which is from 1996 to 2006.

28 The vertical distance between the triangle and the square on the first curve in figure III.5.

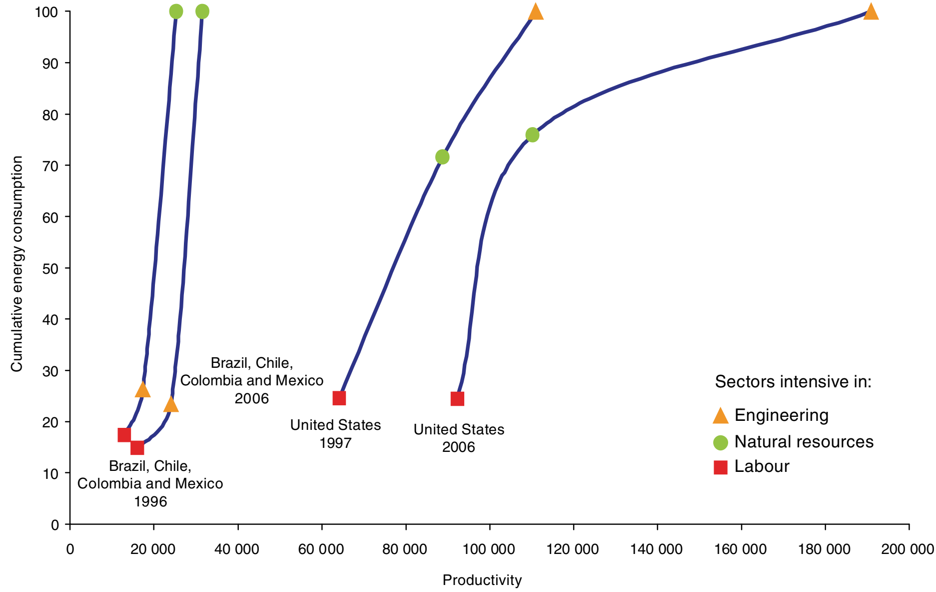
29 The vertical distance between the circle and the triangle on the first curve in figure III.5.

30 The vertical distance between the circle and the triangle on the second curve in figure III.5.

31 The vertical distance between the triangle and the circle on the third curve in figure III.5.

32 The vertical distance between the triangle and the circle on the fourth curve in figure III.5.

Figure III.5
LATIN AMERICA (FOUR COUNTRIES) AND THE UNITED STATES: STRUCTURE OF ENERGY CONSUMPTION AND PRODUCTIVITY
(Percentages and 1985-constant dollars)



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

Diagram III.2
ANOTHER EMPTY BOX? THE ENERGY GAP AND THE PRODUCTIVITY GAP, 1996-2006

<table>
<tr><td rowspan="4">Production convergence</td><td>Narrowing of production convergence</td><td colspan="2">Chile – Natural resources
Chile – Labour
Colombia – Natural resources
Mexico – Natural resources</td><td></td></tr>
<tr><td rowspan="3">Widening of production convergence</td><td>Brazil – Engineering
Brazil – Natural resources
Brazil – Labour
Brazil – Total
Chile – Engineering
Chile – Total</td><td>Colombia – Engineering
Colombia – Labour
Colombia – Total
Mexico – Engineering
Mexico – Total</td><td>Mexico – Labour</td></tr>
<tr><td colspan="2">Widening of energy convergence</td><td>Narrowing of energy convergence</td></tr>
<tr><td colspan="3">Energy sustainability</td></tr>
</table>

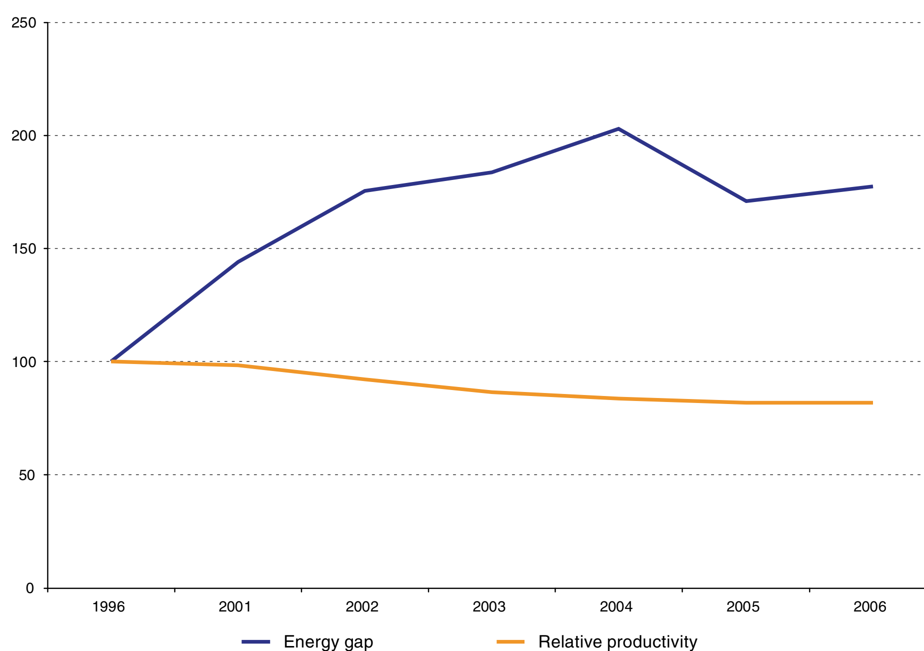
Source: Economic Commission for Latin America and the Caribbean (ECLAC).

If productivity determines a country's pattern of specialization, further specializing in the most productive sectors in the United States would set the country on the course of virtuous development and would encourage high-technology-content activities, such as engineering-

intensive activities, in which productivity rises more quickly. This would also raise the United States' energy efficiency, given that the promotion of these activities would have a positive structural effect in terms of energy, as well. Further specialization in the most productive sectors (natural resources) in the four Latin American countries under consideration, however, would promote activities in which innovation and productivity gains come more slowly and, given their energy-intensive nature, would raise demand for energy**.** Because of these factors, energy consumption per unit of output is rising more quickly in the region than in the United States; without, however, there being a simultaneous narrowing of the productivity gap (figure III.6).

Figure III.6

BRAZIL, CHILE, COLOMBIA AND MEXICO: ENERGY GAP AND RELATIVE PRODUCTIVITY COMPARED WITH THE UNITED STATES, 1996-2006



Source: Economic Commission for Latin America and the Caribbean (ECLAC).

A final issue to be considered is the positive correlation between higher energy consumption per unit of output and rising greenhouse gas emissions. For economic and social reasons, current production and consumption patterns rely heavily on fossil fuels, and this has spurred higher energy consumption while at the same time generating an unsustainable pattern that the international community will begin to sanction through economic and trade measures.

Externally, as Latin America's export markets continue to emphasize consumption patterns based on lower-carbon-content goods and services, production processes will come under increasing pressure regarding the emissions that their outputs generate during their useful life. In France, Germany, New Zealand, the United Kingdom and the United States, for example, carbon labelling initiatives for products and services are already under way (see Samaniego and Schneider, 2009).

In addition to seeking to increase its involvement in more dynamic production processes, the region should also take steps to gradually but steadily adopt technology to reduce the carbon footprint of its exports and of its economy overall. One of the major challenges will be to transform current incentives so that relative levels of profitability are shifted and consumer demand is channelled towards lower-carbon-content materials and products.

In 2009, the United Nations Environment Programme issued a proposal to document this connection and called for in economic policy innovations that would reactivate the world economy while reducing carbon emissions at the same time, particularly as regards the energy supply, demand for transportation, waste management and agriculture. The aim is to promote options that offer the largest simultaneous benefits for the economy and the climate and to redirect economic incentives and policies towards the pursuit of increased energy efficiency and an energy matrix that is cleaner or, at least, carbon-free (UNEP, 2009).

E. Difficult choices

As far as designing a production development strategy is concerned, countries must keep in mind that the different options lead to different paths of specialization. In selecting from the range of options open to them, each country must weigh its current situation and its possibilities, as well as its patterns of international specialization and the manner in which it has chosen to respond to the challenges posed by climate change. The choice of sectors —which is the lynchpin of efforts to bring about structural changes through production development policy— should be keyed to the advantages and drawbacks of the different options. The analysis can start with a simple classification of economic activities into three types of sectors: natural-resource-intensive, technology-intensive and labour-intensive.

Except during the fifty-year import-substitution industrialization period, for centuries the region has been staking it bets on natural-resource-intensive sectors, whose productivity gap with regard to the technological frontier is, at most, negligible. However, these sectors are also highly capital-intensive and create only small numbers of jobs. Given the high concentration of ownership of natural resources (which is greater than in the case of industrial property, commerce and human capabilities), their development may also have an adverse impact on income distribution. These negative effects must be offset with redistributive policies that collect and share out the income obtained from natural resources. Chapter VI examines these policies.

Pursuing the development of technology-intensive sectors brings benefits in terms of incorporating technical progress, promoting learning and generating dynamic competitive advantages. Nevertheless, it also has costs, which must be taken into account. As the region is further from the international technological frontier in these sectors than in natural-resource sectors, the effort required to develop them will be greater.

There are two employment scenarios in the technology-intensive sectors. The sectors that rely on more mature technology (autos, mechanical-engineering, chemicals and petrochemicals) are dominated by concentrated oligopolies and produce differentiated goods, which generally take advantage of economies of scale. Labour intensity in these activities ranges from medium to low. In the sectors at the heart of the technological revolution (the electric-electronics, pharmaceuticals and petrochemicals industries), large enterprises exist alongside small ones. Knowledge is more highly valued for the activities carried out in these industries and wages are

thus also higher. However, the direct impact that these sectors will ultimately have on employment is not yet clear, and the initial assumption that sectors with predominantly small enterprises would become increasingly influential does not appear to be holding true, at least in the case of activities in which there are players that control a large share of the global market (for example, Amazon, Microsoft, Google, Intel, Sony and similar ICT companies, or large pharmaceutical firms).

Efforts to favour labour-intensive sectors could have a more positive impact on employment and equality, but such an option faces some constraints, the principal one being the cost of labour in the region. Much has been written on this topic, from Chinese competition to the "doubling of the global workforce." A choice in favour of labour-intensive sectors would require changing the type of relationship with the outside world (through trade protection) or reducing the cost of labour, which would undermine the objectives of equality and social cohesion.

These options must all be considered during the policy-design process. Even not selecting one, in other words, not pursuing a production development policy, is to make a choice: the choice to continue specializing in natural-resource-intensive sectors -with their rent-seeking advantages and their distance from the technological frontier- and to avoid the cost of adapting to a new structure. However, this also entails disadvantages, such as weak job creation, not fully participating in the technological revolution currently under way and perpetuating the concentration of income and power.

F. Incentive schemes and production policies

The region must construct a strategy that will allow it to overcome the structural heterogeneity that characterizes its production base and to narrow its productivity gaps. Consideration must be given to a series of elements related to macroeconomic policy and the microeconomic market incentives that affect enterprises, on the one hand, and to industrial, technological and SME support policies, on the other. The first set of elements defines the context in which promotion policies are designed and carried out, while the second is the basic core of tools and lines of action around which an integrated production development policy is built. Each set of elements is important and interacts with the other: it is not possible to consider one at the expense of the other and construct an effective proposal for tackling the backwardness and inequalities of production in Latin America.

1. Macroeconomic structures and development policies

Since the early 1990s, the countries of the region have generally corrected their fiscal disequilibria and brought down inflation within a context of less restricted trade and finance, more flexible markets and the privatization of public enterprises. As noted in chapter II, during the same period, inflation-targeting regimes were widely adopted, the prerequisites for which include a freely floating exchange rate and the partial or complete opening up of the balance-of-payments capital account. In this regard, macroeconomic stability goals may clash with development goals inasmuch as they make the economies of the region vulnerable to the abrupt exchange-rate swings that are generally associated with external shocks generated by the high volatility of the capital account and of the prices of the region's main exports. In addition, monetary policy itself may lead to exchange-rate appreciations, causing, among

other problems, a decline in the profitability (and viability) of non-traditional tradable-goods sectors. Countries often resort to a variety of policy tools to mitigate the unwanted effects of these macroeconomic policies on the real economy, including:

- a consolidated development bank with a strong capacity for intervention (such as in Brazil), to make it possible to offset the loss of price competitiveness stemming from a higher exchange rate by making large amounts of subsidized, long-term credit available;
- State ownership of the main natural-resource exports (for example, copper in Chile), taxes or royalties on extractive or primary-production activities, clearinghouses in the commodities markets (these policies make it possible to mitigate the effect of strong price swings and even finance, during international price booms, policies to offset Dutch disease, which may be caused by higher prices);
- a public-investment policy to strengthen existing production linkages by promoting new links in higher-knowledge-content sectors (hence, some State enterprises in the region that develop natural resources have a huge investment capacity, such as Petrobrás of Brazil);
- a proactive industrial policy that consistently supports non-traditional sectors by strategically combining various trade and fiscal tools (for example, tariffs and taxes) in the pursuit of a given sectoral development strategy;
- an aggressive technology-development policy to promote and finance R&D investment, public-private interaction in laboratories and universities and other measures to consolidate a national innovation system.

The countries have substantially different institutional frameworks of support for production development, as will be shown below. One prominent example is Brazil, with its more consistent and longer-standing industrial policy, which implies more enduring social consensuses regarding the aims of industrialization. The country’s robust industrial policy is reflected in a strong development bank with considerable investment capacity and macroeconomic influence and a clearly defined policy for industry and technology. This distinguishes Brazil from the rest of the region, where development banks in some cases have been dismantled and in others are embryonic and therefore have little influence over the economy.

Despite these differences, in practice, macroeconomic regimes and microeconomic and sectoral policies would appear to have been designed as “compensation” mechanisms. In several cases, sectoral policies or public ownership of key natural resources has been used to counteract the negative impact of orthodox macroeconomic schemes on the real economy. In other cases, heterodox macroeconomic regimes have been used to orientate exchange-rate and relative price polices (for example, through mechanisms that set different exchange rates for each sector) in favour of given strategic (non-traditional) sectors, precisely to compensate for the lack of more consistent sectoral and microeconomic policies. What has not been seen in the region yet is an “ideal” combination of a macroeconomic regime that favours development and a set of aggressive microeconomic and sectoral policies that promote structural change on the basis of technical progress.

2. Microeconomic market incentives

An understanding of how the production structure has evolved requires a grasp of corporate behaviour at the microeconomic level. Production structures are shaped and transformed by their interaction with business strategies, which are an essential part of the region's international trade pattern. In particular, large companies' investment strategies play a highly important role in determining the future profile of industry.

If the incentives structure, of which relative profitability is a major component, is biased towards traditional sectors, a lock-in process may emerge. The region has overwhelmingly specialized in sectors that, according to past experience, generate less aggregate growth and knowledge over the long term. At the same time, there are no incentives for agents to channel their investments into new sectors.

Aggregate figures for sector-by-sector sales by large firms in Latin America show that the share corresponding to manufacturing has tended to decline while natural-resource and services sales have tended to rise.[33] Engineering-intensive sectors have had little effect on large enterprises, for multiple, complex reasons, some of which have been studied in depth: the macroeconomic context and related public policies, institutional shortcomings, limitations in executing policies to promote import-substitution industrialization, the manners in which foreign investment has been attracted and issues related to management models and family control of companies (ECLAC, 2007b). On top of all of these reasons is path dependence. There is a wealth of literature showing that apparently minor, and often random, historical events may have important, magnified repercussions for the future development of the system (David, 1985; Arthur, 1994; Arrow, 2000).

To break with the dominant pattern, an exogenous intervention that "alters its configuration or transforms the underlying structural relationships among the agents" (David, 2000) is needed, which implies a key role for policymaking. Otherwise, in the absence of such external forces, the existing pattern is perpetuated, as is poor economic performance.

Production specialization is linked to microeconomic incentives, which determine how investments are allocated. This fact sheds light not only on specialization, but also on the self-reinforcement of specialization and on the effect of certain shocks on the workings of the development model. Hence, sectoral profitability serves to impose path dependence and lock-in on the diversification model of the large companies in the region. Between 2001 and 2005, the quotient of companies' profits to their assets (that is, their return on assets, or ROA) was five times higher in the mining sector than in engineering-intensive activities (ECLAC, 2007b).

Profitability of knowledge- and engineering-intensive companies declined from 1991 to 2005, particularly after 2000. This stands in contrast with the profitability performance of mining and, to a lesser extent, of oil subsectors during the same period, which benefitted from international prices. These differences in profitability tend to reaffirm the current model for integration into the global economy as they encourage investment to flow to traditional sectors. The differences are explained by various factors, in particular, by technological asymmetries between Latin America and the Caribbean and the developed countries, which are sharper in more technology-intensive subsectors. The productivity gap is broader and competitiveness is more limited in these subsectors, and corporate profitability is therefore lower than in the

[33] Large enterprises are in a better position to lead a process of reallocation of production favouring not only static comparative advantages but also structural change, by strengthening more knowledge-intensive activities.

natural-resources subsectors, whose goods compete better in international markets. Under like conditions (at least in the tradable-goods sectors), the correlation between technological intensity and profitability is negative, which helps perpetuate inequalities over time.

Nevertheless, technological intensity is not the only factor that influences relative profitability among sectors. Shocks induced by international prices can also have a significant impact, such as the increase in international demand from the beginning of this decade until 2008 that considerably widened the gap between prices and unit production costs. Within a context of high demand for primary products, the trade-liberalization model caused the region to further specialize in products that had long been its competitive base.

As noted above, there is a set of production development policies that can counteract the influence of the less positive signals emanating from the macroeconomic climate and microeconomic market incentives that most discourage structural change. These policies are discussed in greater depth below.

3. Industrial policy

In the first half of the 1990s, significant progress was made in macroeconomic stability, but long-term policies were eschewed. As the State shrank in size, industrial policy further lost legitimacy, having been discredited by poor industrial performance since the late 1970s and early 1980s.[34] As a consequence, not only was industrial policy abandoned but such policies came to be perceived as an obstacle to growth.

The persistence of growth problems in the region, many years after the reforms had been carried out, and the ever-present contrast with the proactive policies adopted by better-performing Asian countries allowed industrial policy to gradually recover a significant place in the strategy debate in Latin America. In recent years, the region has slowly returned to industrial policies, with different characteristics and approaches from one country to the next.[35]

The sector-specific nature of industrial policy has varied across the region. Some countries have revived sector-specific policies; others have implemented de facto sectoral policies, labelled “cluster policies”; while still others have adopted more horizontal policies and eschewed sector-specific policies. Some countries have simultaneously adopted all three approaches, recognizing that each serves a specific development objective. This is the case of the 2008 industrial policy of Brazil.

The countries have differed not only in the sector-specificity of their industrial policies but also in their coordination of those policies with their national development strategies. Some countries continually seek to develop their industrial sectors within explicit public-intervention strategies (for example, Brazil, Colombia and El Salvador). Others often strive to implement an industrial policy but not as part of a national development strategy (Argentina, Chile, Costa Rica and Mexico). The vast majority of countries make only sporadic efforts without having a national development strategy. And in nearly all countries, policy as formulated is far removed from

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[34] Industrial policy is a specific field of productive development policy. Whereas the latter encompasses both sector-specific and horizontal actions (technological development, SME promotion and so on), the term *industrial policy* should be used for cases in which the proper priority is given to approaches that are centred on the sectoral dimension or that have a vertical scope.

[35] See Peres and Primi (2009).

policy as actually carried out. Assessments of policy action should therefore focus not on what policy documents state but on the policies that are in fact implemented.

The institutional development component is crucial, since cases of stop-and-go industrial policies still exist. In addition to often being intermittent, industrial policy is much less sector-specific than it was in the 1960s and 1970s. In the end, this lack of sectoral specificity has favoured primary sectors such as petroleum and mining and some services.

As noted, pro-competitiveness macroeconomic policies are the required counterpart to, but not a substitute for, industrial policies. Whereas the former create a context that favours a buoyant export sector and growth, the latter make it possible to fully tap the resulting potentials for learning that are the offshoot of that growth. The task of industrial policy is to provide an exogenous stimulus that enables the economies of the region to take paths other than those leading to low-growth equilibrium. Consequently, and given the need for the region to move towards an inclusive development strategy that will reduce heterogeneity, a broad reappraisal of industrial policies is imperative. However, a yawning gap currently separates industrial policy on paper and the policies that are implemented. Two complementary approaches must be now adopted simultaneously.

First, institutional capacity must be improved or even rebuilt, with a focus on two priority areas: implementation capacity, which means narrowing the gap between policy design and the institutional capacity to carry policies out (by, among other things, increasing the number, and improving the skills, of the specialists who design and implement policies); and the assessment of the impact of initiatives to spur economic growth and technological progress and to raise productivity.

Second, industrial policy must have a clear sectoral focus and support a price structure that will make it possible to change predominant investment patterns. Relative prices must be skewed so as to favour technology-intensive sectors or sectors in which global demand is growing more quickly, so that resources are reallocated to them. Horizontal policies that reduce costs and facilitate innovation, although also important, are generally insufficient to bring about quickly changes as important as those needed for open economies to be able to catch up, especially with an international technological frontier that is moving ahead at speed. It should be borne in mind that productive capabilities and technological capabilities are highly complementary, and one cannot be fully developed without the other. Structural-change policies are required to increase the influence of technology-intensive sectors and to generate synergies with technology policy and the demand for innovation among agricultural and industrial producers. Consequently, vertical policies favouring the emergence and consolidation of capabilities in sectors that are highly dynamic in technological terms are a necessary condition to ensure that horizontal policies intended to foster innovation have a real impact.

Lastly, to complement income-redistribution policy and different types of sectoral incentives, the creation of mechanisms to supervise, evaluate and penalize firms and agents is extremely important, in order to ensure the correct use of these incentives. This is closely associated with the setting of targets and deadlines for meeting them. The lack of supervision and the certainty that there are no consequences for violating the implicit contract between society (which offers the resources) and firms (which use them subject to certain conditions and objectives) is one of the main differences between Asia's experience with industrial policy and Latin America's. An income-redistribution policy degenerates into a rent-seeking policy when agents fail to abide by agreed growth and competitiveness guidelines.

4. Technology policy

The region's history in science and technology policies provides useful lessons. During the import-substitution industrialization period, the public sector played a fundamental role, both directly and indirectly, by supporting the generation of technological capabilities and creating institutional infrastructure for science and technology (ECLAC, 2002). These efforts led to the establishment of national science and technology councils, whose objectives included founding universities and research institutes, improving university systems and promoting and supporting research projects. In addition, institutions and public enterprises were created and given the task of supporting scientific and technological research in specific strategic sectors considered critical for industrial development. Although some notable progress was made in broadening the supply of technological capabilities, the system was not linked to the demand for innovation. A top-down approach prevailed, with policies being decided by authorities without the participation of beneficiaries, under the notion that technological innovation and dissemination would follow a linear path from generation in research agencies to adoption in production methods. The key role played by users in innovation was thus overlooked.

In the 1990s, the focus shifted to demand-side factors. The goal was to lay new foundations for a hands-off science and technology policy in which the market would supplant the State as the active promoter of development (Chudnovsky and López, 1996). Public intervention was justified solely to correct market failures (information asymmetries) and to allow private-sector demand to guide scientific and technological activities. It was assumed that the dissemination of information and the guarantee of access to it would help solve problems related to the creation, adoption and spread of technology. Under these new public policies, however, knowledge and technology imports rose, which weakened the State's role and undermined its policy to boost home-grown technological capabilities.

Technology policies became contingent on market behaviour and on the productive sector's ability to explicitly make known its requirements for technological know-how. Foreign investment, as a source of technology, was promoted, and new patent laws were adopted. Demand was subsidized, mainly through the allocation of resources to projects proposed directly by companies, and the services of specialists and consultants in production and technology management ("technology brokers") were made available to companies to facilitate and increase access to information.

However, policies intended to subsidize demand helped make the local production system even more heterogeneous. Companies with little managerial ability and those with the greatest difficulties in obtaining information and resources were adversely affected. On balance, the policies implemented in the 1990s were better at dismantling the technology-supply system inherited from the import-substitution industrialization period than at constructing a new system based on incentives to increase the demand for innovation and technology. The market of agents driving up demand for technology never materialized. This was partly because the structural change process seen in the 1990s (which increased the importance of non-technology-intensive sectors) tended to depress such demand.

On the basis of the experience of the two previous phases, the vision of technology policy has gradually evolved into a systemic approach that privileges interaction between technology's supply- and demand-side variables. Firms acquire and adapt technology in response to signals from their milieu and improve it over time so as to enhance their technological capabilities and

competitive advantages. Their decisions are influenced by the incentives structure, the factors and resources markets (skills, capital, technology, suppliers) and the institutions (in the fields of teaching and training, technology, finance, and so on) with which they interact. Innovation is therefore an interactive process that links agents, such as firms, that respond to market incentives with institutions that operate on the basis of non-market strategies and rules. The agents, institutions and rules through which technology is incorporated together make up what is known as the "innovation system" (ECLAC, 2002).

The generation and incorporation of technology and the consequent attainment and improvement of international competitiveness thus constitute systemic processes. In developing countries, not only do externalities and huge information gaps make it difficult to frame a suitable response to these challenges, the institutions that should be backing companies are often ineffective or non-existent. In many countries of Latin America and the Caribbean, the action and efforts of science and technology agencies have been undermined by unstable policies, forcing institutions to act according to a short-term logic and, increasingly, to resort to market-like mechanisms. This instability has generally diminished the effectiveness of policies by dispersing accumulated capacities and sending out contradictory signals about incentives and what can be expected in terms of public-sector support.

The topic of intellectual property must be fully incorporated into any strategy for accumulating development capabilities. The region has fallen far behind in its analysis of this issue. Investing in the human resources and infrastructure needed to manage intellectual property effectively is, undoubtedly, expensive, and beyond the means of many developing countries and, in particular, of small enterprises. Nevertheless, an intelligent management of intellectual property rights has considerable potential benefits. They include reducing the costs of products that have a high impact on the population's well-being (as some developed countries have done with certain pharmaceutical products), paving the way for research activities based on patented technologies, preventing foreign patents being granted for biodiversity-related products and making progress with the patenting of the region's own innovations.

There are some fundamental requirements for designing and implementing a science and technology policy that will strengthen innovation processes: an institutional framework that places science and technology decision-making agencies on a par with other Government agencies, coordination with other policies (especially those related to education and industry) and a long-term outlook.

In recent years, several countries of the region (Argentina, Brazil, Colombia and Costa Rica) have supported institutional reforms to convert their decision-making centres into more centralized and cohesive units. They have thus elevated their science and technology institutions to the rank of ministries and allowed them to play a direct role in strategic decisions. Other countries still have institutional structures composed of various Government entities that design and implement innovation policies independently and through their own branch offices. In these countries, either decision-making remains in the hands of a number of different ministries (such as finance and education), or the agencies and commissions still have the status of presidential or ministerial bodies (Chile, Mexico and Uruguay).

The reformulation of the strategic vision and institutional framework for science and technology has been accompanied by a diversification of the policy instruments deployed. Rather than solely resorting to traditional mechanisms to stimulate supply and demand (such as support

for scientific and technological research and training, subsidies for projects proposed directly by the productive sector or fiscal incentives), some countries are broadening their range of tools. The most novel of these instruments include technology funds (which multiplied in the 1990s), sector-specific funds, venture capital incentives and other financial mechanisms, initiatives to promote university-enterprise cooperation, networking and government procurement. Although currently most incentives are horizontal in kind, others that seek better coordination between technology supply and demand, particularly between researchers and companies, are beginning to emerge.

One key element that needs to be strengthened is the monitoring of public policy and the evaluation of its outcomes. The region still lacks management mechanisms that provide continual feedback for improving policy design and updating policy guidelines (that is, monitoring systems). In addition, the time lags between the implementation and assessment of a policy are often so long that they make evaluation and ongoing adjustments extremely difficult.

In sum, technology policies in the region face a formidable challenge. Together with other industrial, education and macroeconomic policies, they need to foster an environment of fast learning and structural change that favours the development of the technologically most dynamic sectors. The results thus far are not encouraging, and parts of the production structure that were important for innovation have been lost.

5. SME-support policies

SMEs lag far behind other enterprises in productivity and export capacity and this increases structural heterogeneity and perpetuates the high levels of economic and social inequality in the region. SME-support policies are thus essential for raising productivity of the economy as whole, building an interlinked production structure, reducing differences among enterprises and sectors and helping a larger number of workers join the formal labour market and earn decent wages.[36]

Starting in the mid-1990s, Governments across the region began to take a greater interest in SMEs owing to the marked rise in unemployment triggered by the point reached in the economic reform process. Despite the good intentions, SME-support policies have so far yielded few concrete results. Although the situation varies from country to country, the institutions that design these policies wield little influence and suffer from a shortage of effective policy instruments. In the 1990s SME-promotion agencies in several countries were raised to the ministerial or vice-ministerial level, but this higher status has not come hand in hand with more power to execute policy (Peres and Stumpo, 2002).

The development of these agencies has differed greatly from one country to the next. Some countries have institutions with ample experience, scope and operational capacity, such as the Micro and Small Business Support Service (SEBRAE) in Brazil or the Production Development Corporation (CORFO) in Chile. Others have only recently created agencies with the power and capacity to unify and coordinate support for SMEs. Such is the case of the National Commission for Micro and Small Businesses (CONAMYPE) in El Salvador, established less than six years ago, and the Fund to Support Micro, Small and Medium-sized Enterprises in Mexico, created in 2004.

[36] This section refers primarily to SMEs, but there is a segment of microenterprises which, owing to their greater dynamism and capacity for accumulation, could also be addressed in the policy proposals put forward here. Microenterprises are otherwise difficult to incorporate into production development strategies and therefore need to be targeted by social policies instead.

These efforts recognized the importance of building a stable organizational and institutional framework to design policies with a view to meeting medium- and long-term needs that is, to a certain extent, immune to changes on the political front. In other countries, no sustained effort to develop institutional capacities has been made: isolated actions, lacking coordination and continuity, can be found in Argentina, Colombia, Ecuador, Paraguay, Peru and Uruguay (Ferraro and Stumpo, 2010).

Beyond these differences, the institutions responsible for designing and implementing policies all face severe financial and human-resources constraints. At best, an amount equivalent to not even 0.1% of GDP, and often less than 0.01% of GDP, is allocated to support thousands or hundreds of thousands of enterprises —depending on the specific country— which account for a significant percentage of total employment (see table III.10).

Argentina, Brazil, Ecuador, El Salvador and Mexico stepped up the amount of financial resources allocated to SME support between 2003 and 2008. In countries that rely heavily on international financial cooperation, the continuation and steady expansion of funding depend on exogenous decisions.[37] Often a limited institutional capacity produces bottlenecks that prevent funding allocated to SME policies from being used and increased. In sum, not only must development institutions' budgets increase, but their capacity to map out strategies, design policies and put support mechanisms and instruments into operation must also improve considerably.

Table III.10

LATIN AMERICA (SELECTED COUNTRIES): SPENDING BY INSTITUTIONS THAT SUPPORT SMALL AND MEDIUM-SIZED ENTERPRISES, 2005

(Percentages of GDP)

Country	Spending	Country	Spending
Argentina	0.004	Mexico	0.015
Brazil	0.085	Nicaragua	0.022
Chile	0.030	Panama	0.027
Colombia	0.008	Paraguay	0.005
Costa Rica	0.004	Peru	0.004
Ecuador	0.005	Dominican Republic	0.033
El Salvador	0.019	Uruguay	0.002
Guatemala	0.006	Venezuela (Bolivarian Republic of)	0.024
Honduras	0.005	Latin America	0.018

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of P. Angelelli, R. Moudry and J.J. Llisterri, "Institutional capacities for small business policy development in Latin America and the Caribbean", *Sustainable Development Department Technical Papers Series*, Washington, D.C., Inter-American Development Bank (IDB), 2006.

Another recurring problem is that many Government initiatives have sought to have an effect through demand-side subsides, based on the erroneous assumption that potential beneficiary companies have similar capacities to respond to market signals. In many cases this error has led to the privileging of a small segment of faster-growing companies and widened the structural-heterogeneity gap. If the interventions are based solely on demand-side subsidies, only

[37] For example, in El Salvador, in 2006, 58% of the budget of CONAMYPE came from external funding, and in Paraguay almost all funding comes from international cooperation. In other cases, there are areas of strategic importance, for example, credit, that largely operate with external funding.

a small group of the most dynamic enterprises will be able to make effective use of the available instruments. The productivity of these companies allows them to cover the transaction costs required to gain access to support tools, and they can correctly diagnose their needs and help create markets for the different types of services that they need. Most SMEs do not fall into this category and have very limited access to support tools (Ferraro and Stumpo, 2010).

Some countries have been more rigorous than others in applying the logic of demand-side subsidies in the design and implementation of SME-promotion programmes. Whereas Chile has followed this logic very strictly, Mexico's adherence has been more nuanced, as seen, for example, in the direct action of some public agencies, such as the Regional Centres for Business Competitiveness (CETRO-CRECE). Brazil has taken a much more pragmatic approach, diversifying its policies by sector and geographic area, as evidenced by the actions of SEBRAE (Ferraro and Stumpo, 2009).

This all suggests that a new institutional framework is needed to bring about a qualitative leap in SME-promotion policies. To devise a strategy to support SMEs and transform them into enterprises that play a dynamic role in productive development and in their countries' international competitiveness will require more than a short- or medium-term effort. And this, in turn, will require the construction of institutional and learning capabilities. Some of the building-blocks of this process are outlined below.

First, the project must be a long-term one, and the retention of managerial and technical staff must be guaranteed.[38] Long-term planning requires institutional learning processes that involve systematic evaluations of all action carried out. Evaluations make it possible not only to measure the outcomes and the impact of tools and programmes but also to analyse and assess how instruments work and, above all, to determine if they are indeed contributing to the fulfilment of the overall strategy.

Second, institutional strengthening should be accompanied by a gradual, but steady, increase in funding, given the low amounts currently allocated to SME promotion. Consideration should be given not only to the financial but also to the human resources needed. In many cases, training will be required, in particular in areas such as production linkages.

A new institutional framework or, in some cases, an improved existing one is a necessary but not a sufficient condition for SMEs to overcome their considerable lags. For this objective to be attained, specific lines of action will also have to be designed and implemented in some priority areas.

For example, the problem of credit must be addressed. In the region's segmented financial markets, SMEs are treated less favourably than are large companies, as noted in chapter II. This bias can cause significant inefficiencies in resource allocation inasmuch as the lack of credit prevents the completion of viable projects that would produce higher returns than those that absorb the limited available financing. In addition, the credit limitations faced by SMEs can often lead to the closing of viable enterprises and to a loss of physical, human and organizational capital.

Although SME credit-support programmes have for many years been included on development institutions' agendas, no substantive improvements have been seen in SME access to financial markets.

[38] These characteristics, which should be obvious, are unfortunately not found in many SME-promotion systems in the region (Ferraro and Stumpo, 2010).

In the 1990s, approaches based on second-tier instruments were adopted throughout the region. Hence, rather than State-owned banks directly extending loans,[39] public development institutions call for tenders on funds to be used and managed by private banks to provide credit to SMEs.

Under second-tier public programmes, private banks tend to replicate the credit-market segmentation seen in operations they conduct outside of those public programmes. Thus, they repeat the selection bias that favours the largest enterprises, but within the beneficiary segment that they are "required" to serve (SMEs). Moreover, public institutions are often concerned mainly with the efficiency of their programmes and therefore focus on ensuring that the bids that they hold are successful. In several cases, they have raised the ceiling on annual sales for the classification of medium-sized enterprises, and enterprises that for every other purpose are classified as large have been included in second-tier lending programmes.

More than a decade after second-tier credit programmes began to be introduced in the region, no significant change can be seen in the ability of SMEs to access financial markets. This lack of progress is quite clear to the heads of many development institutions, who are becoming somewhat sceptical about second-tier approaches. First-tier programmes have thus become more common in recent years in the countries of Latin America.[40] Nevertheless, these programmes are of very limited in scope and have failed to significantly impact the operations of credit markets, in which SMEs continue to play an extremely small role.

Chapter II emphasized the role that development banks can play in giving relatively smaller enterprises access to credit. And this is a key reason for the State to once again take the lead in dealing with an issue that the market has clearly been unable to solve.

A second area in which State intervention can have considerable influence is human resources training. Chapter V notes that training incentives are used more commonly by large enterprises than by SMEs, essentially because approaches based on demand-side subsidies have also come to play a pre-eminent role in training policies.

The availability of skilled human resources has a two-fold importance for SMEs: they make it possible to improve existing production processes and to raise productivity and they disseminate knowledge and innovation within enterprises. This means that for SMEs to overcome their weakness in this area, policies must be devised that go beyond the logic of demand-side subsidies and reach the least dynamic enterprises (that is, most SMEs). For this to occur, the State must once again provide professional-training services in coordination with economic agents and intervene more vigorously, in particular for the least dynamic enterprises engaged in production-related activities.

The focus of these two areas of intervention is the provision of basic inputs (credit and human resources) for the vast majority of SMEs, which are unable to take advantage of instruments that are based on demand-side subsidies. However, there is another —clearly

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39 These are known as "first tier" operations.

40 This is the case, for example in Ecuador, of National Financial Corporation's Credipyme (SME credit) programme and of the National Development Bank's 5-5-5 Programme. In Argentina, the National Development Fund for Micro, Small and Medium-Sized Enterprises (FONAPYME) is executed by the Office of the Deputy Secretary of Small and Medium-Sized Enterprises, the Bank of the Argentine Nation (Banco de la Nación Argentina) and the Foreign Trade and Investment Bank (Banco de Inversión y Comercio Exterior - BICE), while the Estímulo PYME (SME stimulus) programme is executed by BICE. In Brazil, the General Law on Micro and Small Enterprises requires State-owned banks to make specific credit lines available to small enterprises, and for some years the National Bank for Economic and Social Development (BNDES), Banco do Brasil and Caixa Econômica Federal (a federal savings and loan scheme) have had specific credit programmes for small enterprises.

smaller— group of more dynamic SMEs (as noted in section C of this chapter) that will need more specific tools. In this regard, production-linkage policies can have positive results and be effectively integrated with the industrial-policy actions referred to in that section.[41]

6. Towards an integrated agenda for production development

Structural heterogeneity calls for intervention in different spheres and consideration of the diverse agents whose needs must be met. To meet this challenge, an integrated agenda for production development that coordinates actions in the three policy areas in question —industry, technology and SME support— must be formulated. To focus on just one of the areas would raise the competitiveness of some groups of enterprises, to the detriment of others, exacerbate heterogeneity and fragment productivity. A strategy that prioritizes sectoral and industrial policy alone could strengthen large and perhaps medium-sized enterprises but would exclude the vast majority of SMEs and microenterprises. This could raise aggregate economic productivity, but at a slower pace than other alternatives would, and it would increase heterogeneity among agents regardless of the extent to which it succeeded in partially reducing heterogeneity among sectors. Likewise, a policy that focused solely on supporting the least dynamic enterprises might have positive effects on heterogeneity among agents but would not lead to the leap in productivity required to narrow the gap with the most developed economies.

In addition, actions in the three policy areas cannot be coordinated and integrated within a context of adverse macroeconomic policies. A macroeconomic approach strictly geared to meeting inflation targets, for example, would turn microeconomic-policy efforts into mere compensatory measures, greatly undermining their effectiveness.

A pivotal item on the agenda is the identification of key sectors, which will have to be selected on the basis of the specific features of each country's production structure and in accordance with the sectors' capacity to generate and disseminate knowledge and innovation and to encourage linkages with other manufacturing and services activities. It will be the task of industrial policy to focus efforts on these sectors.

For their part, SME-promotion policies will have to involve interventions in the areas of credit and human resources to provide these two basic inputs to nearly all enterprises in this category. As more SMEs succeed in upping their growth rate and narrowing their productivity gaps, they will also find it easier to join the supply chains of large companies and form enterprise networks, which will create synergies with industrial policy.

Technology policy will play a key role in this strategy, in two ways: first, by promoting innovation, essentially in large and medium-sized enterprises in selected strategic sectors; and second, by encouraging the dissemination of knowledge and technology in the companies with the greatest lags, through SME-specific interventions.

Establishing linkages among the different spheres of action is a complex process, as it involves various types of institutions (sectoral, technological, financial and those that focus on promoting SMEs) that tend to follow their own lines of action and specific objectives. For this reason, priority objectives need to be established within a strategic agenda. This can be attained only through consensus on those objectives (among public and private actors and, more generally, society as a whole) and under clear leadership by the State.

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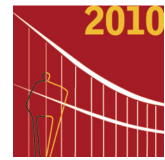
[41] That is, instruments intended to create horizontal and vertical networks, clusters and supply chains. See Dini and Stumpo (2004).



Chapter IV

Place does matter: territorial disparities and convergence

A. Introduction

The previous chapter showed the striking segmentation and lags in the productivity of Latin American economies, resulting from intersectoral or intrasectoral gaps, or gaps in terms of labour productivity. These gaps are a huge obstacle to development as it is understood herein, as they are the manifestation of the system's rigidity, weaknesses in the region's medium- and long-term positioning in the world economy and deep-seated inequalities that spread from the productive base to the rest of society.

Achieving productive convergence requires closing productivity gaps with more competitive countries, while also reducing internal structural heterogeneity. These social and productivity gaps can literally be "mapped out", as they are reflected in —and partially caused by— territorial segmentation. In other words, production gaps have a territorial correlation. Such segmentation means that, in each country and the region as a whole, place of residence largely determines socio-economic status. Of course, these maps can shift and in certain areas synergies are activated between productivity gains and social integration. But other areas still lag behind and remain unintegrated, and others still slip deeper into poverty and increasingly sluggish production growth (Ramírez, Silva and Cuervo, 2009).

Territorial and social inequalities are dialectically interwoven. In other words, differences among subnational territories in terms of income, poverty, productivity, access to well-being and natural-resources endowment contribute to the aggregate contrasts in these indicators at the national level. For this reason, narrowing the gaps among territories is vital if equality is to be improved. Hence the importance of policies that consider not only productive convergence but also spatial convergence. The importance of formulating macroeconomic policies that enable countries to bring their real GDP closer to their potential GDP was discussed in chapter II but, in

order to achieve this at the spatial level, productive synergies must be pursued in a manner that is consistent with the territorial reality. Just as productive development needs the social development required to build human capacity and provide an environment of increased well-being, so spatial development cannot occur unless the basic deficiencies in the most disadvantaged subnational territories are resolved, to provide them with the minimum conditions for increasing their low levels of productivity.

B. The territorial dimension of inequality

In recent years, development thinking has come to encompass a host of new factors, including innovation, tacit knowledge, social capital and associativity, which have made it possible to explore and implement new approaches in public policy. Importantly, these new factors are all highly dependent on the intensity and form of relations among social agents.

This is the context in which territory —understood as a constantly evolving system of historically structured social interactions— becomes vital to understanding the real-life processes affected by the new development factors. Spatial proximity and face-to-face relations, which are essential for generating trust, largely explain many examples of successful territorial development worldwide. At the other extreme are many territories that have been unable to escape from the stagnation trap, which is typified by high levels of deeply entrenched poverty. Such places have historically structured systems of social relations that perpetuate and deepen the economic and social backwardness, and require new systemic relations if the situation is to be improved.

In recent decades, the theoretical analysis of territorial disparities has concentrated on two main problems: the level and evolution of overall disparities in income and living conditions between the inhabitants of different territories; and the spatial concentration of economic activity and population.

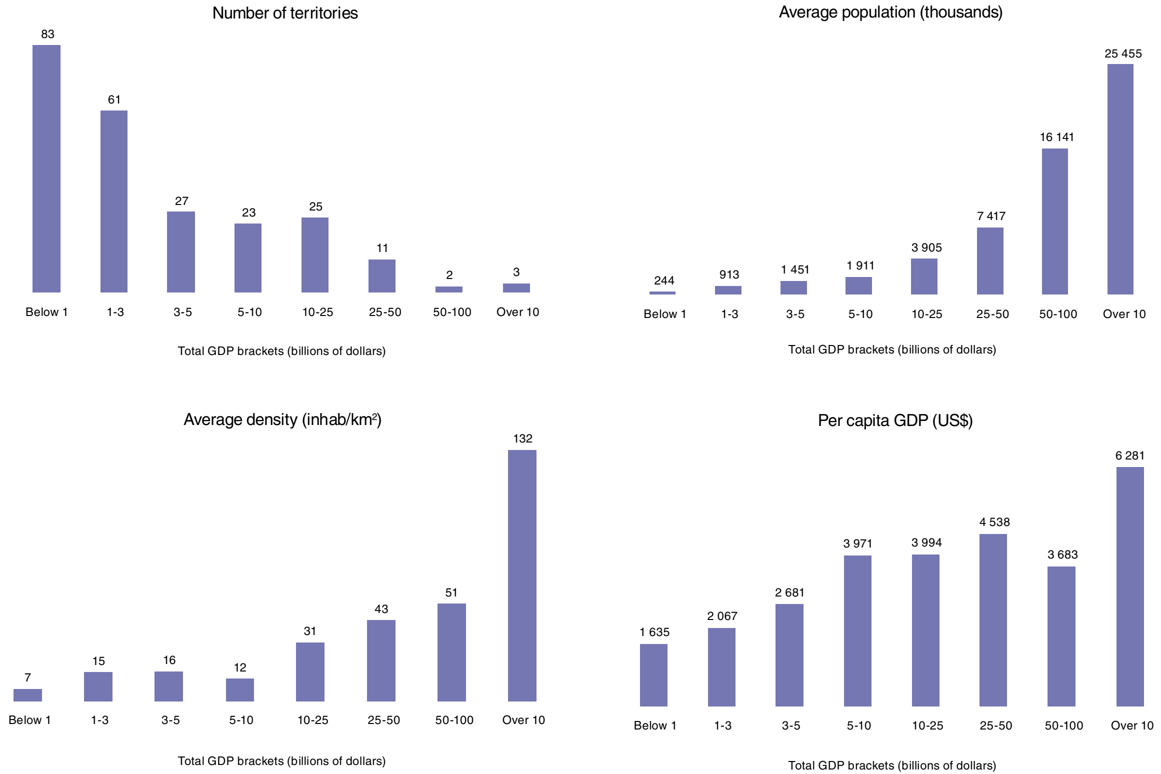
1. Territorial heterogeneity in Latin America

The strong heterogeneity of subnational territorial entities in Latin America takes the form of high spatial concentration and persistent inequalities in the territorial distribution of wealth.[1] From the demographic and economic point of view, the region has a large number of small territories, and very few large territories. Counting only the smallest and largest territories in terms of share in GDP for 11 countries, the 83 smallest territories had an average population of 245,000, while the three largest territories had an average of 25.5 million inhabitants. The concentration and unevenness of settlement patterns are accompanied by a major imbalance in the distribution of opportunities for material well-being. As shown in figure IV.1, per capita GDP increases in direct proportion with the economic size of the territory, rising from between US$ 1,635 to US$ 3,971 for the four lowest brackets of GDP, to around US$ 4,000 for the next four brackets, before surging to almost US$ 6,300 in the top bracket.

[1] For the purposes of this section, subnational territorial entity shall be taken to mean the first level of political-administrative divisions of each country.

Figure IV.1

LATIN AMERICA: DISTRIBUTION OF TERRITORIES ACCORDING TO BRACKETS OF TOTAL GDP, AROUND 2003



Source: Latin American and Caribbean Institute for Economic and Social Planning (ILPES), on the basis of official figures.

This analysis of territorial heterogeneity becomes more meaningful and significant in the context of an international comparison, by using two coefficients to draw contrasts with the situation in countries of the Organisation for Economic Co-operation and Development (OECD): the territorial concentration coefficient and the territorial Gini coefficient.[2] The first of these measures the territorial distribution of economic activity, while the second measures the

[2] Territorial concentration coefficient:

$$\left(\sum_{i=1}^{N} = \left| y_i - a_i \right| / 2 \right) * 100$$

where:

y_i: relative weight of territory i in total GDP;

a_i: relative weight of territory i in total surface area, and

N: number of territories.

Gini coefficient:

$$\frac{2}{N-1} * \sum_{i=1}^{N-1} \left(F_i - Q_i \right) \qquad F_i = \frac{i}{N} \qquad Q = \frac{\sum_{j=1}^{i} y_i}{\sum_{j=1}^{N} y_j}$$

where:

y_i: per capita GDP of territory i, and

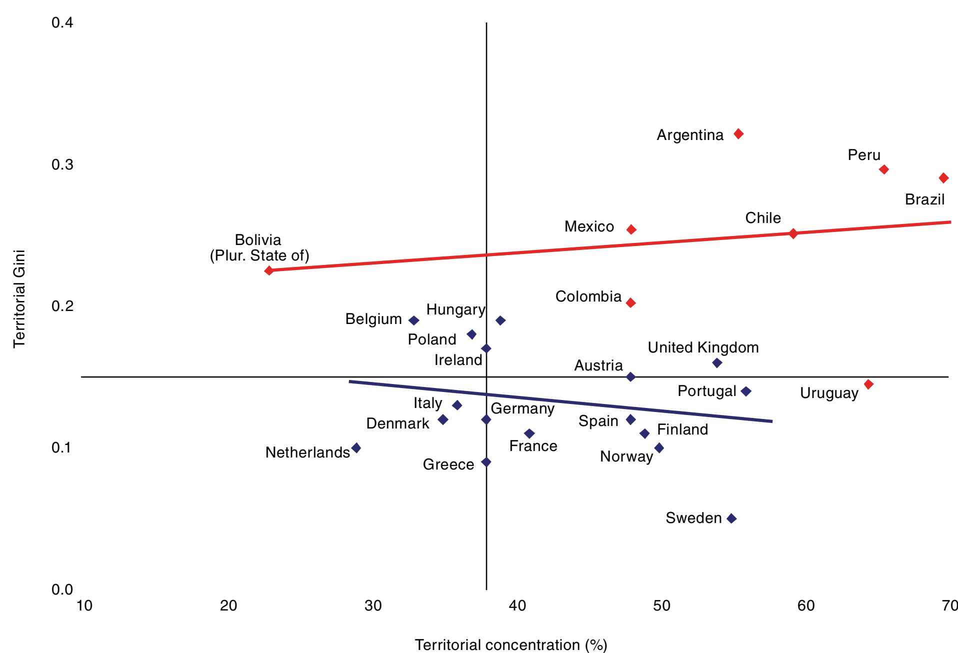
N: number of territories.

distribution of wealth. The concentration coefficient compares each territory's share in total GDP with the share of its geographical area, and its values range from 0 (minimum spatial concentration) to 100 (maximum spatial concentration). The territorial Gini coefficient measures disparities in average per capita GDP for each territory, with values of between 0 (lowest disparity) and 1 (maximum disparity).

Figure IV.2 shows the overlap between these two indicators and clearly illustrates the peculiarity of Latin America where, unlike in European countries, territorial concentration of GDP goes hand in hand with inequity. In the group of OECD countries, an increase in concentration leads to a slight improvement in the territorial concentration coefficient. In the group of Latin American countries, concentration rises in tandem with the Gini coefficient (except in Uruguay).

Figure IV.2

LATIN AMERICA AND OECD COUNTRIES: TERRITORIAL CONCENTRATION AND DISPARITIES, AROUND 2003 [a]



Source: Latin American and Caribbean Institute for Economic and Social Planning (ILPES), on the basis of official figures and Organisation for Economic Co-operation and Development (OECD), *OECD Regions at a Glance*, 2007, Paris, 2007.

[a] Although the values of the territorial concentration coefficient go from 0 to 100 and the values of the Gini coefficient go from 0 to 1, the scales of the figure have been adjusted to provide a clearer representation.

Sweden and Uruguay are interesting cases, because despite being in the quadrant for high territorial concentration, they have significantly high levels of territorial equity (a low Gini coefficient). This suggests that there is no one-way relationship between the two dimensions, and that differences could be an expression of different institutional systems (at the national and subnational levels) that have considerable impact on disparities.

2. Economic territorial disparities in Latin America

Economic territorial disparities refer to inequalities in the distribution of opportunities for economic development, and in this case they are measured using per capita GDP as a proxy variable. One telling indicator is the gap between a country's richest and poorest regions in terms of per capita GDP. Table IV.1 compares certain Latin American and OECD countries: in OECD countries, per capita GDP in the richest region is no more than twice the figure in the poorest region (the average figure is a difference of just under 1.76 times), while in Latin American countries the difference can be over eight times (as in Argentina and Brazil).

Table IV.1

LATIN AMERICA AND MEMBERS OF OECD (BOTH SELECTED COUNTRIES): VARIATION IN GAPS BETWEEN PER CAPITA GDP OF THE RICHEST AND POOREST REGIONS, BY COUNTRY

Country	Currency	Reference year	Wealthiest region	Poorest region	Wealthiest over poorest	Gap variation
Latin America						
Argentina	1993 $	1993	Tierra del Fuego	Santiago del Estero	6.79	
		2005	City of Buenos Aires	Formosa	8.09	19%
Bolivia (Plurinational State of)	1990 B$	1990	Santa Cruz	Potosí	2.29	
		2006	Tarija	Potosí	3.55	55%
Brazil	2002 R$	1990	Federal District	Piauí	11.86	
		2006	Federal District	Piauí	9.22	-22%
Chile	2003 $	1990	Magallanes	Araucanía	5.12	
		2007	Antofagasta	Araucanía	4.48	-13%
Colombia	1994 $	1990	Bogota	Chocó	4.10	
		2007	Bogota	Chocó	4.87	19%
Mexico	1993 $	1993	Federal District	Chiapas	5.46	
		2006	Federal District	Chiapas	6.07	11%
Peru	1994 NS$	1994	Moquehua	Apurimac	8.11	
		2007	Moquehua	Apurimac	7.57	-7%
OECD countries						
France	US$ PPP 2000	1995	Ile de France (Greater Paris)	Corse	2.08	
		2005	Ile de France (Greater Paris)	Languedoc-Roussillon	1.95	-6%
Italy	US$ PPP 2000	1995	Bolanzo (autonomous province)	Calabria	2.36	
		2005	Bolanzo (autonomous province)	Campania	2.04	-13%
Japan	US$ PPP 2000	1990	Kanto	Okinawa	1.80	
		2005	Toukai	Okinawa	1.57	-13%

Table IV.1 (concluded)

Country	Currency	Reference year	Wealthiest region	Poorest region	Wealthiest over poorest	Gap variation
Korea	US$ PPP 2000	1990	Gyeongnam	Jeolla	1.86	
(Republic of)		2005	Gyeongnam	Jeju	1.88	1%
Netherlands	US$ PPP 2000	1995	West	Oost	1.27	
		2005	West	Oost	1.31	3%
Spain	US$ PPP 2000	1995	Madrid	Extremadura	2.04	
		2005	Madrid	Extremadura	1.92	-6%
Sweden	US$ PPP 2000	1995	Stockholm	Ostra Mellansverige	1.44	
		2005	Stockholm	Ostra Mellansverige	1.63	13%

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

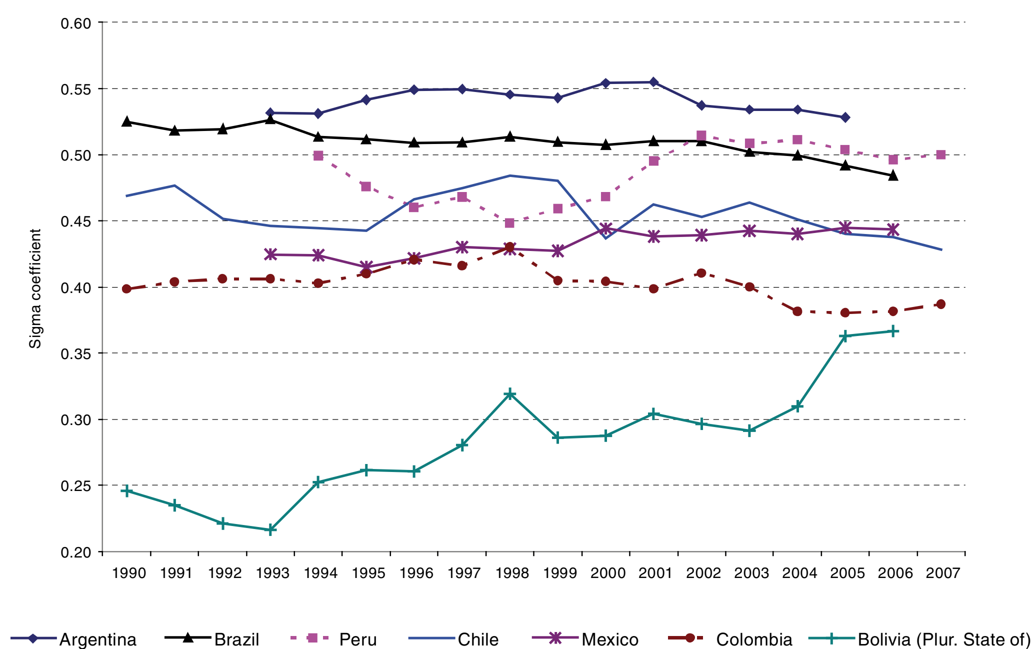
Furthermore, in several OECD countries the gap narrows in the period under consideration, which could be related to a reduction in disparities. A similar development is seen in Brazil (from 1990 to 2006), Chile (from 1990 to 2007) and in Peru (from 1994 to 2007), and this will subsequently be analysed using regression calculations.

Other indicators commonly used to measure territorial disparities are sigma convergence (σ) and beta convergence (β), which use territorial GDP per capita as the main variable. Sigma convergence measures disparities by focusing on the level of dispersion (standard deviation) of the logarithm of territorial GDP per capita, while beta convergence establishes a trend over time and identifies whether the poorest regions are catching up with the richest ones and how long it would take for the gap to be completely closed. Beta convergence between regions is considered to exist if there is an inverse ratio between growth rate and the initial level of per capita GDP, in other words if the relatively poorer regions tend to grow more quickly than the richest regions.

Figure IV.3 shows the sigma coefficient between 1990 and 2006 for the Latin American countries studied. Based on the value of this coefficient, two groups of countries may be identified in Latin America and the Caribbean: the first (Argentina, Brazil and Peru) has high values of between 0.50 and 0.55; and the second (Chile, Colombia, Mexico and the Plurinational State of Bolivia) has values that, though still high, are more moderate (between 0.35 and 0.45). Two groups may also be distinguished by trend: one in which the sigma coefficient is rising (including Peru (1998-2006), Mexico (1995-2006) and the Plurinational State of Bolivia (1993-2006)); and another in which it is falling (Argentina (2002-2005), Brazil (1993-2006), Chile (1999-2007) and Colombia (1998-2007)).

Table IV.2 shows the beta convergence coefficient for two subperiods: the 1990s and the most recent period. This indicator supplements the two previous ones because, independently from the level of existing disparities, it provides evidence of convergence over time. In other words, it indicates any trend towards a reduction in inequalities, and whether this may or may not be the result of public policy.

Figure IV.3
LATIN AMERICA (SELECTED COUNTRIES): SIGMA COEFFICIENT, 1990-2006



Source: Latin American and Caribbean Institute for Economic and Social Planning (ILPES), on the basis of official figures.

Table IV.2
LATIN AMERICA (SELECTED COUNTRIES): SUMMARY OF BETA CONVERGENCE OUTCOMES, BY PERIODS

Country	Period	β coefficient	Standard error	R^2	*p value*	Statistical significance (5%)
Argentina	1993-2002	0.000046	0.005166	0.000004	0.9930	No
	2002-2005	-0.006517	0.005612	0.056694	0.2580	No
Bolivia (Plurinational State of)	1990-1998	0.023938	0.031743	0.089821	0.4754	No
	1998-2006	-0.013601	0.031049	0.024018	0.6746	No
Brazil	1990-2002	-0.005787	0.004486	0.058503	0.2088	No
	2002-2006	-0.012417	0.002996	0.395382	0.0003	Yes
Chile	1990-1999	-0.002402	0.009961	0.005148	0.8139	No
	1999-2007	-0.014546	0.005388	0.371253	0.0207	Yes
Colombia	1990-2002	-0.005972	0.007319	0.026255	0.4228	No
	2002-2007	-0.014320	0.006881	0.149193	0.0488	Yes
Mexico	1993-2000	0.003450	0.005721	0.012268	0.5510	No
	2000-2006	-0.001464	0.003608	0.005412	0.6878	No
Peru	1994-2001	-0.006127	0.007022	0.032094	0.3923	No
	2001-2007	-0.000688	0.005850	0.000626	0.9074	No

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

In the 1990s, there is no evidence of convergence or divergence, whereas in the most recent period there is convergence in three of the countries studied (Brazil, Chile and Colombia), and the coefficient switched from a positive number (non-significant divergence) to a negative one (non-significant convergence) in three of the remaining countries (Argentina, Mexico and the Plurinational State of Bolivia). Peru is the only country where the coefficient remains negative, although without being statistically significant. Combining the results of the various indicators leads to the conclusion that, on the basis of international comparisons, disparities in Latin America and the Caribbean remain high and have not changed significantly in the last two decades. This is despite the fact that in recent years disparities have decreased slightly in Brazil, Colombia and Chile; risen in the Plurinational State of Bolivia and Peru; and remained relatively stable in Argentina and Mexico.

In sum, the high spatial concentration of population and economic activity in Latin America is accompanied by considerable territorial disparities (gaps in territorial per capita GDP), while in OECD countries, concentration indices are not as high and are not associated with disparities. The exercises for OECD countries show that spatial concentration of economic activity and population does not necessarily have to mean significant wealth gaps among territories. In Latin America, however, concentration and disparities have gone hand in hand, thus generating a situation of territorial inequality that calls for commensurate public policy responses.

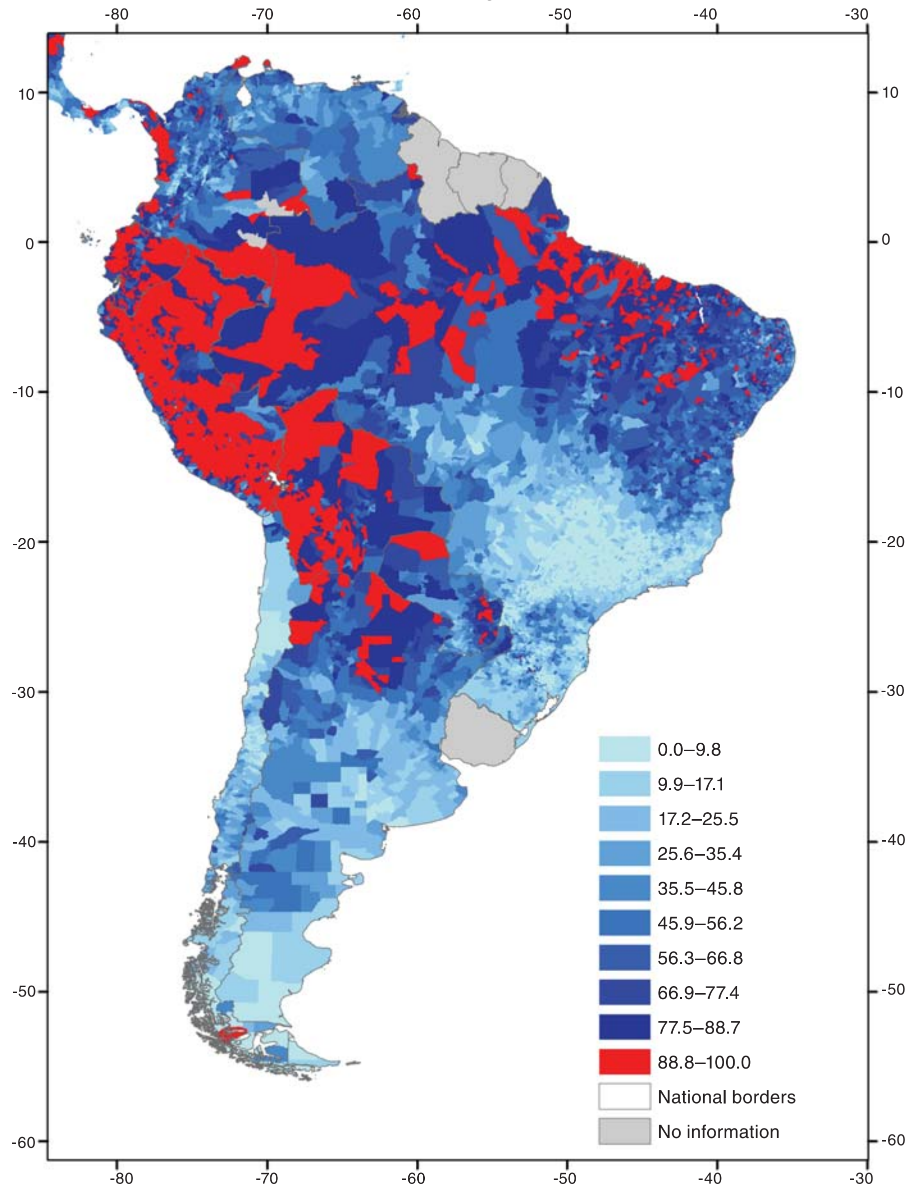
C. Hardship and segregation: regional and urban maps

1. The map of hardship in Latin America

The above typology shows economic territorial inequalities. To supplement this, it is useful to analyse how social hardship is distributed throughout the subregion. This may be illustrated in the maps below, which show the territorial distribution of hardship intensity (in other words basic unmet needs). The measure used was the percentage of the population aged under 18 years with one or more serious hardship. The following factors were used: dwelling construction materials, overcrowding, access to drinking water, sanitation, children's education and presence of information or communication media.

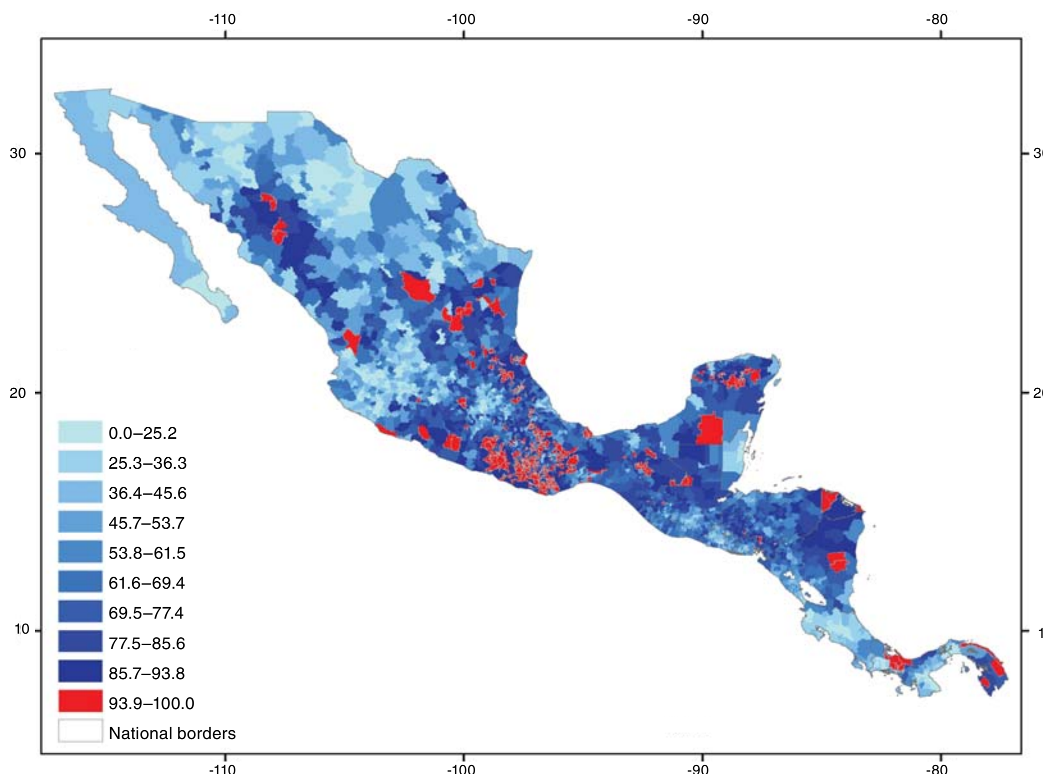
In South America, the map shows extremely high concentrations of inhabitants under the age of 18 with serious hardships, especially in the Andean and Amazon regions (which cover vast territories where between 88.8% and 100% of the population is in this situation). In Mexico and Central America, the territorial distribution of population with serious hardships shows the more disadvantaged territories more spread out. Yet, as in the case of the Andean and Amazon regions, the greatest hardship tends to occur in areas with a large indigenous population (for example, southern Mexico and Guatemala).

Map IV.1
SOUTH AMERICA: POPULATION AGED UNDER 18 YEARS WITH AT LEAST ONE SERIOUS HARDSHIP IN SMALLER ADMINISTRATIVE REGIONS, AROUND 2000
(Percentages)



Source: Latin American and Caribbean Demographic Centre (CELADE) - Population Division of ECLAC, in the framework of the joint project with the United Nations Children's Fund (UNICEF) "Child Poverty, Inequality and Citizenship Study for Latin America and the Caribbean", on the basis of special processing of census microdatabases.

Map IV.2
CENTRAL AMERICA: POPULATION AGED UNDER 18 YEARS WITH AT LEAST ONE SERIOUS HARDSHIP IN SMALLER ADMINISTRATIVE REGIONS, AROUND 2000
(Percentages)



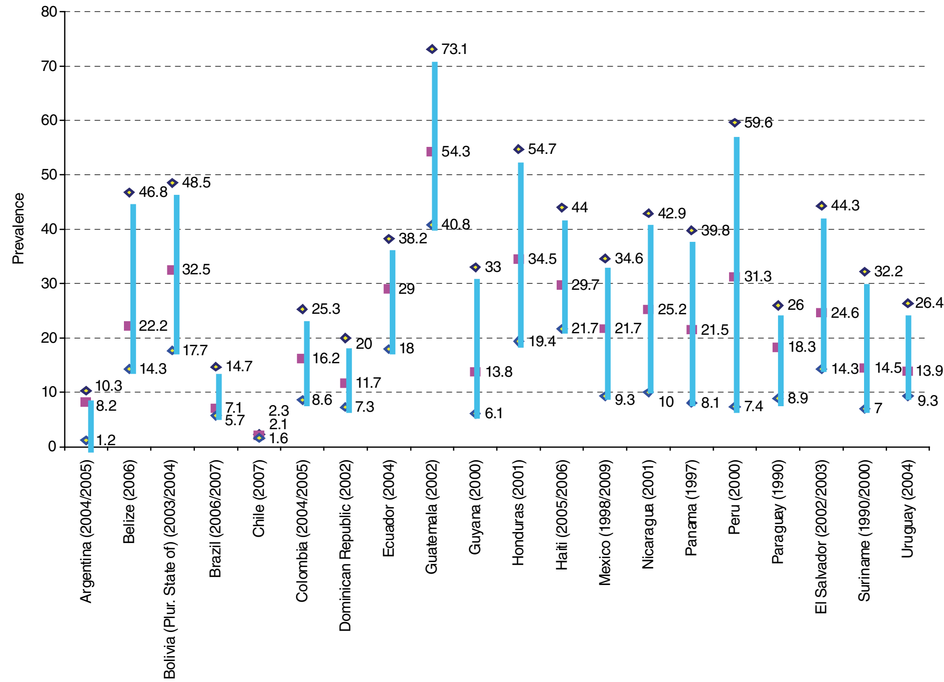
Source: Latin American and Caribbean Demographic Centre (CELADE) - Population Division of ECLAC, in the framework of the joint project with the United Nations Children's Fund (UNICEF) "Child Poverty, Inequality and Citizenship Study for Latin America and the Caribbean" , on the basis of special processing of census microdatabases.

Figure IV.4, which uses the prevalence of chronic undernutrition (stunting in children aged under five years) as an indicator, shows how deprivation is unevenly distributed within countries. Chronic child undernutrition (stunting) is a good indicator or proxy for basic deprivation, because territories with a high incidence of this problem tend to show a combination of other hardships which worsen this one: a low educational level in the family, limited income, lack of access to wide social networks and poor health care. The largest disparities occur in Guatemala, Honduras, Peru and the Plurinational State of Bolivia. In Peru, the overall rate of stunting is almost nine times higher among the children of Huancavelica than those of Tacna, while in Honduras there is a 35-percentage-point difference between the areas with the highest and lowest levels. In Guatemala, nearly 75% of children in the north of the country suffer from chronic undernutrition, while in the metropolitan region the figure is 41%. In the Plurinational State of Bolivia, Santa Cruz has a chronic child undernutrition rate of 17.7%, compared with Potosí, where half of children under age five chronically undernourished.

Figure IV.4

LATIN AMERICA AND THE CARIBBEAN (20 COUNTRIES): PREVALENCE OF CHRONIC UNDERNUTRITION (STUNTING), MAXIMUM AND MINIMUM VALUES BY COUNTRY, ACCORDING TO WORLD HEALTH ORGANIZATION (WHO) STANDARDS

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures and data from the World Health Organization (WHO) [online] www.who.int.

In absolute terms, vulnerability varies less sharply in countries with lower undernutrition rates. However, the probability of suffering from chronic undernutrition in Argentina is eight times higher in Formosa than in Tierra del Fuego, and in Brazil the probability is three times higher in the north than in the south. The most nutritionally vulnerable child population generally tends to be concentrated in the high regions of Central America and the mountainous areas and high plains of the Andes, and the worst affected are usually indigenous children whose mothers are completely illiterate or did not complete primary education, live in extreme poverty and have limited access to drinking water and sanitation services. Nutritional vulnerability is also higher in rural areas than in urban areas.

2. Urban segregation as a replicator of inequalities

In Latin America and the Caribbean, around 434 million people (77.36% of the population) live in urban areas (Jordán and Martínez, 2009). This concentration of the population[3] is the reason why the region's public authorities have, in recent decades, devoted much of their management and planning efforts to implementing measures to satisfy the increasing demands for infrastructure and social services in cities.[4]

Although free-market dynamics create inequalities in cities around the world, in Latin America and the Caribbean the inequalities are more dramatic because of the striking asymmetry in infrastructure and social services. In urban areas, where demand from the fastest-growing economic activities and the highest-income families is concentrated, land acquires real estate value and this prevents access by or forces out less profitable activities and lower-income families (Smolka, 2001).

This urban layout intensifies segregation, as the concentration of informal or less profitable economic activities in areas inhabited by low-income families generally pushes land prices down. This reduces or limits municipal income from property taxes,[5] business licences and municipal permits, which in turn affects the funding capacity for investment projects and for building and maintaining infrastructure and public services. This deterioration of public spaces leads to problems of access to services, a lack of places for socialization and a decline in public safety, not to mention problems of institutional disaffiliation as young people drop out of the education system and the labour market. As their average income rises, families tend to leave these disadvantaged areas, and this deters more profitable economic activities from setting up there (Kaztman, 2001).

Urban poverty and informal labour markets go hand in hand. As pointed out in chapter III, urban concentration in Latin America has been coupled with sluggish labour markets, especially since the start of the 1980s, which has left much of the working population concentrated in informal urban sectors with low productivity. This has combined with the phenomenon of urban marginalization observed in previous decades: the rapid expansion of precarious settlements on the outskirts of large cities (mainly as a result of intensive migration from rural to urban areas and the natural population growth in towns). The combined effect of urban marginalization and informal labour markets was the formation of a vicious cycle of spatial and productive exclusion.

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[3] During the period 1970-2000, the region's urban population grew by 240%, while the rural population grew by just 6.5% (United Nations, 2005b).

[4] In 2006, in Latin America and the Caribbean (46 economies) the percentage of households with access to sanitation services and drinking water was 86% and 97%, respectively, in urban areas, while in 1990 the figures had been 81% and 84% (ECLAC, 2009i).

[5] Property contributions (the main source of funding for many local governments) consist of an annual payment of the percentage of the financial value of the property. The tax is set by considering the type and quality of the property, its location, market value and the services and facilities to which it has access. Given that infrastructure is assessed according to the value of the land, the contributions payable for property are directly and indirectly dependent on the availability of infrastructure in that area.

This in turn strengthens the vicious cycles of urban segregation. As differences grow in the coverage and quality of infrastructure and social services, so inequalities deepen in terms of quality of life and access to opportunities (Rodríguez and Sugranyes, 2005). In particular, there are fewer possibilities for social mobility in a city where the daily reality of the least well-off is marked by poverty and precarious working conditions. The geographical location of a household affects opportunities, as a result of the impact that social interaction has upon the individual behaviours and outcomes (Saraví, 2004).

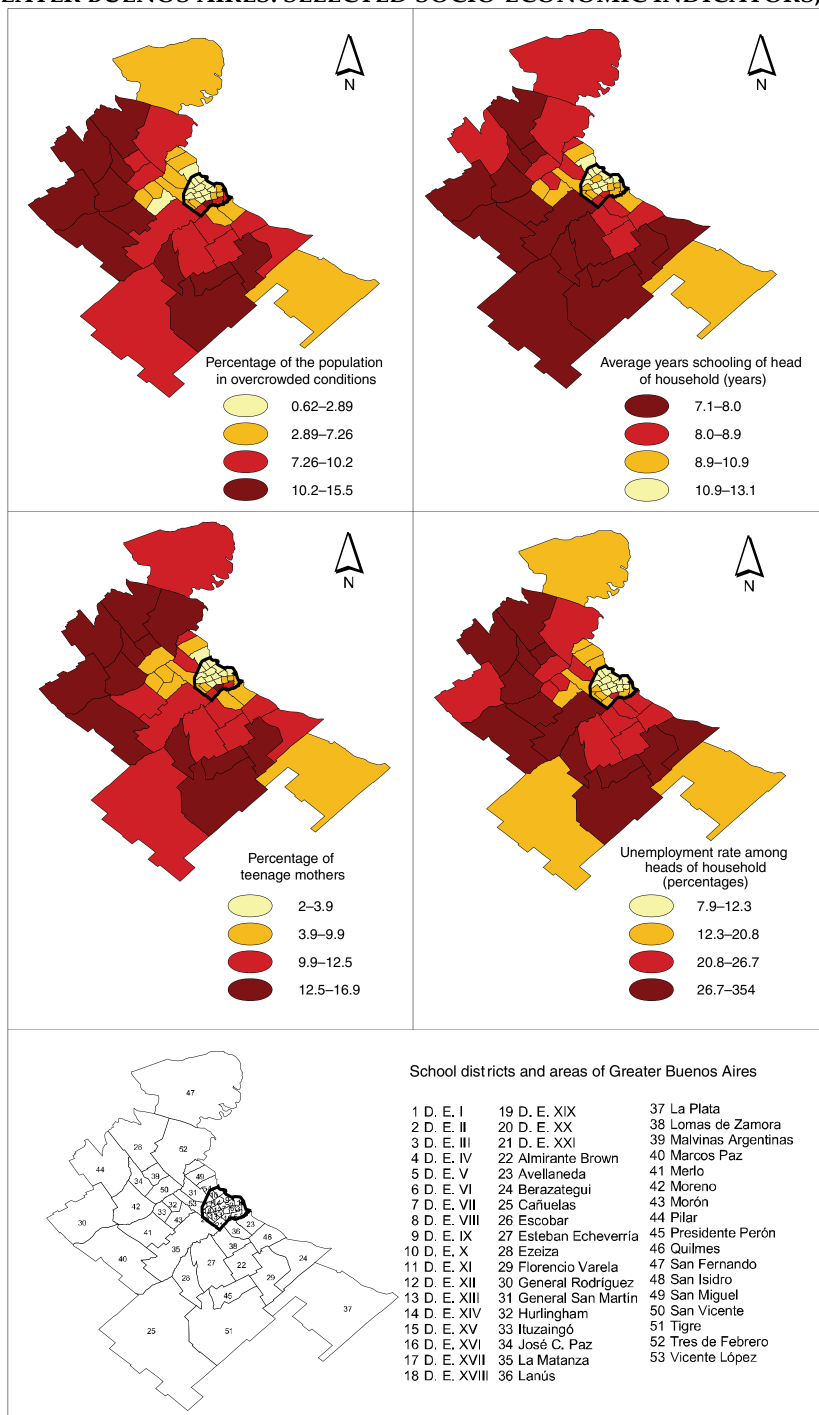
Residential segregation occurs when different socio-economic groups in a city or metropolis live separately, with little or no coexistence. At the extreme, each residential area[6] in a city is completely socio-economically homogenous, and is entirely distinct from the areas where other socio-economic groups live. It is worth mentioning that spatial segregation is often accompanied by administrative segregation and fragmentation, with an unequal distribution of public services and access to education and knowledge, especially in large urban centres that have no centralized administration but rather function as a set of local governments or municipalities that (with their limited resources) replicate and promote such differences. Related phenomena include the reduction in the use of public services by the middle classes, the growing segmentation of non-residential social meeting places, weak links of the lower classes with the labour market and the stigmatization of poor neighbourhoods (Kaztman, 2009). Several of these processes are due to State inaction or absence, which is why the strategic response would be to revive State intervention in urban areas.

Urban segregation in Latin America is distinguished by the precarious nature of areas on the outskirts, where most of the poor and most deprivation are concentrated. The following maps of four large urban centres in Latin America speak volumes: with different variations, hardship and poverty reproduction tend to be mutually reinforcing in the same territories, which are marked by persistently low levels of schooling, high levels of overcrowding, unemployment and teenage pregnancy. This is the territorial basis for the vicious circle that reproduces poverty and disadvantage in the cities that are home to over three quarters of the population in Latin America and the Caribbean.

[6] Municipalities, communes, districts, neighbourhoods, settlements or blocks.

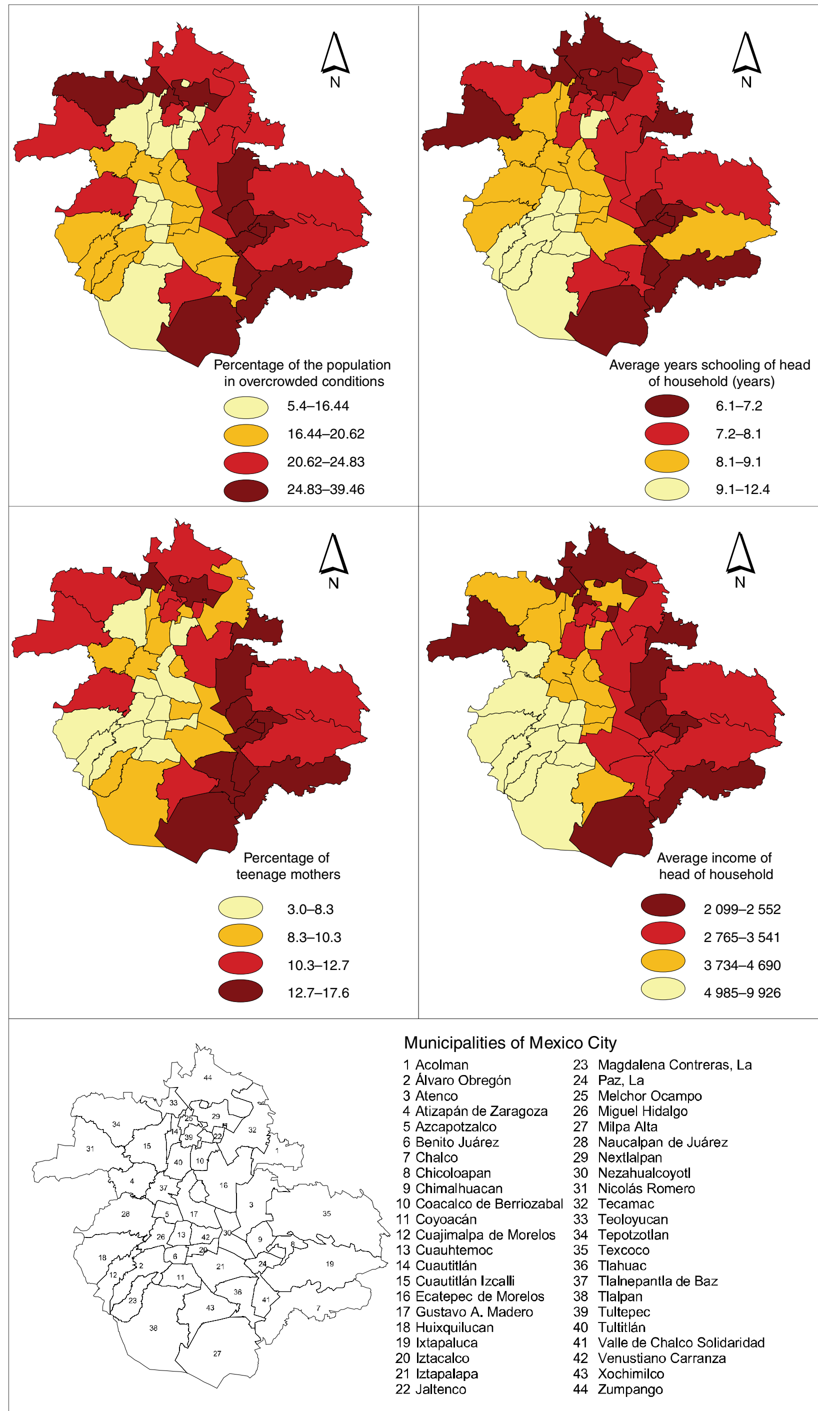
Map IV.3

GREATER BUENOS AIRES: SELECTED SOCIO-ECONOMIC INDICATORS, 2001



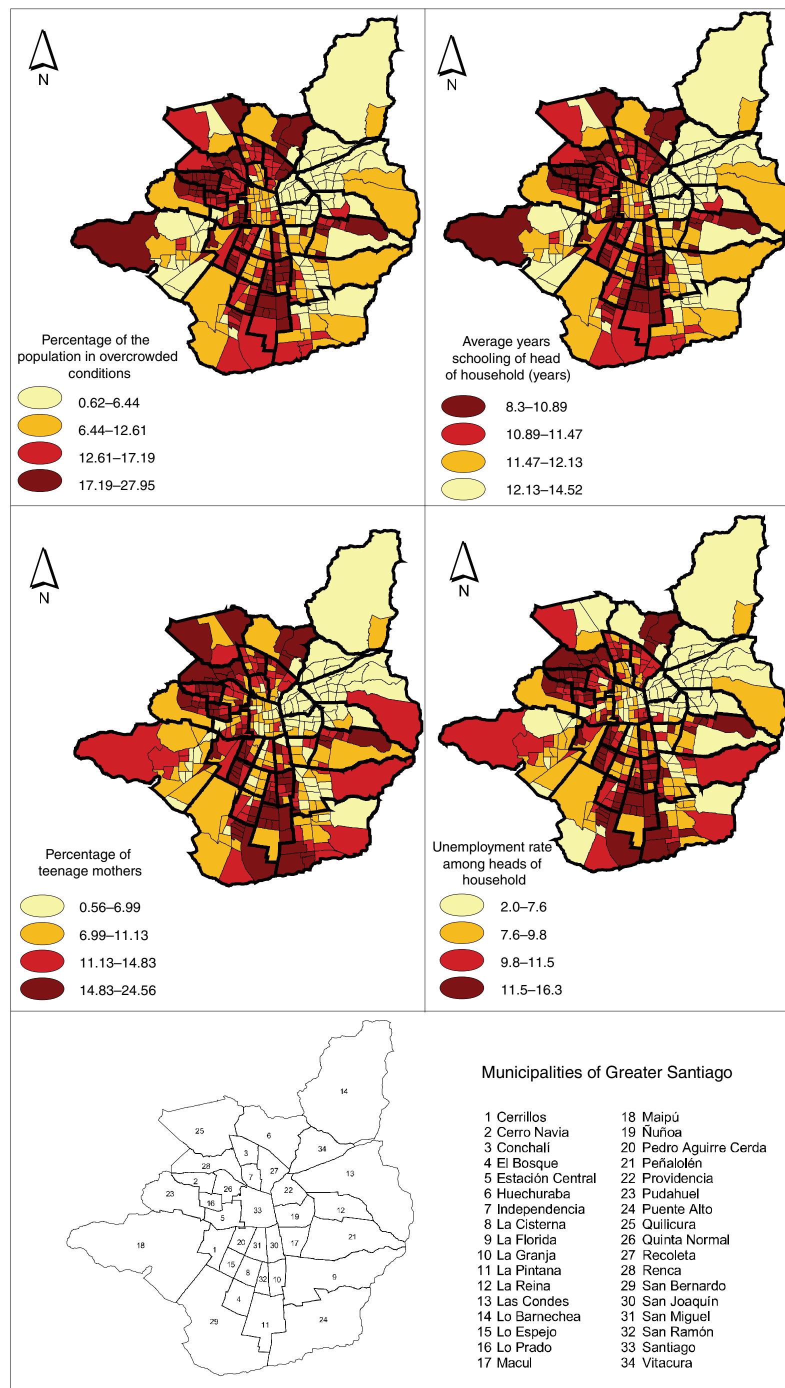
Source: Latin American and Caribbean Demographic Centre (CELADE) – Population Division of ECLAC, on the basis of special processing of census microdatabases.

Map IV.4
MEXICO CITY: SELECTED SOCIO-ECONOMIC INDICATORS, 2000



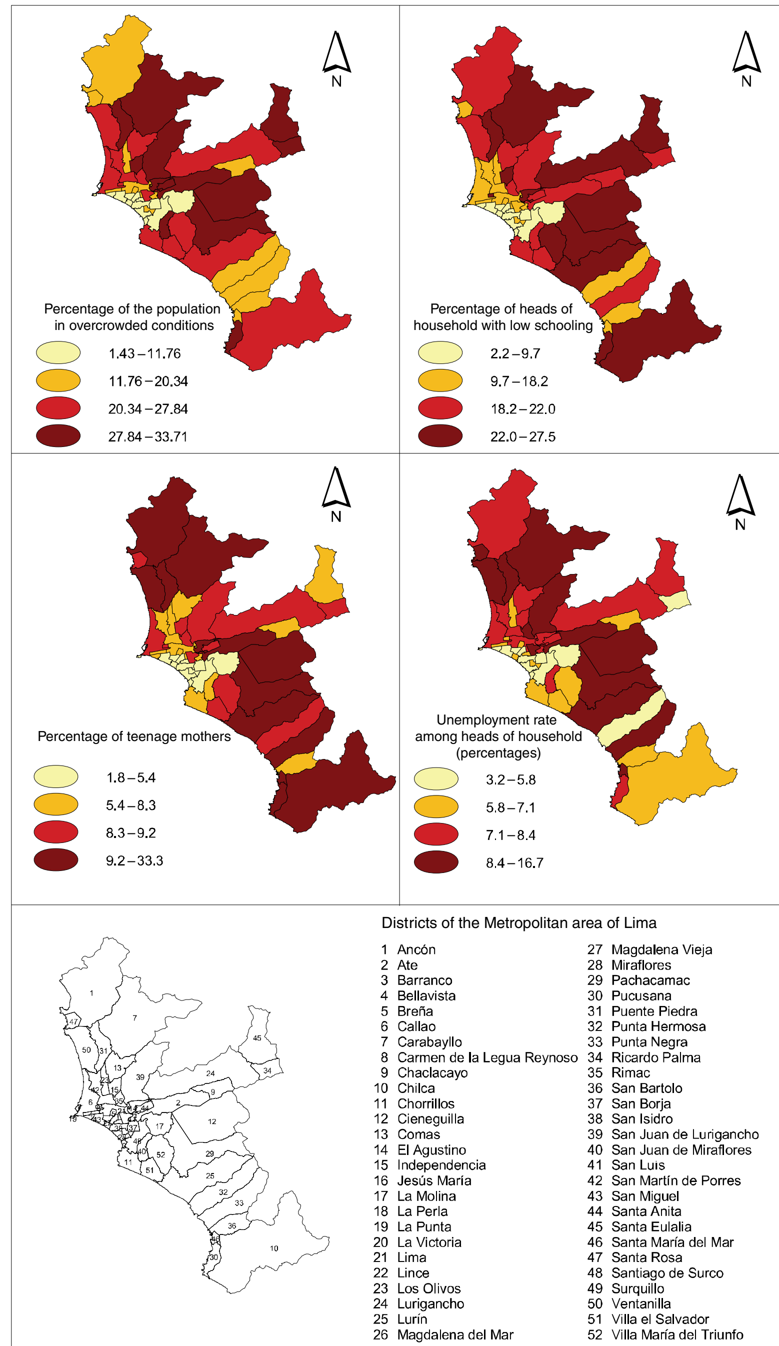
Source: Latin American and Caribbean Demographic Centre (CELADE) – Population Division of ECLAC, on the basis of special processing of census microdatabases.

Map IV.5
GREATER SANTIAGO: SELECTED SOCIO-ECONOMIC INDICATORS, 2002



Source: Latin American and Caribbean Demographic Centre (CELADE) – Population Division of ECLAC, on the basis of special processing of census microdatabases.

Map IV.6
METROPOLITAN AREA OF LIMA: SELECTED SOCIO-ECONOMIC INDICATORS, 2007



Source: Latin American and Caribbean Demographic Centre (CELADE) – Population Division of ECLAC, on the basis of special processing of census microdatabases.

D. Policies for greater territorial equality and cohesion

1. Local development: many strategies, one aim

Territorial heterogeneity in Latin America calls for selective and targeted strategies. Local development, understood as a bottom-up process, mobilizes endogenous potential to build territories that are better able to create and drive their own capacities. Synergies among public and private agents, the various levels of Government, and local production sectors and wider markets are essential in activating territorial development. These efforts must link in with national measures that, through decentralization policies and the territorial allocation of resources, seek to promote the development of the most disadvantaged regions and meet their most pressing needs. The interaction between mobilization from within the regions and the action of national territorial cohesion policies must therefore generate virtuous circles between social capital and public policy, so as to strengthen the specific development capacities needed by each region.

Progress towards the productive convergence described in chapter III requires linkages that connect less productive sectors with more productive ones, as this would increase the mainstreaming of technical progress, access to markets and credit and capacity-building. This is vital if countries are to boost local production systems, made up mainly of low-productivity micro- and small enterprises. In this, the formation of agglomerations and production clusters thus becomes a key part of the transformation. Here, territorial belonging is a symbolic asset that is vital if businesses are to interact in a shared local space with a twofold effect: productive growth and social integration.

Territory, then, does matter. Proximity has its specific advantages: it enables learning by means of interaction, which then crystallizes into innovation —hence the notion of regional innovation systems. Although growth macromodels have tended to disregard the territorial dimension, many of the factors that explain or might explain greater growth are location-specific. This limited mobility means that such factors cannot be transferred to another place (Cuadrado, 2001).

Given the variety of institutions and actors involved in territorial development (both bottom-up and top-down), it is essential to make progress towards agreements and consensus around the type of policies proposed. Territorial cohesion must be the point of convergence for the bottom-up and top-down promotion of local and regional development, and the focal point for coordinating and linking sectoral and cross-cutting policies, which have hitherto been treated separately. An interesting model that could usefully be replicated elsewhere is the Territories of Citizenship programme implemented by the Government of Brazil since 2008 (see box IV.1).

Furthermore, as noted earlier, basic unmet needs show a heavy territorial bias among and within countries. Tackling this requires an integrated approach to create synergies between productive systems, market access and policies of direct support to meet the most urgent needs (such as nutrition).[7]

[7] These proposals are based on ECLAC (2008d) and Martínez (2005).

Box IV.1

TERRITORIES OF CITIZENSHIP: AN EQUALITY POLICY WITH A TERRITORIAL FOCUS

In 2008, the Federal Government of Brazil created the Territories of Citizenship programme, which aims to reinforce policies to reduce poverty and social inequalities in the country's rural areas. The programme involves integrated actions at three levels (federal, state and municipal) and establishes and coordinates management committees at the national, state and territorial levels. The main objectives of the programme are to integrate public policies on the basis of territorial planning, expand mechanisms for social participation in the management of public policies and provide a broader range of more universal citizenship programmes.

The programme has two basic lines of action: one to support production activity, and another aimed at the exercise of rights and institution-building. The aim is to achieve social inclusion by stimulating income generation in the rural economy, as well as citizen participation in the planning of sustainable territorial development and access to essential public services such as civil documentation, food and nutritional security, health care, education, culture, social organization and infrastructure (housing, access roads, energy and sanitation).

The programme selects territories based on the following criteria: (i) territories with a lower human development index (HDI); (ii) territories with a high concentration of beneficiaries of the cash-transfer programme *Bolsa Familia*; (iii) concentration of family-based subsistence farming and agrarian reform settlements; (iv) high concentration of *Quilombola* (descendants of runaway slaves) and indigenous populations; (v) territories with a high number of municipalities with slow economic growth; and (vi) territories with a high level of social organization (social capital).

According to the Ministry of Agricultural Development (MDA) of Brazil, which is the main federal manager for the programme, the current coverage is 164 territories, representing 58% of the country's surface area and 52 million inhabitants.

Table 1

COVERAGE OF TERRITORIES OF CITIZENSHIP PROGRAMME

	Brazil	Territory	Percentage
Number of territories	164	-	-
Number of municipalities	5 564	2 500	44.93
Surface area	8 626 768.60	5 046 045.50	58.49
Population	183 197 044	52 238 323	28.51
Rural population	28 425 733	15 923 286	56.02
Fishermen	390 676	224 094	57.36
Subsistence farmers	4 139 357	2 414 240	58.32
Settled families	785 300	581 210	74.01
Social demand [a]	5 142 454	3 129 816	60.86
Bolsa Familia programme	11 047 139	4 805 853	43.5
Quilombola	1 219	863	70.8
Indigenous lands	612	340	55.56
Number of high-income municipalities [b]	1 567	335	21.38
Number of low-income municipalities [c]	725	485	66.9
Number of buoyant municipalities [d]	1 002	731	72.95
Number of stagnant municipalities [e]	2 264	948	41.87

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of data from the Ministry of Agricultural Development (MDA), Territorial Information System (SIT) [online] www.mda.gov.br [date of reference: 2 February 2010] and from the Ministry of National Integration, 2005 for data on municipalities; and MDA, "Territórios da cidadania, proposta do Ministério do Desenvolvimento Agrário para redução da desigualdade social no meio rural brasileiro", Brasilia, 2008, unpublished.

[a] Social demand is the sum of families occupying land, settled families and subsistence farmers.

[b] High-income municipalities are considered to be those that have a high household output per capita, irrespective of buoyancy.

[c] Low-income municipalities are considered to be those that have a low household output per capita and low economic growth.

[d] Buoyant municipalities are considered to be those that have low or average household output, but a fast-growing economy.

[e] Stagnant municipalities are considered to be those with average household output but limited economic growth.

In terms of food access and production, a number of objectives are to be pursued: (i) facilitate access by the most vulnerable families to productive assets in terms of land, equipment and financing; (ii) promote soil improvement, appropriate water management and storage, and outreach activities that increase associative capacity and process industrialization; and (iii) promote and improve food practices based on indigenous and traditional products.

In relation to social infrastructure, the map of hardship shows the need for investment in the following areas: (i) schools and health services in the most vulnerable areas; (ii) drinking water and sanitation in disadvantaged areas and the identification of cheaper alternatives with acceptable standards of hygiene in isolated areas; and (iii) irrigation infrastructure, especially in areas aiming for self-sufficient production but with a shortage of water for irrigation.

As for production infrastructure, progress must be made towards achieving the following objectives: (i) setting up access routes to facilitate the commercialization of local products and food distribution in emergencies; (ii) making progress in trade agreements that affect food products; and (iii) devising ways of ensuring that small-scale producers are not excluded from modern food production and marketing processes.

As far as food assistance is concerned, it is vital to: (i) provide food supplements to pregnant and breastfeeding women, infants and pre-school children and encourage breastfeeding; (ii) provide school meals in the most disadvantaged areas; and (iii) create or improve emergency food protection systems.

In health care, the use of information and communications technologies (ICT) is a key to reducing territorial gaps in access to care and timely treatment. The various specializations of telemedicine, such as teleradiology, teledermatology or telecardiology, not only provide services in areas with insufficient coverage but also narrow gaps in quality by means of remote referrals to specialists or distance consultations of second opinions by conventional practices. According to estimates for the telehealth experience in the Bolivarian Republic of Venezuela, for instance, almost 80% of cases that rural health professionals were unable to solve directly can be resolved through teleconsultation. In other words, only 2 in every 10 patients need to be transferred to more specialized hospitals.

However, for this type of experience to be implemented across the board and fulfil their promise at the national level, progress must be made towards developing a solid network infrastructure and creating suitable legal frameworks for the practice of telemedicine.

2. Institutional complexity and fiscal instruments

The past two decades have seen the emergence and consolidation of a wide range of public policies with an awareness of territorial development at various levels. Public policies and institutions must at least make reference to and consider the following coexisting and juxtaposed aspects:

- Local economic development policies and initiatives that have promoted the territorial domain and brought new development visions, strategies and instruments to the fore;
- Land-use planning has been consolidated as a concept and a body of policies and has taken on institutional forms that have served as vehicles for concerns about the appropriate use of natural resources and the achievement of sustainable development;

- Policies for productive development, training, research and technology have gradually incorporated the notion of territory as an instrument for managing their development; and
- Some countries have reinstated regional policies, designed by national governments, with the aim of tackling the particular issues of specific territories.

To make progress in territorial cohesion policies, it is therefore essential to recognize the coexistence of institutions and policies that until now have not been integrated. This has often resulted in a lack of coordination and a waste of national government resources and local and territorial assets (which are usually in short supply in the first place). Here each country must craft its own architecture to rise more effectively to the challenges of coordinating various sectors and territorial levels of government.

Leaving aside the specific features of countries and the differences between them (be they unitary or federal States), there are common factors in the genesis of fiscal imbalances that must be considered in this architecture. These imbalances may be vertical or horizontal, and they affect the possibilities for development of subnational territories.

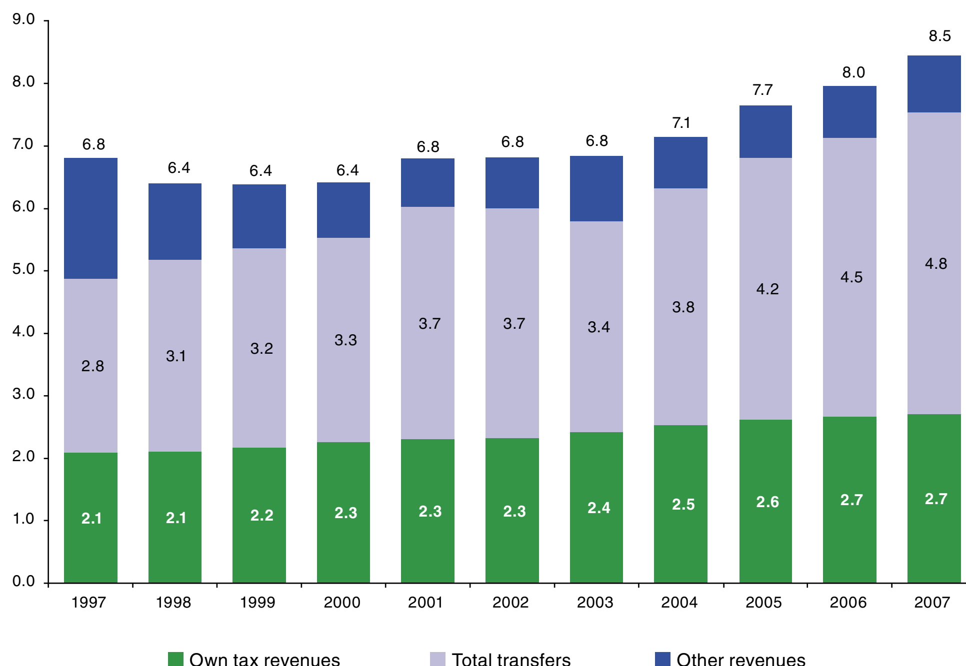
Vertical imbalance relates to the formation of a structural imbalance between subnational revenues and expenditure, because local tax bases are relatively limited and therefore tend to yield much less than the total cost of goods and services that should ideally be provided at the subnational level. The resulting vertical imbalance leads to and forms the rationale for the development of a system of intergovernmental transfers from the upper to the lower levels.

In addition, the considerably uneven territorial distribution of wealth and economic activity gives rise to significant differences in tax receipts from various jurisdictions. Potential tax bases vary considerably from territory to territory, and this generates a horizontal imbalance. Generally speaking, the highest receipts are concentrated in those jurisdictions with the most buoyant economic activities and the residents with the highest incomes.

For the same reason, intergovernmental transfers can play a strategic role in correcting disparities, especially through regional development policies administered at the national level that, properly attuned to the specificities of each territory, can use national resources to boost endogenous development in subnational territories. In this framework, like central governments, subnational authorities have improved their public accounts in recent years. After running deficits in the 1990s, in the current decade they have posted primary surpluses that are unprecedented in both level and stability, even though the average surplus shrank slightly (by around 0.1% of GDP) in 2008-2009, compared with the peak reached in 2007. Subnational public sectors have also become less vulnerable, as their level of borrowing (expressed as a debt-to-GDP ratio) dropped considerably between 2002 and 2008.

This improvement in subnational finances is also strongly associated with positive growth in intergovernmental transfers, on the back of rising economic activity levels and higher prices for natural resources. On average, total transfers expanded by two GDP points between 1997 and 2007, while tax revenues rose more modestly from 2.1% of GDP to 2.7% in the same period (see figure IV.5). This limited increase in subnational tax receipts in Latin America is related to the low level and weak structure of subnational taxation, which in turn is linked to the tax bases available to these levels of government.

Figure IV.5
LATIN AMERICA: AVERAGE STRUCTURE OF SUBNATIONAL REVENUES, 1997-2007
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

The difficulties that subnational governments have in collecting their own taxes are exemplified by the property tax, which is usually the main tax for local governments. In Latin America, receipts from this tax account for an average of approximately 0.4% of GDP, or one fifth of the receipts collected by developed countries. However, the situation varies among countries: in some this indicator is less than 0.2% of GDP (as in Ecuador, Mexico and Peru), while in others it is between 0.5% and 0.7% of GDP (Argentina, Chile, Colombia, Plurinational State of Bolivia and Uruguay).

These outcomes highlight the need to strengthen the property tax at the subnational level in the region, by reducing exemptions, eliminating tax amnesties and pardons and improving tax administration, including property records, the updating of property values and tax billing. Ultimately, territorial development must be funded and the disparities overcome on the basis of territories' own fiscal efforts and on transfer systems that, in addition to their usual destinations, also target broadly consulted development programmes. In this sense, decentralization programmes should pay special attention to inequalities among subnational territories (see box IV.2) and, accordingly, introduce suitable mechanisms for relevant transfers from central government.

Box IV.2

DECENTRALIZATION AND EQUALITY IN LATIN AMERICA

In Latin America, decentralization is extremely difficult, given the high level of regional productive disparity that seriously limits the functioning and financing of decentralized services (especially where their provision affects equity). In the light of large territorial disparities such as those that exist between the region's various subnational territories, attempts to decentralize resources to support greater fiscal equivalence have been hampered by an unequal distribution of tax bases, which has increased fiscal tension whenever there is a need to compensate for differences in capacity.

This is why the result of reforms will depend on the accompanying system of financial transfers and the compensatory role played by central governments. However, even when the required financial resources are to hand, disparities will also affect the availability of human resources and, in general, the capacities for interjurisdictional management. This implies that the transfer of monetary resources must be combined with training and capacity transfer.

Progress with decentralization has been distinctly uneven in the region. Taking the percentage of a country's total public expenditure dispensed by subnational governments as an indicator, two of the region's federal and also largest countries (Argentina and Brazil) emerge as the most decentralized, with figures in excess of 40%. Countries that have implemented major decentralization reforms in recent decades (Colombia, Mexico, Peru and the Plurinational State of Bolivia) have slightly lower percentages of between 25% and 30%, while the Bolivarian Republic of Venezuela, Chile, Guatemala and Uruguay post relatively low levels of decentralization (between 10% and 20%). Lastly, the other countries of Central America, as well as Ecuador and Paraguay, display the lowest percentages (Cetrángolo, 2007).

Although central governments having the main responsibility for distribution is a well accepted notion, there is still considerable debate around the decentralization of functions that have a strong impact on equity (such as health care, education, housing, water and sanitation). Unconditional advocacy of decentralized social services assumes a guaranteed minimum level of provision nationwide and adjustments to achieve marginal improvements at the local level. In Latin America, though, the shortcomings in this regard make it essential to establish which level of government should ensure equal rights in such differentiated territories. Furthermore, decentralization involves many challenges, depending on the sector being reformed. For instance, the establishment of public health-care networks involves very different challenges in terms of territorial structure than do the construction of a basic school system or road network.

In some cases, a sectoral approach has been introduced into the design of cash transfer schemes. For instance, Brazil applied such an approach to the Fund for Primary Education Development and for Enhancing the Value of the Teaching Profession (FUNDEF), with a constitutional amendment in 1996 to stipulate that every federal unit must allocate to FUNDEF 60% of a quarter of the state and municipal tax revenues allocated to education under the Constitution. Colombia adopted a general system of participation under Law No. 715 of 2001, which incorporates specific allocations for education and regulates their distribution on the basis of cost-of-service indicators. Argentina approved an education financing law that includes specific transfers to ensure fulfilment of a certain target for increased sectoral spending.

The debate on decentralization has highlighted the role of subnational governments. Nevertheless, refocusing on the need to ensure a basic level of rights in relation to decentralized sectoral policies leads to the conclusion that much needs to be done to redefine the role of central governments in decentralized countries, while also consolidating fiscal sustainability. This also emphasizes the need to avoid the overlap of functions and allocations among the various levels. This appears to be the ideal opportunity to analyse the combined impact on social cohesion and fiscal sustainability, taking account of the tensions between the above-mentioned policy objectives.

Source: Economic Commission for Latin America and the Caribbean (ECLAC).

3. Territorial cohesion funds

In Latin America and the Caribbean, there are alarming territorial gaps in terms of productive capacity, income levels and the incidence of basic lacks. Moreover, the gaps are a cause (as well as an unfortunate consequence) of the profound inequality that runs through the region in many ways. Alleviating territorial inequality therefore implies tackling general inequality as well. Therein lies the importance of State-led public policies, supported by covenants among stakeholders at the various levels of territorial disaggregation, and policies that are aimed at promoting greater territorial equality.[8]

A territorial cohesion fund has at least three objectives. The first is to transfer funds from the central level to subnational levels, and commit them to be used in generating synergies among production, capacity-building and efforts to resolve basic lacks. This is not merely a territorial reallocation of resources to respond to urgent needs (although these are of course included): there must also be a certain level of conditionality, with a commitment at the subnational level to mobilize local energies to break the vicious circles of poor capacities, deficient productivity and economic stagnation. For the same reason, there must be support from the centre, not only in terms of monetary transfers but also for the development of management capacities, the mobilization of local actors and guidelines to promote those synergies.[9] There is thus a contract between the State and the subnational body (departmental, provincial or municipal), which must be monitored and audited, to drive territorial revitalization through the cohesion fund.

The second objective is redistribution: social cohesion funds level the playing field for the different territorial units. They take the form of cross transfers or subsidies, and are similar to income tax in that the aim is to transfer resources or provide services to those who cannot afford them. Redistribution for the benefit of more equal opportunities and rights is part of the role of the State that is being advocated in this document. A territorial cohesion fund fulfils this function, but at the spatial level. However, this clearly should not function as a disincentive, or discourage investment from local actors in the most productive regions or cease promoting growth in the most disadvantaged areas. In the same way that a welfare State formulates fiscal covenants where the various actors contribute to a national project to achieve greater growth, cohesion and opportunity for all, social cohesion funds must be explicit in terms of the effects that these cross subsidies for the most disadvantaged territories will have on the rest of the country: activating domestic markets in which traders come from all over the national territory and creating more profitable investment opportunities in a larger range of areas within the country.

The third objective of a territorial cohesion fund is to act as a means of coordinating sectoral policies with spatial policies, so as to avoid the duplication of efforts and promote more integrated forms of intervention. The fund is an intersectoral planning tool that focuses on places that are overlooked by sectoral decentralization (see box IV.2). Although transfers do not have a sectoral origin, in the subnational area targeted they should be used to promote greater intersectoral and intrasectoral coordination between the national and subnational levels.

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[8] The concept of structural funds and cohesion funds originated in the European Union, where it was a policy to increase territorial cohesion among original members, by achieving equality based on the European social model.

[9] The previous sections offered examples of these synergies in the context of food policies: in addition to tackling undernutrition directly, it is also vital to promote local food production, food markets and school assistance through the provision of school meals in the most disadvantaged areas.

4. Intervention criteria for urban segregation

Urban residential segregation is the combined effect of economic and cultural forces that States should make greater efforts to tackle using improved spatial planning instruments. Economic forces influence the functioning of land and housing markets, where profit-seeking on the part of the wealthiest actors tends to encourage segregation, either because exclusivity pushes up prices in affluent areas or because low prices on the outskirts stimulate the construction of social housing or informal settlements. Cultural forces are related to the barriers to different socio-economic groups living side by side in the same areas. In both cases, there is resistance to the action of public policies, and this combines with the historical limitations of States that have failed to promote more integrated and less segregated cities.

Although States intervene decisively to encourage different socio-economic groups to live in proximity in other parts of the world, this does not tend to happen in Latin America and the Caribbean.[10] In this sense, sustainable urban management must tackle urban problems from within, by establishing strategies related to densification,[11] recovery and rejuvenation of historical centres, enhanced surroundings, focal points, public spaces, facilities, accessibility, roads and improvements to the urban environment.[12] In order to realize this systemic vision of urban management, it should be borne in mind that all decisions and interventions regarding public spaces have an impact on the allocation and effectiveness of resources: all economic activity has an effect on third parties and the environment, which in turn generates social benefits and costs for various sectors.

Sustainable urban management therefore implies the active participation of all involved (public and private actors, including civil society organizations). This requires a comprehensive vision of the urban unit, and a form of planning that incorporates new methods of government, including: (i) intersectoral integration of planning instruments; (ii) vertical integration of levels of government; (iii) public-private partnerships; and (iv) citizen participation.

The basic services provided by municipalities in segregated cities with municipal financing systems based on territorial taxes are highly unequal and represent an additional factor of adversity for the poor (Kaztman, 2009; Rojas, Cuadrado-Roura and Fernández, 2005; Marpsat, 1999). This is a crucial point, because the State has the scope to intervene and prevent residential segregation from having a multiplying effect on inequality. Indeed, inequality in basic municipal services can be reduced by means of direct policies, such as funds to redistribute territorial taxes, compensatory resources, area-specific allocations and special programmes in disadvantaged areas. In some cases, these measures will require considerable political determination, as the redistribution of resources is likely to cause certain reactions.

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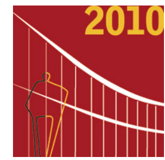
[10] For instance, no States or municipalities in this region implement social rented housing programmes. In many European countries, these programmes are one of the main policy tools used to promote social heterogeneity among municipalities.

[11] According to the European Union, an effective supply of public services can only be guaranteed if there are minimum levels of concentration of economic agents in the territory (European Union, 1999).

[12] The OECD promotes joint initiatives (such as the polycentric reorganization of cities and urban areas, the rejuvenation of urban centres, integrated planning of transport and the promotion of infrastructure for new communications technologies), so as to make cities more attractive and competitive within a framework of sustainability (OECD, 1994).

In the Latin American and Caribbean region, urban and housing policies must aim at more than the coverage and provision of basic services. It must enhance the purchasing power of lower-income sectors so that they can access better locations without this resulting in a disproportionate rise in land prices on the back of speculative or monopolistic practices. In this domain, subsidizing demand and calling upon the State capacity to buy and distribute land for the construction of good-quality housing, neighbourhoods and services to lower income groups represent a possible course of action. A second and related challenge is to encourage the application of subsidies for solutions that do not involve land use, such as residential densification and the purchase of existing housing units. These options are necessary to tackle the process of urban segregation and the rising prices of land in prime locations. A third option would be to require construction companies bidding for social housing contracts to present projects in different areas and to give the institution responsible for selecting projects the prerogative to choose schemes that carry the lowest social cost, rather than the lowest financial cost.



Chapter V

Employment and labour institutions: the key to equality of opportunities and social inclusion

The performance of the labour market is the most obvious outward sign of the quality of economic and social development. The labour market's ability to absorb the economically active population, underpin a reasonable degree of social mobility, provide acceptable wages, working hours, employment stability, labour rights, contracts and union organization, as well as offer protection for the unemployed and retired population, are all key pieces in the puzzle of social cohesion. The labour market also needs to be able to do these things in order to promote a type of economic growth that can impact more positively on the distribution of income and employment.

These achievements, however, are not a natural result of market forces, but depend on appropriate public policy decisions. Decisions in this area must take account of four important dimensions: (i) the democratically chosen values that govern the development pattern, which are structured around legitimate and stable social covenants that are duly acknowledged by the authorities (see chapter VII); (ii) the dissemination, through industrial and technology policies, of a production paradigm that can underpin steady and sustainable productivity gains (see chapter III); (iii) the adoption of a macroeconomic regime in consonance with decisions on public and private productive investment and consumption (see chapter II), and (iv) a regulatory framework that supports the development of an institutional structure that is consistent with the public policy choices made.

Broadening social equality and reducing existing gaps in societies that are structurally heterogeneous is a basic task bequeathed by history to public policymakers in Latin American and Caribbean countries. Labour market institutions are essential for creating the conditions needed to absorb productivity gains generated by a new technological paradigm and translate them into rises in real wages, shorter working days and access to social protection, at a rate in keeping with overall systemic productivity. Public policies on employment form the bridge between social and production policies. Alternatively, they may be seen as the fulcrum of the scales that enable the State to balance the two. Real wage gains can also be reinforced through the channel of indirect income transferred by means of public social spending, which broadens the range of public services needed to support the reproduction of the workforce. The array of public spending also has a strong stabilizing effect on the business cycle, since it reduces fluctuations in income and employment, thereby protecting the more vulnerable population in times of crisis (see chapters I and VI).

A. The vectors of equality and inequality in employment

Much of the inequality in the Latin American and Caribbean region can be traced back to the labour market and has been shaped largely by the economic model chosen by each country and by productivity patterns. The first part of chapter III discussed the huge productivity and wage gaps that have developed amid the highly uneven production structures that are typical of the region. The following pages return to this analysis, this time from the point of view of labour market dynamics.

The material well-being of most households in the region is largely determined by the quantity and quality of jobs, specifically by labour income (Medina and Galván, 2008). Inequalities in the assets available to the working-age population —and accordingly the unequal opportunities that those assets provide for employment in production sectors— heavily influence well-being and social cohesion. Well-being and social cohesion also reflect gaps in labour income and in access to social protection among the different groups in the workforce, differentiated by education, experience, sex, area of residence and other factors.

Labour market outcomes are not driven by individual characteristics alone, however, but also by the way that market works, determined, in turn, by the production structure, development policies and the fabric of labour institutions. This fabric, which is made up of market regulations, legal provisions and collectively negotiated rules, arose chiefly as a result of another structural inequality: that between workers and business owners, which has grown sharper since the 1980s. In recognition of this and often as a result of social conflicts over the rights of workers as the structurally weaker actors in the labour market, regulations (such as restrictions on the length of the working day) had been introduced as far back as the nineteenth century to protect labour rights and to limit the scope of self-regulation by the market. The right to trade union organization and collective bargaining has also been formally recognized. The creation of the International Labour Organization (ILO) in 1919 represented recognition at the global level that the labour market was inherently unequal and needed to be regulated.

The recent phase of globalization has worsened other labour-market-related inequalities. Against the backdrop of a production apparatus that is structurally very uneven, the nature of employment varies sharply by sector of the work force. That is, people who have similar characteristics as individuals may find themselves with very different jobs in terms of income,

access to social security and employment stability. Competition has also arisen among countries owing to asymmetries in rights and conditions of employment.

These differences are partly the result of large productivity gaps between the different production sectors (see chapter III) and the fact that labour and social institutions cover a small —and shrinking— portion of the labour force. The rest forms the vast informal sector, which spans a very large proportion of the region's economically active population. This sector lacks access to labour institutions and suffers from precarious employment conditions, low income and scant social protection. Informality casts an immense shadow over labour institutions and makes the protection they offer fragile. Even within formal enterprise there is a large segment of informal employment, as a result of subcontracting strategies adopted to cut costs, which free employers of the obligation to observe full rights for subcontracted workers.[1]

Lastly, the labour market is made up of groups that are differentiated by sex and generation, with uneven access to employment. Employment conditions are more disadvantageous and less regulated for women, ethnic minorities and young people of both sexes. Longstanding forms of discrimination converge in occupational segmentation —horizontal and vertical— in which workers with similar abilities or responsibilities enjoy very different employment conditions and pay.[2] These patterns exacerbate the inequality of the labour market. Accordingly, certain groups of workers need special protection because they are more vulnerable; hence, for example, the regulations referring to pregnant women and to child labour.

Developments over time also reveal another pattern: the intergenerational transmission of inequality. Household characteristics (especially the level of education and jobs of the parents) strongly influence the employment opportunities of any one generation. As will be discussed in chapter VI, it is essential to level the playing field in terms of access to education, educational achievement, and timely learning. Policies that foster capacity-building regardless of personal and social background help to reduce the transmission of inequality from one generation to the next.

B. Inequalities and gaps: the data speak for themselves

1. Labour market patterns at the aggregate level

With economic growth highly volatile and posting low average rates, the 1990s and early 2000s were lean years for employment and social protection for labour rights in the countries of Latin America (see figures V.1 and V.2). By contrast, the period of relatively strong growth between 2003 and 2008 impacted favourably on employment and unemployment levels, before this

[1] As well as informality, increased precariousness in the labour market encompasses the loss of legal entitlements in the formal sector. This has come about through legally endorsed changes (alterations to labour legislation on dismissal and the individual rights of workers) as well as through illegal formats and arrangements occurring within the formal sector. The latter have been encouraged by a more limited capacity for inspection on the part of the supervisory bodies whose function it is to oversee the application of the rules. Lastly, the weakening of the trade union movement, especially in the private sector, has also eroded the capacity of workers —not even to lobby for better legislation to protect them, but simply to ensure respect for the legislation that already exists.

[2] Non-discrimination is also a key principle in the regulatory framework developed by ILO.

trend was abruptly ended in 2009 (see figure V.1).[3] In the English-speaking Caribbean countries, measures to increase public-sector employment, by dint of fiscal spending (and fiscal deficits) helped to make up for the sluggish performance of the economy,[4] but even so, unemployment rates in the Caribbean have remained high, especially among women and young people.[5] In addition, the concentration of the labour force in sectors that are in rapid decline, such as agriculture and, to an extent, manufacturing, has been a leading cause of unemployment in the subregion.

Employment creation was lacklustre in Latin America in the 1990s (see figure V.1). This was also partly attributable to the phase of the demographic transition, in which the proportion of the working-age population had grown proportionally larger. The downside of this was the worsening of unemployment, while the upside was the increase in the working-age population with respect to the passive population (or the population considered passive, that aged between 0 and 15 or over 65). Accordingly —with major differences between countries— even with a standstill or fall in the employment rate (which is generally expressed as a percentage of the working-age population), the employed population has risen as a percentage of the total population (Cecchini and Uthoff, 2007).

The increase in women's participation in the labour market also reduced dependency rates within households, although that increase was achieved without sufficient public spending or social services to sustain care work in low-income families. This has led to many women undertaking a double working day (one of remunerated work and another of care for the members of the household) while many others, especially those from poor households that cannot afford to pay for the care services provided by the market (the main provider), are unable to enter employment owing to the heavy care burden in the household. This has simply reinforced inequality, inasmuch as the difficulties of lower-income households in delegating care work reduces their possibilities of placing another potential breadwinner in the labour market (ECLAC, 2008a). As will be discussed in chapter VI, the State has a key role today in providing services that help to promote greater equality through support for care work in poor and vulnerable households, thereby facilitating women's entry into the labour market. This is a key pillar of equality, since it speaks at once to gender quality, equality of capacities (by linking care with early childhood education) and lesser inequality in family income (by improving the ratio between productive and dependent persons in lower-income households).

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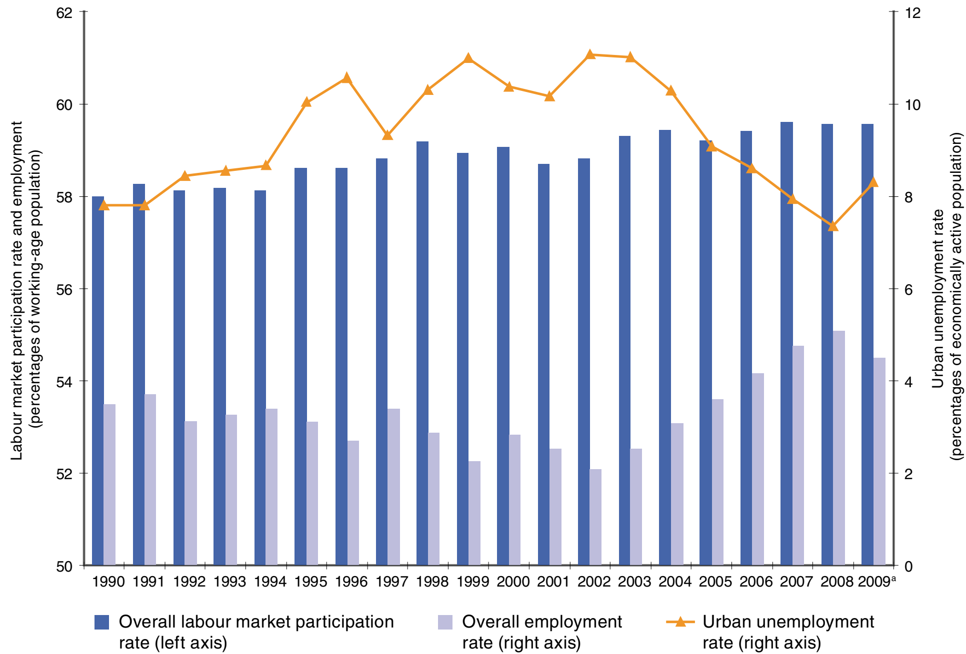
[3] Between 2003 and 2008 the unemployment rate fell both in Latin America (from 11.2% to 7.2% as a simple average for 18 countries) and in the Caribbean (from 11.3% to 8.0% as a simple average for 5 countries). Both subregions saw unemployment rise sharply in 2009 (ECLAC, 2009a).

[4] In Jamaica the number of civil servants rose from 90,000 in 2001 to 120,000 in 2004. Public-sector employment expanded by 54% and 15%, respectively, in that period in Saint Kitts and Nevis and Dominica.

[5] In the Bahamas, the unemployment rate was 9.1% in 2002 and 7.6% in 2006; in Barbados, 10.3% and 8.7%, respectively; in Belize, 10% and 9.4%, respectively; in Jamaica, 14.2% and 10.3%, respectively, and in Trinidad and Tobago, 10.4% and 8%, respectively. But the crisis has slashed employment and pushed average unemployment up from 9.8% to 11.2% in Jamaica between 2007 and 2009, and from 14.2% to 17.7% in Saint Lucia in the same period, while in Trinidad and Tobago unemployment fell from 5.5% to 5.1% (data from national statistical offices in the respective countries).

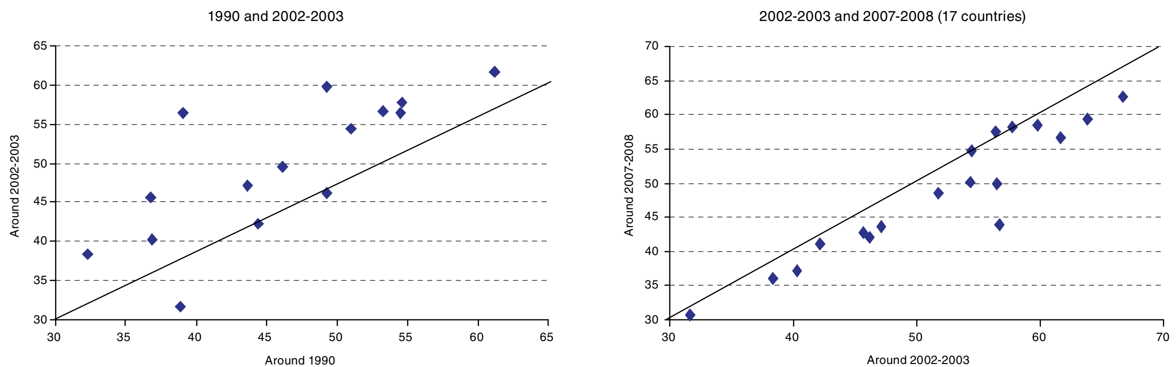
Figure V.1
LATIN AMERICA AND THE CARIBBEAN: LABOUR MARKET PARTICIPATION, EMPLOYMENT AND UNEMPLOYMENT, 1990-2009



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Average.

Figure V.2
LATIN AMERICA: URBAN POPULATION EMPLOYED IN LOW PRODUCTIVITY SECTORS, AROUND 1990, 2002-2003 AND 2007-2008
(Percentages of the urban employed population)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

Real average wages in the formal sector climbed moderately during much of the 1990s, with a weighted average growth rate of 1.3% per year between 1990 and 1997. They contracted by 0.8% a year on average between 1997 and 2003, however, as a result of the series of crises that hit the region starting in the late 1990s. The economic upturn in the period 2003-2008 had only a small impact on real wages (1.5% per year). Consequently, the increase for the period 1990-2008 overall was only 12.2%, or 0.6% per year. Average labour income varied little, with a slight drop in the simple average of the data for urban areas in 16 countries of the region (see table 21.1 of the statistical annex in ECLAC, 2009c), from 4.2 poverty lines around 1990 to 4.1 around 2002 and back to 4.2 around 2007.

In a number of countries, the rise in labour income helped to reduce poverty in the region during the last five-year period, while in others the benefits were due to higher employment levels (Cecchini and Uthoff, 2007). Many of the employed did not earn sufficient income to raise them out of poverty, however. In 2004-2008, 25% of the urban employed (simple average for 17 countries) and as much as 41% of the rural employed (simple average for 16 countries) remained below the poverty line (ECLAC, 2009c), which shows that the labour markets lacked the necessary inclusionary power.[6] These limitations are now compounded by the negative impact of the current crisis on employment.

In light of this evidence, the following sections examine the behaviour of the main labour market variables in terms of distribution.[7]

2. Widening of the skills-wage gap

During the last decade of the twentieth century the wage gap widened in the countries of the region and the highly industrialized countries alike. National and comparative studies[8] both suggest that the income of the most highly skilled rose, broadening the gap between this group and the employed population with lower levels of education. Meanwhile, there was no increase in the gap between the employed with intermediate and lower educational levels, which tends to be attributable to the sharp rise in the labour supply with intermediate levels of education.

The increase in the income gap came as a surprise to analysts who had expected globalization to increase the demand for lower-skilled labour in Latin America and the Caribbean through a more efficient international division of labour and the creation of niches of opportunities, within a market that would assign factors of production globally on the basis of economic reforms (especially in trade, finance and labour). This vision, as discussed in chapter III, overlooked the requirements of production convergence and the strategic importance of incorporating technical progress to raise the economy's productivity. In other words, that vision enshrined a type of development based on low-cost labour which, as argued in this document,

[6] The mass emigration of Latin American and Caribbean labour that has taken place in the last few decades largely reflects families' needs for wages (or remittances from wages) in order to satisfy basic needs.

[7] This does not refer to the functional distribution of income, although this plays a significant role in overall inequality. Harrison (2002) found that, between the 1960s and the 1990s, the labour factor declined as a proportion of primary distribution in poor countries. Rodríguez and Ortega (2001) found that trade liberalization increased the share of capital in GDP, because increased competition had weakened the bargaining power of trade unions. Lindenboim, Graña and Kennedy (2005) analysed the case of Argentina and found a regressive trend for the period 1993-2004.

[8] See national studies in Robbins (1994), Beyer, Rojas and Vergara (1999), Harrison and Hanson (1999), López-Acevedo (2001), Pavcnik and others (2002), Altimir, Beccaria and González Rozada (2002), Arabsheibani, Carneiro and Henley (2003), Feliciano (2001), Gindling and Robbins (2001), Gasparini (2003). See comparative studies in Lora and Olivera (1998), Behrman, Birdsall and Szekely (2000), Taylor and Vos (2001), IDB (2003) and Contreras and Gallegos (2007).

reinforces vicious cycles of underdevelopment instead of activating virtuous cycles that propitiate development. What most surprised the proponents of that model was its failure to create employment and reduce income gaps on the basis of abundant low-skilled labour. On the contrary, however, the 1990s were characterized by high rates of unemployment in many countries of the region, and by a clear widening of gaps in wages and employment conditions. The reforms did not raise employment or income and did not lead to an increase in work for lower-skilled labour, still less convergence in well-being though greater equity in the labour market.

The empirical evidence has demonstrated how wrong the above-mentioned assumptions were. Probably, given the increase in the supply of skilled labour in the past two decades, demand preferences shifted towards a higher level of education. Outcomes were not as expected in international trade either. Contrary to the suppositions of the 1990s reformers, many countries' comparative advantages turned out to be based not on low-skilled labour (owing to their intermediate position in the global economy) but on natural resources (De Ferranti and others, 2002). Thus, trade liberalization did not benefit the least skilled, but instead facilitated capital goods imports and, with them, the use of technological patterns of highly industrialized countries, thereby replicating their skills bias. To this was added competition from countries outside the region with enormous reserves of low-waged unskilled labour (Freeman, 2005a).[9]

It has also been argued that macroeconomic policies, particularly exchange-rate and monetary policies, have sometimes worked unfavourably on relative prices, by raising the cost of labour in relation to capital (Lora and Olivera, 1998; Ramírez and Núñez, 2000). Institutional factors (falls or freezes in minimum wages, the weakening of trade unions) may also play a role (Cortéz, 2001).

As shown in table V.1, in the 1990s, income for the most skilled workers (those with more than 12 years of schooling) rose in comparison with other educational groups. This widening of the wage gap took place for wage workers as well for the employed population overall, and for both men and women.

As shown in table V.1, however, the wage gap has stopped growing and may even have begun to narrow again slightly in the past six years.[10] The relative income of the most highly educated dropped in comparison with the least skilled, although the gap did not return to the proportions of the early 1990s. Although the changes are very small in both phases, the gap between the least skilled and the group with 9 to 12 years of schooling narrowed slightly (from 68.1% to 72.6%) between the early 1990s and 2006-2008 in the case of wage workers, but remained stable for the wider employed population. In light of developments with respect to education, one interpretation for this is that the increase in the supply of labour with intermediate and, in this decade, higher educational credentials has had a hand in reducing this group's relative income.[11]

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[9] Specifically, trade liberalization may have contributed to broadening the wage gap in cases such as Colombia, where tariff reduction was greatest in sectors that made intensive use of labour with a lower level of education; as a result, while protection had enabled a certain level of income distribution towards those workers, liberalization led to sharp wage drops (Goldberg and Pavcnik, 2001). Other research works attribute to trade liberalization a small negative impact on increasing wage gaps (Feliciano, 2001; Acosta and Montes Rojas, 2002; Galiani and Porto, 2006).

[10] It cannot be distinguished on the basis of the data shown in table V.1 whether the gaps changed because of wage improvements for the least skilled or because of wage losses for the most skilled. The evidence presented in ECLAC (2009c) indicates that part of the convergence is attributable to compression of average wages for the most skilled. In 2003-2008, the levelling did reflect wage improvements for the less-skilled sectors.

[11] If medians are used instead of simple averages, the same trends are observed for the employed overall, but the wage gap between the most skilled and the neighbouring group is slightly larger. Monsueto, Machado and Golgher (2006),

Table V.1
LATIN AMERICA: RELATIVE LABOUR INCOME OF URBAN EMPLOYED WORKING BETWEEN 35 AND 45 HOURS PER WEEK, BY LEVEL OF EDUCATION AND SEX [a]
(Simple average for 15 countries, index: 9-12 years of schooling=100)

Period	Years of schooling	Employed			Wage earners		
		Total	Men	Women	Total	Men	Women
Around 1990	Up to 8	70.1	71.5	62.4	68.1	69.4	60.7
	9-12	100.0	100.0	100.0	100.0	100.0	100.0
	Over 8	182.2	193.0	165.6	177.5	190.6	162.6
Around 2000	Up to 8	68.4	68.7	63.0	69.0	69.5	63.2
	9-12	100.0	100.0	100.0	100.0	100.0	100.0
	Over 8	215.5	229.0	206.3	205.7	219.0	196.8
2006-2008	Up to 8	70.0	70.9	63.8	72.6	72.6	68.6
	9-12	100.0	100.0	100.0	100.0	100.0	100.0
	Over 8	197.7	206.2	195.9	193.3	205.0	189.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] In order to control for the double effect of the fact that women work fewer hours, on average (higher hourly income and lower total income under part-time contracts), the calculations were limited to a range of "intermediate" working days excluding outlier values.

3. Distributive aspects of the production structure

Another aspect with a strong bearing on distribution outcomes is employment creation by sector. In the 1990s, the share of low productivity sectors in urban employment rose from 47.2% around 1990 to 50.8% around 2002, before dropping back to 47.4% around 2007.[12] The recent moderate decrease has reflected more buoyant economic growth in the past few years and, although comparable data are not available, the economic downturn in 2009 is likely to have halted this process. As argued in chapter III, it is essential to bolster these processes with production development policies.

The relatively weak creation of productive employment in the 1990s was also manifested in a widening of the income gap between the segments of production. Between the start of the 1990s and around 2002, average wages in micro-enterprises receded with respect to those in small, medium-sized and large firms, from 73% to 62%. The income of own-account workers (not including professionals or technical workers) fell even more steeply, from 99% to 73%, in relation to average wages in small, medium-sized and large firms. By contrast, in the years that followed (up to around 2006), when wage job creation picked up in formal firms, these gaps stopped widening and narrowed slightly, to 66% in the case of micro-enterprises and 75% in the case of own-account workers.[13]

as well as Castro Lugo and Huesca (2007) and Airola and Juhn (2008), have found recent reductions in wage inequality by educational level in Brazil and Mexico.

[12] Simple average for 15 countries calculated on the basis of ECLAC, (2009c) table 18 of the statistical annex.

[13] Based on data from household surveys conducted in the respective countries.

4. Quality considerations

Between 2000 and 2007 the percentage of urban employed with social protection in the form of health care, pensions or both rose from 54.5% to 60.8%.[14] Apart from economic growth and the rise in formal sector employment, this also reflected the lower incidence of informal working arrangements in formal firms during this period of relatively rapid growth.[15] Improvements in inspection and oversight also played an important part in a number of countries.[16]

Employment patterns show clear signs of exposure to the volatility of the economic cycle (see figure V.1). Unemployment rose with each crisis between the mid-1990s and the early 2000s, not dropping fully back to pre-crisis levels before being hit by a fresh crisis. In some countries, labour reforms encouraged the use of fixed-term employment contracts, which led to a "flexibilization at the margin" (Tokman and Martínez, 1999) and made formal employment more unstable. Hence, as discussed in chapter II, the importance of managing macroeconomic instruments to reduce vulnerability to global volatility and its impacts on employment and well-being. This must be complemented by labour legislation that prevents more powerful sectors from using legal flexibility to lower the cost of labour by making employment more precarious during economic crises. A more sustainable and better regulated macroeconomy and labour institutions that prevent employment from being more precarious in times of crisis are two sides of the same coin in relation to decent work.

Firms tend to try to retain more specialized, highly skilled workers, while for less skilled staff they seek more flexible modalities with less protection, opting for fixed-term contracts without indemnity clauses or subcontracting arrangements (Echeverría and others, 2004). More and more new contracts are awarded on a fixed-term basis and new entrants find the labour market complex and unstable, with uncertain prospects for an upward career path (Auer, 2007; Weller, 2006).

5. Labour-market integration of disadvantaged groups

As shown in table V.2, the rate of labour market participation for urban women rose sharply in the 1990s, but only slightly in recent years. Much of this increase has to do with women's higher education credentials, given the high correlation between level of education and rate of female labour market participation. By contrast, labour market participation by less educated women increased only moderately and recently came to a standstill.[17] This indicates the persistence of major obstacles to labour market entry for these women.

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[14] Weighted data (ILO, 2009c, table 8 of the statistical annex). According to the same source, the proportion of employed with health protection increased from 52.1% to 58.4% and the percentage of employed covered by a pension system rose from 50.1% to 52.8%. In some countries, the number of contributors to social security systems surged between 2003 and 2008. For example, in Brazil, Chile, Costa Rica and Panama the number rose by over 30%; in Argentina, Nicaragua and Uruguay, by over 50%. Other countries, such as Guatemala and Mexico, posted smaller growth of between 10% and 20% in this variable.

[15] Between 2005 and 2007, informal wage employment in the formal sector dropped from 36.9% to 31.6%, as an average for five countries (ILO, 2008).

[16] See Simão (2009) in the case of Brazil.

[17] In rural areas, for which less information is available for historical comparisons, between the mid-1990s and the mid-2000s the female participation rate rose from 42% to 46% and the participation gap between women of different educational levels narrowed slightly (simple average for 12 countries) (ECLAC, 2009c).

Table V.2
LATIN AMERICA: INDICATORS OF WOMEN'S LABOUR MARKET INTEGRATION

	Urban participation rate (14 countries)						Urban unemployment rate (14 countries)		Share of employment in low productivity sectors (13 countries)	
	Women (total)	0-3 years of schooling	4-6 years of schooling	7-9 years of schooling	10-12 years of schooling	13 or more years of schooling	Women (total)	Ratio (women/men)	Women	Ratio (women/men)
Around 1990	43	32	40	38	51	66	8.8	122.5	53.5	124.3
Around 2002	51	36	46	46	55	71	12.7	132.1	55.1	115.9
2007-2008	52	35	45	44	55	72	8.4	141.7	52.0	118.4

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

As shown in table V.2, the breakdown by sex shows that access to the labour market and productive employment is still highly unequal (Piras, 2004).These inequalities are partly a reflection of social relations that attribute to women a specific role revolving around reproduction, asset gaps, labour market institutions designed to fit the model of the male breadwinner and mechanisms of discrimination (Giosa and Rodríguez, 2009).[18] The gender gap in working conditions is also worrisome because, by and large, the contingent of women entering the labour market today is forming a pool of labour that is vulnerable to being made to work under conditions that run contrary to both labour legislation and advances in legal standards on gender equality. The asymmetry in working conditions between the sexes represents a dual obstacle to equality of rights.

The female urban unemployment rate has reflected the evolution of the region's economies, rising sharply between 1990 and 2003, then dropping back to the level of the early 1990s. But, as shown in the table, women suffered worse than men from rising unemployment and benefited less from its subsequent fall, with the result that the unemployment gap between women and men widened during both phases.[19]

The integration of women into low productivity sectors of the labour market reflected developments in the region's economy, rising in the early 1990s and later falling. Here, the gender gap narrowed in the first phase, perhaps as a result of pressure on many men who, as principal breadwinners in the household, were obliged to accept any employment they could find, even in low productivity sectors. The economic upturn that followed partially reversed that reduction in the gender gap.

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[18] Atal, Ñopo and Winder (2009) found a gender gap of 10% in hourly wages in Latin America. However, the wage gap is even larger (19.5%) then the observable variables that often impact relative wages, such as level of education, are taken into account.

[19] The crisis of 2009 had a different impact, at least at first, since in most of the countries unemployment rose faster for men than for women (ELAC/ILO, 2009a).

As shown in table V.3, the income gap between men and women decreased in the 1990s (both for wage earners and for the broader employed population), both at the aggregate level and for each of the three educational groups. In contrast, during the 2000s, the gap narrowed very slightly at the aggregate level while widening in several educational groups.

Table V.3
LATIN AMERICA: LABOUR INCOME OF URBAN EMPLOYED WOMEN WORKING BETWEEN 35 AND 45 HOURS PER WEEK, RELATIVE TO MEN, BY LEVEL OF EDUCATION
(Simple average for 15 countries)

Period	Years of schooling	Employed	Wage-earners
Around 1990	Up to 8	66.2	71.9
	9-12	76.5	82.4
	Over 12	64.9	69.7
Total		73.9	81.8
Around 2000	Up to 8	70.6	75.3
	9-12	77.1	82.5
	Over 12	69.7	74.7
Total		78.6	86.1
2006-2008	Up to 8	67.8	76.1
	9-12	74.9	80.0
	Over 12	71.5	74.2
Total		80.2	86.5

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

The studies show that wage discrimination persists against ethnic minorities, although the gap decreased somewhat in the 1990s (ILO, 2007, cited in Atal, Ñopo and Winder, 2009, p. 10). There is also evidence of wage discrimination by social background.[20] Young people also face particular problems of labour market integration, although they form a heterogeneous group whose employment options vary by age, educational level, gender, household characteristics, area of residence and ethnicity (ECLAC/OIJ, 2008). Poor education credentials seriously limit existing and future options of labour market integration for young people, confining them to low productivity, low income and, in general poor employment quality and limited prospects of an upward career path.

The problem of youth unemployment is particularly severe in the English-speaking Caribbean countries. According to available data, while unemployment among the economically active population (EAP) averaged around 11.2% in 2009 in Jamaica, it stood at 39.7% for the 14-19 age group. In Trinidad and Tobago these rates were 5% and 13%, respectively. High youth unemployment is also a factor in pushing young people to emigrate to countries with greater employment opportunities, leading to a flight of the skills needed to increase productivity and diversify the production structure of the Caribbean economies. Youth unemployment also

[20] In the case of Chile, Núñez and Gutiérrez (2004) identify a large wage gap by socio-economic background. In Colombia, Gaviria, Medina and Palau (2007) found that wages were lower for individuals with atypical names, which are associated with low socio-economic strata.

coincides with severe institutional disaffiliation (a high percentage of young people who neither study nor work), and extremely high levels of labour informality among young people. This is a major risk factor for the steep increase in youth crime in the Caribbean.[21]

C. Trends for the future

The previous section discusses some of the differences between the 1990s and the 2000s. In the 1990s the employment structure worsened and new jobs were concentrated in low-productivity sectors, at the same time as unemployment rates rose and some wage gaps widened, especially between those with different levels of education and those working in different segments of production. The gender gaps in labour market participation and wages both narrowed, however. During the phase of relatively high economic growth, the employment creation pattern changed, with more jobs created in medium- and high-productivity sectors, which improved links between employment and social protection. The wage gap between employees with high and low education credentials stopped widening and actually closed slightly. No further reductions were seen in the gender wage gap and women's labour market participation ceased to rise. Despite some progress, many factors still cause highly unequal outcomes in the labour markets.

Likely future developments will be shaped by a range of factors that converge in the labour markets. These are summarized below.

(i) For many countries of the region, population trends are still offering a temporary window of opportunity that the region should seize. The increase in the working-age population relative to the total population can make a contribution to reducing poverty. But in order take advantage of this opportunity countries must generate enough good quality jobs for a working-age population whose numbers will peak in the next few years before starting to decline owing to population ageing. Capitalizing on this "demographic asset" will take active policies on production (see chapter III) and employment, some of which are mentioned in the following section.

(ii) The same may be said of the long-standing uptrend in female labour market participation. This participation shows large gaps by socio-economic level, with rates very low in the lowest income quintiles and higher in the upper income quintiles. These gaps have decreased recently, which has been an additional factor contributing to poverty reduction in some countries. Women who have little formal education and come from low-income households are typically employed in precarious conditions, hence mechanisms are needed to increase both their access to the labour market and the productivity and income generated thereby (Weller, 2009b).

(iii) Another supply-side factor that will have a strong bearing on future trends in labour markets is the expansion of education systems. Although, as will be seen in chapter VI, broad achievement gaps remain by socio-economic background, greater coverage of education and the longer time spent by young people in the system are changing the profile of the labour supply —average credentials are rising steadily. As noted in chapter III, productive convergence policies are crucial if this trend is to make the economies of the region more productive and competitive. This would benefit both

[21] In a number of Caribbean countries, the informal sector absorbs almost half the labour force, with women foremost in this sector of the economy.

productivity and systemic equality. Improving early-childhood education, broadening the cycle of preschool teaching, and increasing secondary completion rates, as well as far-reaching improvement in the quality of education: these all contribute to this process, as proposed in the next chapter.

(iv) On the demand side, there is evidence that the sectoral composition of growth influences the characteristics of employment creation and its contribution to poverty reduction (Gutiérrez and others, 2007). In this respect, the long-term decline (relative or even absolute) in agricultural employment is likely to continue. In view of the average traits of this type of employment, this decline would benefit equality, provided that young people in rural areas receive an education and qualifications that enable them to perform productive work in non-agricultural activities and that the jobs are created to tap the potential for structural transformation.

(v) In the past few decades new employment creation has been centred in the tertiary sector and this is likely to continue. Employment in this sector is very heterogeneous, however, since it encompasses the bulk of informal occupations, especially in commerce and personal services, as well as high-productivity activities with positive quality indicators. The former expand at times of low economic growth, whereas the latter, which are tied to the modernization of the production structure, the expansion of public services and higher investment levels, grow during periods of economic expansion, to which they also contribute.

(vi) Analysis at the global level indicates that in the region as a whole employment in manufacturing is likely to decline as a proportion of total employment. It will, however, continue to play a key role in the region's productivity and competitiveness and, given, the right conditions, will continue to increase in absolute terms. As discussed in chapter III, policies that encourage more intensive innovation and the reduction of internal productivity gaps, will be the greatest contributors to achieving this.

(vii) As also mentioned in chapter III, this should be complemented with much more vigorous public policies and investment to drive productivity gains in SMEs, in order to maintain the capacity to create employment in that sector, while reducing productivity gaps with larger firms. Redoubling efforts in this area is vital in order to reduce structural heterogeneity and, along with it, social inclusion gaps. As long as the bulk of employment is generated by a sector whose productivity falls short of the average in the faster-growing sectors of the economy, productive divergence will systematically reproduce gaps in all areas. This divergence will not be solved overnight. But it will not be solved at all unless much more robust financial and institution-building efforts are made to do so. As discussed in the last chapter, this social covenants will be necessary in order to close productive gaps.

(viii) As regards wages, the great doubling of the world labour force (Freeman, 2005a), as a result of the incorporation into the global market of countries that were part of the former Soviet Union as well as Asian countries such as China and Viet Nam, is exerting strong downward pressure on wages. Mechanisms are needed, therefore, to link productivity to wages in order to ensure that gains in the first are transmitted to the second. This is an aspect of labour institutions that should be examined in the framework of the new realities in global markets. Other similar factors are considered in the following section.

D. Policies for reducing inequality in the labour market

Work is a pillar of life in society. It is the means by which most people generate the income they need to ensure their family's well-being and the space in which they develop must of their capacities, receive recognition, broaden social interaction and exercise their bargaining rights, forge a sense of fair treatment and formalize protection and social stability.

The multiple meanings and benefits of work do not occur automatically, however. On the contrary, they are the result of a long process of productive development, conflict negotiation and collective achievements. This diversity of meanings also comes with a range of channels of social inclusion. As discussed below, these channels are weak in Latin America, but they have a history and deserve a future.

The achievement of quality employment for all, as cited in target 1.B of Millennium Development Goal 1,[22] is closely associated with two other targets: economic development, since only steadily growing economies with rising productivity can generate this sort of jobs in the quantities required; and social inclusion, since it is not possible for the entire labour force to have access to quality jobs unless the prevailing exclusion and segmentation are reduced. To this end, labour institutions must be established to promote these outcomes.

1. Labour institutions in the spotlight

Labour institutions encompass the array of rules that govern the behaviour of actors in the labour market, which include market regulations, laws and negotiated rules. The design of labour institutions varies significantly in the region.[23] Although there is no single best design, the characteristics of the labour market require these institutions to pursue two objectives (ECLAC, 2009f):[24] (i) the efficient functioning of the labour market with full respect for rights,[25] and (ii) the protection of workers as the structurally weaker actors, especially vulnerable groups that face particular problems in entering productive employment.

It is a major challenge to adapt labour institutions to a changing economic and social context to enable them to fulfil their objectives in a sustainable manner. The changes wrought by the adoption of new technologies and the challenges of intrafirm and systemic competitiveness exert pressure towards greater flexibility in production. Here, a dilemma arises with respect to labour market regulation, insofar as making labour markets more flexible enhances their ability to adjust in the short term, but tends to encourage the use of short-term contract modalities and detract from job stability. Yet a degree of employment stability is necessary for developing new knowledge and skills and steering productivity growth. To be efficient, therefore, the labour market needs to be endowed with both short-term adaptability and long-term productivity.

[22] Target 1.B: Achieve full and productive employment and decent work for all, including women and young people.

[23] The origin of labour institutions in the Caribbean countries sets them apart from those in Latin America (Downes, 2006 and 2009).

[24] See Auer (2007) and references therein to authors who argue along these lines. Freeman (2009) emphasizes that OECD has also recently recognized that different schemes of labour institutions can be effective.

[25] Labour market efficiency implies not only the absence of rigidities and distortions, but also the capacity to incorporate more workers and agents' possibilities of absorbing productivity gains.

In the past few decades, many Latin American and Caribbean countries reformed their labour institutions (Weller, 2009a). Some of these reforms were aimed at deregulating and flexibilizing the labour market, but fell short of expectations with regard to employment creation (Stallings and Peres, 2000; IDB, 2003) and came under strong criticism after the political context in which they had originally been adopted changed. At the present juncture, there is increasing skepticism that radical labour market deregulation can have a favourable impact on employment (Freeman, 2005b).

There are opposing positions in the current debate on labour institutions and flexibility (ECLAC, 2009f). In this framework, criteria still need to be aligned to promote more efficient labour market functioning without making employment conditions more precarious. For this reason, it is important not to take formulas out of context, but to identify specific areas in which there may be bottlenecks in the functioning of the labour market.

Here, it is essential to examine the scope of labour flexibility and private contractualism in the sphere of work. Forms of labour organization are undoubtedly dynamic over time. The technological development embedded in production, changes in societal organization and cultural expectations surrounding work alter the ways in which labour is organized and regulated. This disrupts routines, relations on the job, factor mobility and the freedom-security binomial in the working world.

However, if equality of rights and opportunities in society is assumed to be a non-negotiable value, then flexibility cannot, under any circumstances, be allowed to entrench or perpetuate profound asymmetries in bargaining power and contractual situations. When this occurs —where private contractualism is left to the bargaining power of agents in the absence of State mediation— flexibilization in practice becomes synonymous with greater precariousness, with the attendant deterioration in working conditions and broadening of social gaps. In other words, a contradiction of the right-to-decent-work maxim embraced today by the international community.

In this framework, countries are to be commended for not resorting to flexibility-biased labour reform as a response to unemployment in the current crisis. In situations of rising unemployment and informality, employees' ability to negotiate working conditions decreases while the bargaining power of employers increases proportionately. In other words, agreement between private actors, without State or labour regulation, is highly unlikely to yield positive achievements in this sphere in times of crisis, because trade unions lose power and flexibilization broadens profit margins without increasing employment and income security, even in the short term. Hence, private contractualism is not a good solution in emerging countries, because of legitimacy and stability issues associated with agreements. There are well-known cases in which worker vulnerability has increased, with significant well-being losses and broadening of social gaps. Flexibilization is very different in European countries, where social protection systems have wide coverage and tripartite covenants (between the State, the trade unions and employers) are at the heart of negotiations on working conditions, guarantees and the distribution of costs and benefits among the parties.

2. Economic security and labour market inclusion: capacities, representation, income and quality of work

Many factors are involved in the protection of the structurally weaker actors in the labour market. Under a different, but similar, concept of "economic security", ILO (2004a) has identified seven important components:

- Income security, which refers to the level and payment mechanisms of labour income and financial support received in the event of job loss;
- Labour market security, which refers to the level of employment opportunities in the framework of full-employment-oriented policies;
- Employment security, which refers to ongoing, protected and full-time jobs;
- Work security, which refers to the health and safety standards on the job that are necessary to avoid work-related illness and accidents;
- Skills security, which refers to the possibility of acquiring knowledge and skills needed for the job;
- Job security, which refers to the opportunity to build a career;
- Voice representation security, which refers to levels of organization and collective bargaining.

This variety of components indicates that there is no single mechanism through which the fabric of labour institutions can protect against insecurity. The type of protection instruments varies, as do priorities in terms of the type of insecurity countries need to protect against, and they do not all have the same significance as regards workers' economic security and well-being. There is a range of instruments that serve to strengthen different aspects of economic security:

(a) Access to training

The opportunity to train is important for entering first employment and for moving into a different area, especially in dynamic production structures. It is also essential to enable those who are working to progress in their careers and to improve their skills to take on new challenges at work.

The countries of the region have made efforts to broaden the supply of training, making it more demand-orientated and providing a larger range of training instruments and contents.[26] However, training systems have limited coverage, both for first time entrants to the labour market and for economically active persons needing ongoing skills-building or retaining (ECLAC, 2008c, 2009f). Large firms make more use of training incentives than small firms and they generally provide greater benefits to senior and administrative staff than to production workers. Vulnerable groups have only limited access to training programmes.

Training systems are seldom integrated into long-term development strategies oriented towards continual improvement in systemic competitiveness. Thus no synergies are generated between labour market inclusion and productive development, or between productive convergence and social equality. As noted in chapter III, these synergies do not exist in the

[26] SeeVera (2009).

countries of the region. Training is a key instrument for enhancing labour market trajectories throughout working life, but also plays a part in making firms more productive and competitive. Accordingly, as will be discussed in the last chapter, a social covenant is needed to link training with equality of work opportunities, with a view to achieving greater productive convergence in the Latin American and Caribbean economies.

(b) Voice, representation and negotiation

The right to form trade unions and to collective bargaining have been widely recognized in the ratification of the respective ILO conventions. Trade unionization and collective bargaining tend to reduce wage inequality by strengthening the income of less-skilled workers (ECLAC, 2009f). In Latin America and the Caribbean, however, as in other regions, trade unionization is waning because of changes in the productive and organizational structure, as well as the prevalence of anti-union policies and practices.[27]

Recently a number of countries have made efforts to encourage organized labour. It is argued that deficits in labour representation disperse workers and thus weaken them as actors in the labour market, which contributes to creating a culture of confrontation more than regulated negotiation of demands. Providing broader opportunities for collective bargaining is also a necessary condition for adjusting labour regulations to new economic conditions, which should be pursued in a framework of agreement between actors.

This adjustment does not mean side-stepping legal regulations, but orienting those regulations to ensure that workers are represented in order to guarantee proper opportunities for negotiation and establish minimum thresholds of benefits and rights. This is essential where there is extensive informality and production strata in which union organization is extremely difficult, as occurs in many countries of the region.

(c) Minimum wage

This is an important instrument for protecting the most vulnerable workers. After minimum wage policies were subordinated to counter-inflation policies in many countries in the 1980s and 1990s,[28] a number of Governments have recently adopted such policies to boost the purchasing power of low-income households. The minimum wage has the potential to reduce inequality and poverty, by establishing a floor that benefits the lowest-income wage earners, even in the informal sector (ECLAC, 2009f). Even so, wage policy must take into account the relative value of the minimum wage in order to optimize its impact on distribution and poverty (Marinakis, 2008). But the role of the State in wage policy is not limited to setting the minimum wage. As noted in chapters II and III, working conditions and income for the most vulnerable sectors can only be improved in the framework of a macroeconomy and State strategy explicitly oriented towards improving the labour market's capacity to increase very low wages. This means considering the parameters of goods and services production, the prices of basic consumption baskets and the relative costs of labour.

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[27] Vega-Ruiz (2004) offers a review of trade union freedoms and effective recognition of the right to collective bargaining in Latin America.

[28] This was not the case in all the countries, however: for example, in Brazil and Chile, minimum wages rose steadily in real terms in the 1900s.

(d) Quality and formalization of employment

An important aspect of labour market inclusion and quality of employment is the contractual status of workers. Not only the informal working-age population is prejudiced in this regard; so are those who lack formal contractual conditions even though they work for a formal firm. Some countries have recently taken steps to extend formal employment protection to subcontracted workers. Other measures include protection for home-based workers and domestic employees (Tokman, 2008).

In the past few years, many of the region's countries have applied different measures to encourage the formalization of informal firms and specifically of employment relations. These measures have the potential to reduce labour market inequality and to extend the coverage of labour institutions to groups that were previously excluded. However, experience indicates that reducing the labour costs of formality —specifically through lower contributions to social security systems— is not sufficient to compensate for the higher costs that formalization carries in other areas (taxes, licences, other types of contributions). In order for the cost-benefit equation of formalization to favour a significant number of informal enterprises, it is necessary to provide well-defined benefits (for example, access to business development schemes) and limit the costs associated with formalization (Chacaltana, 2009a). Programmes to promote formalization must avoid deepening segmentation by, for example, establishing legal differences in workers' rights by type of firm, but they could create temporary mechanisms to encourage formalization and, thereby, the standardization of basic working conditions (Tokman, 2008).

Lastly, some situations of informality are not due to the firm's inability to comply with rules under existing conditions, but to strategies of cost reduction and profit maximization. A number of countries have built up the capacities of their labour inspection institutions in order to reduce the impact of such strategies. Given that there is a large grey area —especially in micro- and small enterprises— surrounding the causes of non-compliance with existing rules, it would be advisable to adopt a strategy based on supporting future compliance, rather than sanctioning past infractions (Schrank and Piore, 2007).

Although labour formalization has the potential to broaden the contributory base of social protection, given the huge coverage gap that exists in most of the countries of the region, it is still essential to strengthen non-contributory systems based on solidary transfers (ECLAC, 2006a) (see chapter VI). In the longer term, it might also be possible to consider shifting part of the costs of social protection schemes from the contributory system to general taxes, in order to limit the disincentive to formal contracting implicit in non-wage labour costs.

(e) Labour market inclusion of specific groups

Certain groups require special measures to promote their integration into productive employment. Programmes that stimulate the integration of groups that face special problems in accessing the labour market and productive jobs not only improve income and employment prospects for the direct beneficiaries, but also contribute to enhanced production. In other words, they are not only instruments of social development, but also constitute mechanisms for boosting productive development.

With regard to women, policies to reconcile work and family life are essential to reduce the gaps in labour market access and in employment conditions (ILO/UNDP, 2009). Specifically, the availability of care services for small children increases women's labour market participation and income.[29] There is a need for care services (from the community, the market, the solidary sector or the State), which would serve the dual purpose of broadening children's socialization and providing mothers with more time to devote to work.

Other measures include specific agreements on working hours, flexitime and distance working, emergency leave, the encouragement and facilitation of a larger role for men in caregiving and the inclusion of the issue in collective bargaining processes with a view to finding suitable solutions for particular sectors or firms (Giosa and Rodríguez, 2009). With respect to women already in the labour market, headway must be made with measures to prevent sexual discrimination. Effective legislation is essential to put an end to discriminatory practices: although it cannot replace the cultural change needed with respect to the sexual division of labour and coresponsibility for care work, it can contribute to bringing about the change.

Another group facing clear problems regarding labour market integration is youth, whose unemployment levels are twice and even three times as high as the jobless rates of their elders (with major variations by socio-economic level, educational credentials and gender). In order to facilitate access for young people to good quality jobs, it is necessary to improve the education system and strengthen training and labour intermediation. With respect to the first, young dropouts from the education system must be given options for resuming their studies. As far as possible, this should include modalities that enable them to combine work and study, or subsidies for remaining in or returning to full-time education. With regard to the second, there is a need for training and intermediation instruments, skills certification, hiring subsidies, first-job incentives and support for enterprise, all of which are in their infancy in the region (Chacaltana, 2009b).

In sum, there is no single route to improving labour market integration and combating labour market inequality. This section has put forward a number of areas to which the countries of the region should turn their attention. First, professional training and coaching instruments need to be enhanced on the basis of improved education for all, and adapted to the needs of different groups of workers. Second, it is essential to strengthen collective bargaining, not only in order to improve income distribution but also, as will be discussed later, as a mechanism for building sustainable socio-labour covenants with broad benefits. Third, efforts should be made to unlock the significant distributive potential of the minimum wage, taking into account the specific characteristics of the wage structure in each country. Fourth, formal sector labour relations which, for no legitimate reason, fail to recognize general labour rights must be properly institutionalized as a matter of priority. Fifth, steps must be taken to lessen the vulnerability of workers in the informal sector, by means of productive development instruments and non-contributory social protection mechanisms. Sixth, instruments designed to help groups that face obstacles in securing good-quality jobs should be strengthened. Seventh, as noted in chapter II, the macroeconomic environment must be designed to shield against perverse relationships between external volatility and the quantity and quality of employment.

[29] On average for five countries of the region, the participation rate of women without children under age six in the household is 53.5%, while the rate for women with three or more children under age six in the household is 43.8% (calculation by ECLAC, on the basis of household surveys conducted in the respective countries, in the framework of the joint project conducted by ECLAC and the Swedish International Development Cooperation Agency (SIDA), entitled "Enhancing Economic and Social Conditions and Opportunities of Vulnerable Groups in Latin America".

3. The challenges of labour institutions: reconciling market efficiency and protection of workers

Labour institutions are called upon to contribute to long-term development strategies in which innovation and the accumulation of knowledge and skills are fundamental. As part of this, the coverage, quality and progression rates of education systems must be improved, as discussed in chapter VI. But two components of labour institutions also contribute: training (as noted earlier in this chapter) and labour relations.

The impact of satisfactory labour relations on worker performance has been established both empirically and theoretically. Decent treatment, material and non-material recognition of effort, options for personal development for building an upward career path and the possibility of being heard individually and as part of a collectivity ("representation security"): these are all factors that not only dignify work and the person performing it, but also promote learning and innovation in work routines, which feeds into productivity.

Ease of firing, which is an explicit element of labour flexibility, especially in cost-cutting schemes, is much debated in this context. The negative impacts of firing costs on the possibilities of hiring new workers during expansionary phases of the business cycle are often cited, as is the incentive to reduce the ratio of employment to capital. It is also argued that certain levels of turnover can increase productivity by facilitating the generation and dissemination of know-how, the migration of workers away from low-productivity sectors, and hiring in emerging sectors where productivity is rising.

Be this as it may, however, an institutional setting which encourages high turnover tends to prevent productivity gains, which are favoured by greater stability.[30] This is partly because of the specific know-how and skills a worker gains on the job.[31] High employee turnover also discourages firms from investing in the overall knowledge base and skills of their workers, given the risk that they may not see the returns on that investment (Chacaltana and García, 2001). Eliminating or substantially reducing the cost of firing can therefore have a negative impact on economic efficiency.

It will be recalled, however, that job security is only one component of economic security for workers and it is not necessarily obvious which elements should be treated as a priority. A variety of protection mechanisms correspond to the range of components of economic security. ILO (2004b) used a simplified matrix of two (in)securities to prepare a typology of OECD countries by levels of social and labour protection (proxied by the stringency of active and passive labour market policies protecting income in the event of job loss and facilitating rapid reintegration into the labour market) and employment protection (proxied by the strictness of labour legislation on dismissal) and analysed the relation between the two types of protection and the perception of economic (in)security in the population. Tokman (2008) replicated this exercise for the Latin American countries and, as shown in table V.4, four groups of countries were identified. As in the OECD countries, the perception of security is greater in countries that have higher levels of social and labour protection and, within this group, countries with lower employment protection.

[30] Auer, Berg and Coulibaly (2005) emphasize that employment stability is positively, but not linearly, correlated with productivity.

[31] Hence the loss of income associated with a period of unemployment, even when the worker finds a new job in the same branch of economic activity.

Table V.4
LATIN AMERICA: COMBINATIONS OF LABOUR AND SOCIAL PROTECTION

		Social protection	
		High	Low
Employment protection	High	Stringent labour legislation: second highest Spending on social protection: second highest Perception of security: second highest	Stringent labour legislation: highest Spending on social protection: second lowest Perception of security: lowest
		Bolivarian Republic of Venezuela and Brazil	Colombia, Ecuador, Mexico, Panama, Paraguay and Peru
	Low	Stringent labour legislation: lowest Spending on social protection: highest Perception of security: highest	Stringent labour legislation: second lowest Spending on social protection: lowest Perception of security: second lowest
		Argentina, Chile, Costa Rica and Uruguay	Dominican Republic, El Salvador, Guatemala, Honduras, Nicaragua and Plurinational State of Bolivia

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Víctor Tokman, "Flexiguridad con informalidad: opciones y restricciones", *Macroeconomía del desarrollo series*, No. 70 (LC/L.2973-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2008. United Nations publication, Sales No. S.08.II.G.83.

Differences in the perception of security, in both OECD and Latin American countries, indicate greater sensitivity to income security than to employment protection, which may be explained by the fact that for most workers job loss is associated with income loss and a substantial decline in family well-being, even when new employment is found quickly (Farber, 2001; Bucheli and Furtado, 2002; Herrera and Hidalgo, 2003). The risk of this occurring may be even greater in the Latin American and Caribbean countries since, as unemployment protection systems are weak, the only alternative following the loss of a formal job may to accept poorer-quality employment in the informal sector.[32] Hence the importance (since there is no such thing as absolute employment security) of income security. It may be added that excessive employment security could discourage reasonable levels of risk-taking, which would hinder individual and societal development prospects (ILO, 2004a, p. 15-17).

Linked to the importance of income security is another fundamental issue in the debate on labour institutions: compensation, the instrument traditionally used in the region in the case of dismissal without just cause. This instrument has been criticized for the rigidity it introduces into contractual relations, insider-outsider segmentation of the workforce, and limited coverage. It has also been slated as an inefficient mechanism of protection, given the high percentage of workers fired without receiving due payment (for example, in the event of bankruptcy) or receiving only partial payments in the framework of out-of-court settlements (Velásquez, 2009).

In order to tackle these weaknesses, several countries have created and developed unemployment insurance systems. At this time, Argentina, Barbados, the Bolivarian Republic of Venezuela, Brazil, Chile, Ecuador and Uruguay all have some sort of unemployment insurance scheme. Other countries have introduced systems of individual accounts to which workers have access in the event of dismissal. These systems have flaws too, especially in terms of coverage, and must be carefully designed in order to function as attractive protection instruments without creating disproportionate costs.[33]

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[32] Unemployment protection schemes, which will be discussed later in this section, play a major role in this context.

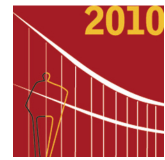
[33] Berg and Salerno (2008) note that many countries that have broad unemployment insurance today began to introduce those schemes when their per capita income was similar to or even lower than the current levels of many Latin American and Caribbean countries.

It has been argued that indemnity payments should be eliminated once unemployment insurance has been introduced. But this is a false dilemma, because the two instruments are not perfect substitutes for each other, particularly inasmuch as indemnity payments constitute a disincentive for dismissal (Blanchard, 2003). Since compensation is not payable in the case of dismissal where due cause exists, the key issue is the definition of just cause and the size of the indemnity payment. With respect to the first point, the question is whether, and in what circumstances, a firm's difficult financial situation may be considered just cause. This question certainly requires rethinking in a context of open and competitive markets. On the second point, it has been proposed that indemnity payments be reduced and contributions to unemployment insurance raised, in order to guarantee payment in case of dismissal and reduce the cost of laying off workers without eliminating altogether the disincentive for dismissal (Goldin, 2009).

In times of economic crisis, there is justification for considering alternatives for protecting workers in precarious employment against job loss. Since, by definition, such a scheme would be funded from general revenues, it could be argued that insurance for formal workers should be funded from general revenues as well, rather than from payroll contributions, as an incentive for formalization. Even if both programmes (for formal and non-formal workers) were financed from general revenues, however, it is important to differentiate the two because the means of verifying unemployed status is different in each case, and the scheme for informal sector workers would be different too. These workers could be asked to perform some kind of counterpart task, along the lines of training or participation in community work, which would vouch for their unemployed status.

Lastly, as will be discussed in chapter VII, social dialogue among actors in the labour market is essential, both as regards worker protection and in the interests of productivity, taking into account the specific context in each country. Building and promoting this sort of dialogue is not easy and requires the social actors to acknowledge each other mutually as representing legitimate, albeit divergent, positions. It also requires the gradual building of trust as a basis for crafting sustainable agreements and for complying with international commitments regarding trade union freedoms and collective bargaining. Among other advantages, social dialogue optimizes the search for mechanisms for increasing labour market efficiency without reducing protection, while generating benefits for workers.

In sum, labour institutions need to be rethought in the framework of a long-term development strategy. This chapter has set forth the guiding principles for improving the apparatus of labour institutions, namely: (i) labour relations that build trust between social actors and lead to productivity gains; (ii) national training systems that respond to the needs of businesses and workers; (iii) equilibria between employment stability and mobility that impact positively on both labour security and productivity; (iv) the development of unemployment protection systems for more volatile labour markets, which can also contribute to more efficient job-seeking, especially if public employment services integrate these passive policies with active labour market policies; (v) identification by the stakeholders of bottlenecks that detract from labour market functioning and outcomes and whose negotiated removal can generate benefits for employers and workers, and (vi) the pursuit of social and labour dialogue as a mechanism for forging agreements that enjoy broad legitimacy. For all these reasons, both the State and the social actors in the production sector have a key role to play in the development of labour institutions.



Chapter VI

Closing social gaps

A. Understanding and combating inequality

The acute inequality that has long marked Latin America and the Caribbean has its roots in the colonial era, when broad swathes of the population were denied rights because of their race or social class and subjected to slavery, serfdom and expropriation of resources. Under later republican regimes, privileges continued to be reproduced in other ways, and asymmetries in rights and living conditions were maintained. Lastly, the pattern of development and modernization served to perpetuate socio-economic divides based on race, ethnic origin, gender and social class. The productive structure and the education system helped to ingrain and reproduce inequality and, to a great extent, continue to do so today.

Successive bouts of social struggle have succeeded in extending rights to traditionally excluded sectors. Yet Latin America and the Caribbean remains the most unequal region in the world in terms of income distribution. The preceding chapters have examined some of the structural factors underlying that inequality. The reforms of the 1980s and the impact of the debt crisis actually widened income gaps, and it was only in the past decade that this trend was reversed, thanks to more inclusive labour market dynamics and the State's assumption of a more active role in income transfer.

The distributional disparity in Latin American countries can be appreciated by comparing income levels between the richest decile and the four poorest deciles, and between the fifth quintile (the 20% of households at the top of the distribution scale) and the first quintile. Taking the first of these indices, the average per capita income of households in the tenth decile is around 17 times that of the poorest 40% of households. This ratio varies greatly from one country to the next, ranging from nine times in the Bolivarian Republic of Venezuela and in Uruguay to 25 times in Colombia (2005 data). The per capita income of the richest quintile is on average 19 times that of the poorest quintile, ranging from a factor of less than 10 (in the same two countries mentioned above) to 33 in Honduras.

The consequences of these levels of inequality on well-being have been amply documented, and they continue to prevent the fruits of growth from being transferred to the poorest sectors.

Between 1990 and 2002, income distribution remained very rigid in the region after rising in the 1980s. The period 2003-2008, by contrast, was characterized not only by sustained economic growth but also by a slight but clear trend towards a lesser concentration of income. The Gini index fell by 5% from its 2002 level for the region as a whole, driven in particular by reductions in Argentina (metropolitan areas),the Bolivarian Republic of Venezuela, Panama (urban areas) and the Plurinational State of Bolivia (urban areas), all of which recorded declines exceeding 10%. Brazil, Chile, Ecuador (urban areas), Nicaragua and Paraguay (metropolitan areas) also saw significant reductions of 7% or more in this indicator.

Figure VI.1
LATIN AMERICA (16 COUNTRIES): GINI INDEX, 1990-2008[a]

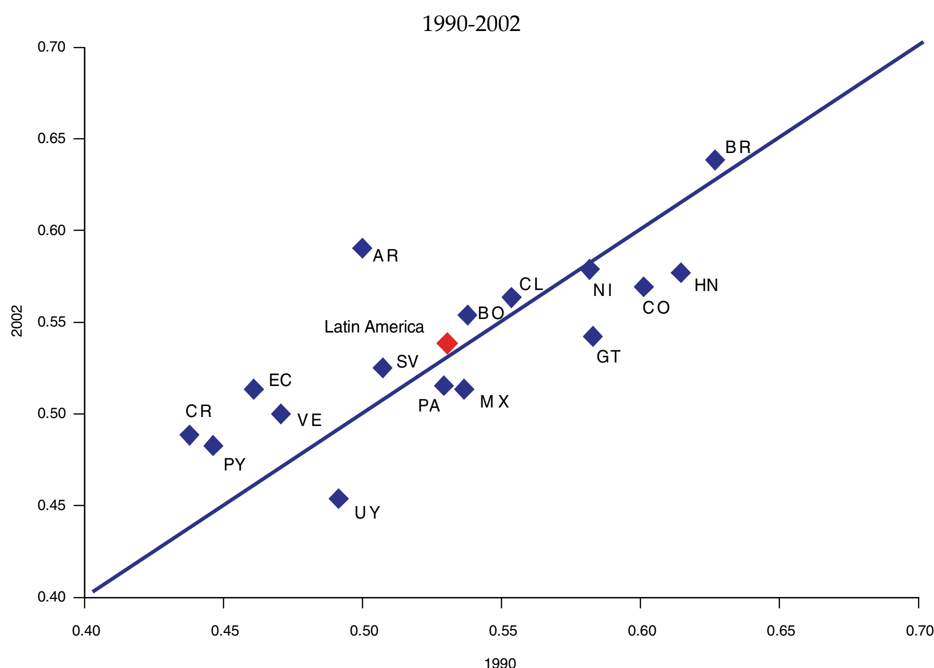
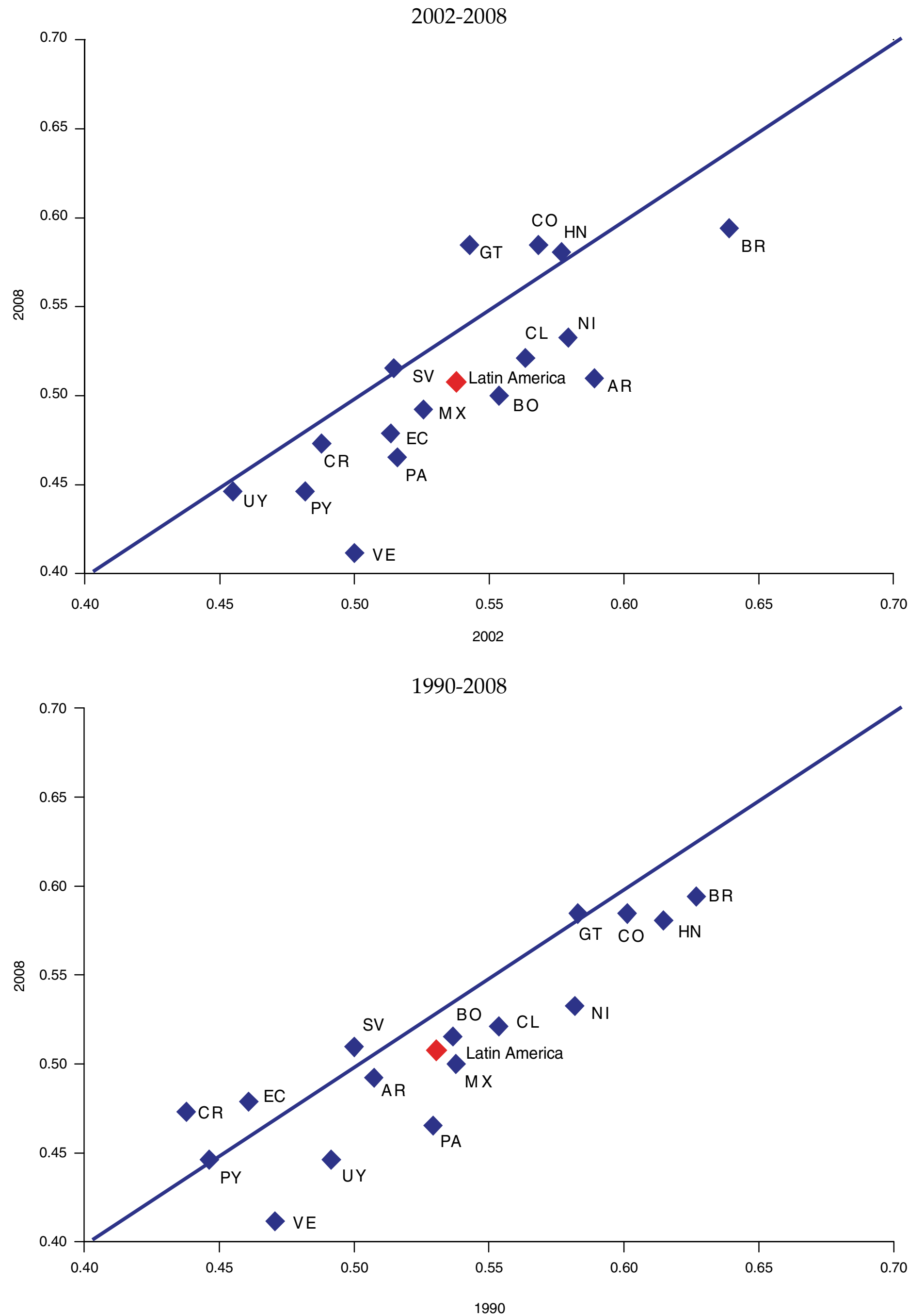


Figure VI.1 (concluded)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

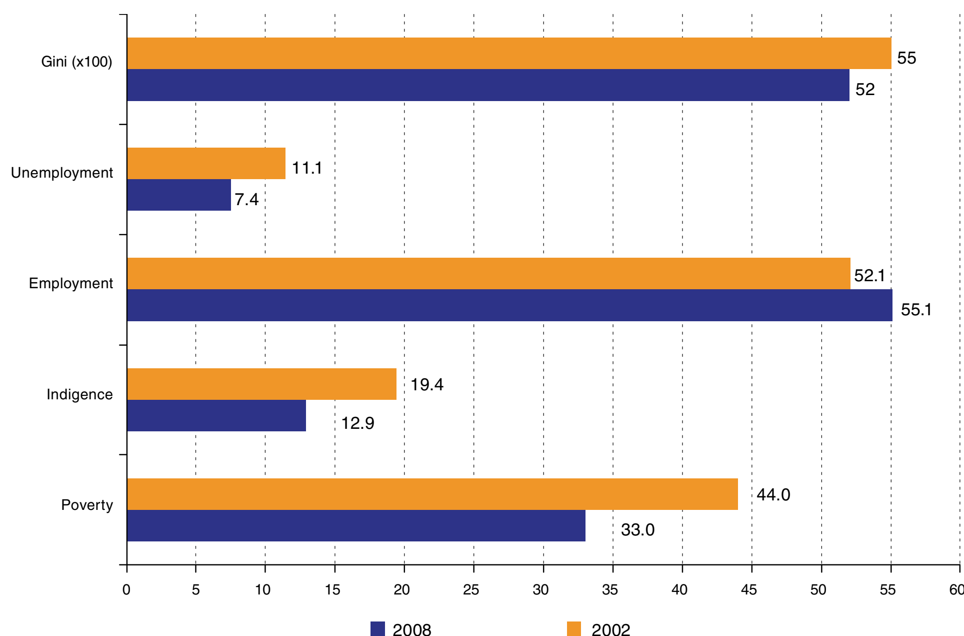
[a] The figure for Latin America corresponds to a simple average of the Gini indices for each country. The survey year used differs from country to country. The period 1990 refers to the available survey nearest to that year; the period 2002, to the most recently available survey between 2000 and 2002; and the period 2008, to available surveys between 2004 and 2008. Data correspond to metropolitan areas for Argentina and Paraguay and to urban areas for Ecuador, Panama, the Plurinational State of Bolivia and Uruguay.

The positive trend in income distribution in Latin America during the six years from 2003 to 2008 was linked primarily to the labour market dynamics discussed in chapter V and, to a lesser extent, to demographic variables (lower dependency rates) and transfers to households. Employment grew faster than the labour supply, and all income groups benefited from the rising employment rate; consequently, this factor did little to reduce the gaps between quintiles. The increase in the proportion of formal, high-quality and full-time jobs, and rising hourly wages, were of proportionately greater benefit to the members of lower-income households, resulting in a narrowing of the gap in average incomes per worker. More active policies for raising minimum wages probably favoured this outcome. Another positive factor was the narrowing of the inter-quintile gap in household transfers. In fact, changes in this income source accounted for roughly one fifth of the reduction in the per capita income gap across the region.

Figure VI.2

LATIN AMERICA AND THE CARIBBEAN: POVERTY, INDIGENCE, EMPLOYMENT, UNEMPLOYMENT AND THE GINI COEFFICIENT, AROUND 2002-2008 [a]

(Gini x 100 and percentages)



Source: Economic Commission for Latin America and the Caribbean/International Labour Organization (ECLAC/ILO), "Crisis and the labour market", *ECLAC/ILO Bulletin The employment situation in Latin America and the Caribbean*, No. 1, Santiago, Chile, June 2009.

[a] The period 2002 refers to the available survey closest to that year and the period 2008, to available surveys between 2007 and 2008. Unemployment and employment data relate to the urban rate for Latin America and the Caribbean.

Although the distributional improvements in the early part of the last decade were encouraging, the evidence points to four key aspects that will constrain future progress towards equality: income distribution, the distribution of education and knowledge, the highly unequal capacity to take advantage of that education and knowledge in the labour market, and the intergenerational transmission of inequality.

Two further factors are widening the gaps on the map of inequality. On the one hand, access to health care and systems of insurance against risk and vulnerability remains deeply segmented, including highly unequal access to health and social security benefits. On the other hand, the fastest growth in social expenditure has been on those instruments that do the least for redistribution, such as social security. Accordingly, the structure of the social safety net needs to be adjusted to move towards greater equality.

As discussed below, the past decade has seen public policies adopt a more active approach to modifying that structure, and some countries are increasing non-contributory income transfers and expanding health-care entitlements. Yet, as noted in the previous chapters, progress in these directions is hostage to regressive tendencies because of economic volatility, inequality in the productive structure, the territorial system and aspects of employment. The clouds now hanging over the region include slowing or stalling regional growth rates (the new scene described in chapter I), the end of the period of reaping the benefits of the demographic dividend (during which there are more people of working age in proportion to the numbers of children and older persons), and low fiscal capacity. For all these reasons, efforts must now be made to strengthen and deepen the mechanisms that have helped to improve distribution and reduce poverty in the recent past.

If the challenge of equality is to be properly addressed, the region must move beyond the "minimalist" view of the welfare State and of social policy that prevailed during the 1990s and move towards the construction of a universal basic social safety net that will become a structural rather than a residual feature of the development model.

B. New approaches to social policy in Latin America and the Caribbean [1]

1. Reforming the reforms of the 1980s

The debt crisis of the early 1980s imposed stiff constraints on public spending in the region. In order to cover fiscal deficits, governments adopted a policy of cutting public expenditure as the preferred adjustment variable for restoring health to the public finances. This implied cutting social expenditure, in particular, at a time when levels of well-being were deteriorating. The State scaled back its role in social, regulatory and enterprise areas. Portions of the welfare system were privatized, public social spending was reduced, and decentralization was promoted. Many social security and health-care were transformed from centralized pay-as-you-go systems in which risk and income were redistributed, to systems that matched benefits as closely as possible to people's capacities in the market, and encouraged individual insurance and self-provided access. The State would step in only with targeted policies designed to help those who were demonstrably unable to deal with basic risks.

On the employment front, social policy under this model generally involved moves to deregulate contractual arrangements and increase flexibility. This tended to lower wage costs and make employment conditions more precarious, which, against a backdrop of high unemployment,

[1] There is much literature on reform alternatives and the thrust of social policy over the last 30 years in Latin America. See Andrenacci and Repetto, (2008), ECLAC (2006a, 2006b, 2007c, 2008a, 2009c), Draibe and Riesco, (2009), Huber (2006), Filgueira (1998, 2007a), Filgueira and others (2006), Mesa Lago (1994, 2008, 2009).

led to an increase in own-account work and informal employment. The coverage of work-related risks was meanwhile recommodified in the framework of privately-managed and publicly-regulated quasi-markets for health care and social security. In the area of social services, education and public health systems were decentralized —which led to funding problems at the subnational level— and, along with basic social infrastructure, partially privatized. Social welfare efforts focused on developing poverty reduction policies, and targeted social programmes expanded and multiplied.

The trend in social protection programmes in the English- and Dutch-speaking Caribbean has been very different from that in Latin America and in the former Spanish and French colonies of the region. Since their independence, the English-speaking Caribbean countries have guaranteed free access to social and health-care services. Another positive factor here has been the non-reciprocal preferential trade agreements such as those signed with the European Union and the African, Caribbean and Pacific (ACP) countries (Lomé Convention 1975-2000) and the Cotonou Agreement (2000-2020) and the Caribbean Basin Initiative, which include provisions for cooperation in social and cultural development. Under the pressure of the structural adjustment programmes of the early 1990s, the provision of services between Governments was cut back, with tangible and visible consequences throughout the region. Nevertheless, the periods of economic growth and the beneficial effect of bilateral and multilateral development assistance in the 1990s and the early years of the new century raised national incomes and more funds were earmarked for mitigating social exclusion and poverty. To address both problems comprehensively, around this time many countries in the subregion created ministries for social development and established offices and commissions to eradicate poverty, with participation by civil society.

In the early 1990s Latin American Governments and the international system came to a new appreciation of the role of social spending in channelling resources to the poorest and most vulnerable sectors, and they recognized the key role of social development in boosting productive development and economic growth. Since that time there has been a clear upward trend in government social spending, in both absolute and relative terms. Yet the higher macroeconomic and fiscal priority attached to social spending since the early 1990s was not accompanied until the end of the decade by any rethinking of the market-centred bias and residualist approach that typified the wave of reforms in the 1980s. It was only at the dawn of the new century that the social role of the State came to be seen in a new light, shifting from a focus on poverty (and the segmentation of services according to ability to pay) towards a more integrated vision. This reflected a greater commitment to social policies on the part of Latin American and Caribbean Governments and societies. Those policies have been acquiring greater guarantees of financing and enhanced institutional stability and legitimacy, although such improvements have been tempered by countries' varying degrees of development and fiscal capacity.

The public resources available for financing social protection systems and promoting capacity-building and opportunities have, in fact, been severely constrained by persistently low tax burdens, revenue collection problems, and growth volatility. Nonetheless, Governments have made major efforts to increase public spending, albeit in a framework of tighter fiscal discipline, especially on budget items associated with social development.

In the current decade, the thrust of government policies reveals a greater public commitment to protecting against events that involve loss of household income and combating income poverty and exclusion. That thrust also reflects the notion of equal rights and not only of equal opportunities. For it is by virtue of rights, given their universality, that societies can move

from a targeted approach to a more universalist one, and from models focused on individual capitalization to systems that explicitly include mechanisms of solidarity for those who cannot finance their own well-being. These new outlooks, then, seek to combine the fight against poverty with the fight against inequality and the promotion of social cohesion. They strive to achieve this through an array of social programmes designed to articulate the achievements of traditional social security with the provision of social services, and the range of welfare programmes. In this sense, the "solidarity" —redistributive or non-contributory— pillar has now gained recognition in debates and on the public agenda as a key feature of social protection systems.

Box VI.1

SOCIAL PROTECTION: BEYOND THE CONTRIBUTORY RATIONALE

One of the key challenges facing countries of the region is to generate positive synergies between economic growth and social equity. This challenge arises in the context of the modernization of the productive apparatus , which is aimed at enhancing human capital formation, productive employment and citizen participation. In this framework, social policy is particularly important, but at the same time it must be truly universal and make efficient use of resources.

To this end, social protection requires a shift of focus in light of the new global order and its impact on societies, as ECLAC argued in "Shaping the Future of Social Protection: Access, Financing and Solidarity", which was prepared for the thirty-second session of the Commission, held in Montevideo in 2006. That document started from the assumption that the main reason for rethinking social policies and social protection is that the labour market had not been able to promote inclusiveness either by creating decent job opportunities or by increasing social security contributions. The region's labour markets have not succeeded in transforming themselves into a universal and dynamic gateway to social protection systems. Consequently, they cannot serve as the sole means, either in the short term or the medium term, for protecting the bulk of the population against the risks associated with loss of income, health problems or ageing.

At the thirty-second session, ECLAC argued that social protection could no longer be confined to contributory mechanisms mediated by the labour market. The great challenge here is to rethink the solidary dimension of social protection in a more integrated way —i.e., both within and beyond the world of work— in order to develop systems that combine contributory and non-contributory mechanisms. Hence the importance of promoting non-contributory social protection mechanisms, which today are generally limited by fiscal constraints, meaning that in practice broad sectors of the population are excluded from formal protection systems. In addition to seeking ways to improve the capacity of domestic economies to generate decent jobs and extend the tax base, countries will have to guarantee adequate and stable financing to supplement employment-based protection with non-contributory protection mechanisms.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Shaping the Future of Social Protection: Access, Financing and Solidarity* (LC/G.2294(SES.31/3)), Santiago, Chile, March 2006.

Following five years of progress in reducing poverty, unemployment and income inequality, the repercussions of the recent global crisis have brought back into focus the role of the State as a regulating and, eventually, intervening agent to protect against failures of the market and its various asymmetries. Some of the risks that people face and that are taken into account in this new perspective are the absence or loss of employment —particularly among groups such as young people, women, ethnic minorities and unskilled workers— and the loss of income which follows job loss by a head of household. There are also risks connected with certain stages in the

life cycle, such as ageing and maternity, the negative impact of school dropout rates on human capital, poor nutrition or the lack of health care, as well as with the effects of natural disasters.

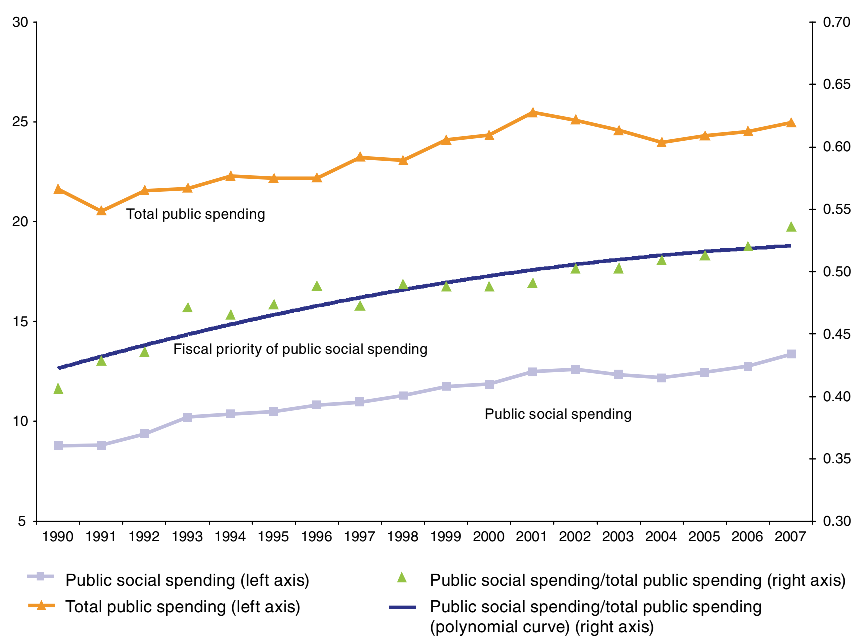
In a way, the more structural principles that characterized post-war welfare States are gaining ground against more individualistic and market-based approaches, and also against targeting as a principle of social assistance. This is occurring alongside practical and theoretical innovations in which the ideas of social capital, cohesion and risk insurance are re-entering the debate and the design of public policies. These principles also show a renewed concern over inequality and recognize the limited ability of family-centred and market-based approaches to address this problem. The State is thus taking on a larger strategic role in the search for solutions to inequality and well-being issues.

This change is reflected in the greater importance now attached to social issues. While the most significant shift in policy orientation occurred only at the end of the 1990s, social spending had in fact been rising since the beginning of that decade. Between 1990 and 2008 it increased by more than five percentage points of GDP, and its share in total public spending rose sharply (see figure VI.3). In absolute terms, government social spending per capita almost doubled from 1990/1991 to 2006/2007, to US$ 820 (at 2000 prices), and it was up by 18% from 2004/2005. There have of course been enormous disparities between countries, with the highest per capita figure as much as 20 times the lowest. Yet despite these differences, as a general trend, social spending has risen as a proportion of GDP in the region during the past two decades.

Figure VI.3

LATIN AMERICA (18 COUNTRIES): TRENDS IN SOCIAL PUBLIC SPENDING AND TOTAL PUBLIC SPENDING [a]

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of information from the Commission's social expenditure database.

[a] Simple averages.

The largest social spending increases have taken place in social security and welfare, followed by education. Generally speaking, the available information indicates that the education, health and social welfare functions generate progressive distribution patterns. This is true in particular of targeted social welfare, primary education and primary health care. While secondary education and hospital care have produced improvements in the distribution of primary income, the system remains regressive.

Social spending in the region has typically been highly procyclical (ECLAC, 2007c, 2008a, 2009c),[2] which explains the excessive impact of successive crises and economic slowdowns on poverty and vulnerability: when social problems worsen, the public funds available to address them diminish. It was not until the 2000s that some countries began to apply countercyclical criteria to social spending, on the understanding that this is essential to protect the positive dynamics of employment and household incomes in order to reduce gaps and consolidate well-being. Moreover, the current financial crisis and its transmission to the real economy have led Governments in the region to redouble and diversify their countercyclical social spending. There is now a greater awareness that social spending is, in effect, social investment (see box VI.2).

Box VI.2

SOCIAL SPENDING AND SOCIAL INVESTMENT

Social policy outlays represent not just spending but investment, the impact of which can be analysed from three different but complementary angles:

(i) The social impact represents the change in social indicators that justify actions in each function (health care, education, and so forth); it is measured as the change in the target population group from the ex ante situation (before the investment was made) to the ex post situation (the outcome of the investment).

(ii) The economic benefit derived from the social impacts generated by the goods and services transferred to households is quantified by the increase in their assets and their resulting productive potential.

(iii) The redistributive impact, understood as the economic value of the transferred goods and services, is measured as the impact of that value on total household income. This serves to identify the degree of resource transfer among households and measure how progressive or regressive the expenditure is.

These impacts need to be examined comprehensively in the region. The amounts invested by Governments are known with some certainty, but evaluations of the impact of social programmes and policies are still rudimentary and unsystematic.

Source: Rodrigo Martínez and María Paz Collinao, “Gasto social: modelo de medición y análisis para América Latina y el Caribe”, *Manuales series*, No. 65 (LC/L.3170-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2009. United Nations publication, Sales No. S.09.II.G.145.

[2] In a recent study Bello and Ruiz del Castillo (2009) confirm the procyclical nature of social spending in the region, with the education and health-care components being the most strongly procyclical. For other research on the determinants and nature of social spending, see Segura-Ubiergo (2007) and Avelino, Brown and Hunter (2005).

This new countercyclical tilt to social spending is a positive development. By contrast, there is a another, longer-running tendency in social spending that needs to be addressed, namely its small redistributive impact. Two years ago ECLAC (2007c) estimated that social spending represented barely 19.4% of household primary incomes, and not all allowances were targeted at the lowest-income population groups. Household survey data reveal the two sides of the coin. On the one hand, people in the first quintile of primary income double their total income through public transfers and services, while the highest-income groups see their total incomes increase by only 9%. On the other hand, the economic value of the funds transferred to the first quintile represents only two thirds of those received by the highest-income families. A key element in explaining the situation is the weight exerted by social security, which is highly concentrated in the fifth quintile.

In light of the foregoing, available country information points to the fundamental importance of social investment in low-income groups, with long-term policies that will counter the swings of the economic cycle and offer explicit guarantees and assured quality levels. Social protection and promotion systems thus emerge as a very useful and comprehensive alternative, although substantial progress is needed in terms of financial security and institutional stability, which again raises the issue of a social covenant that would lend them sustainability.

While there is bad news —social spending in the region has only a marginal redistributive effect— there is also good news: the crisis is leading Governments to place greater priority on social policy. This change of direction reflects the hard lessons learned from previous crises (in particular, but not exclusively, the crisis of the 1980s), which showed how long the social costs of such events can last. It is important, then, to view the crisis as an opportunity to chart a new course, to consolidate the countercyclical slant of social spending, and to maintain the social protection programmes that have emerged in the past decade as they relate to employment policies and social protection for vulnerable sectors.

Such programmes can also make it possible to proceed further with the changes that have been made in the design of social policies over the past decade. Those changes have focused on innovation in five areas of action, although with shadings and variations between countries. These areas make up the platform of what is known as the "reform of the reforms" and are summarized below.

(a) Direct income transfers to the poorest sectors, financed from general revenues

Direct income transfers to the poorest sectors today generally take the form of conditional or “co-responsibility” cash transfer programmes. These are currently one of the key tools in Governments’ strategies and policies for combating poverty. They are non-contributory programmes, designed on the one hand to raise family consumption levels through monetary transfers and thereby reduce poverty over the short term, and on the other hand, to put family members in a better position to break the intergenerational transmission of poverty. Conditional transfer programmes have been spreading rapidly since the mid-1990s, when Mexico launched an education, health and nutrition programme initially known as PROGRESA (now *Oportunidades*) and Brazil[3] began to institute programmes covering the same population group (families with school-age children) and imposing conditions for the delivery of benefits (later consolidated into the *Bolsa Família* programme).

[3] In Brazil, these programmes were launched first in the Federal District (Brasilia) and later in the municipalities of Campinas (1995), Belo Horizonte (1997), Vitória (1997) and Recife (1997) (Godoy, 2004).

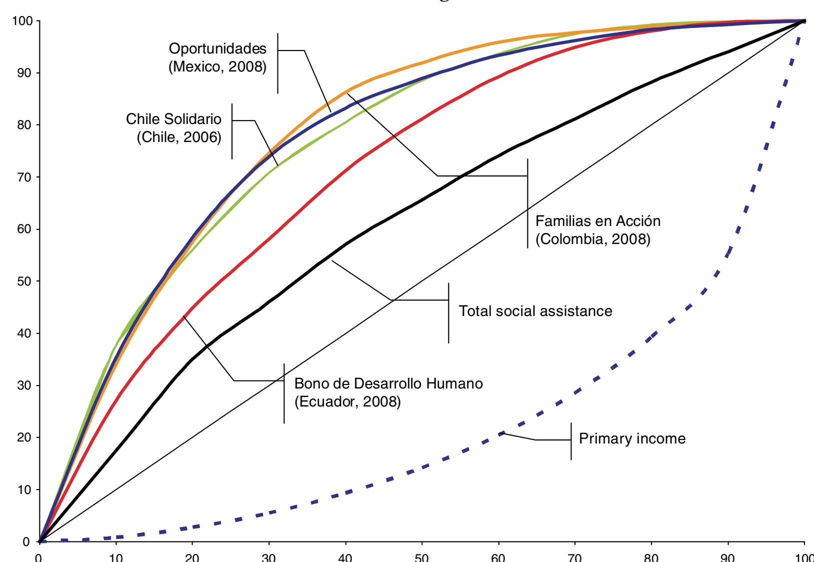
Today conditional transfer programmes are operating in 17 countries of the region, serving more than 22 million families or some 100 million individuals (17% of the population of Latin America and the Caribbean (ECLAC, 2008a)). These programmes have three primary aims: to alleviate poverty through direct income transfers, to provide incentives for investment in human capacity-building, and to bring the target population into the social protection and promotion networks. In the Caribbean, various governments have instituted conditional transfer programmes. The Programme of Advancement through Health and Education (PATH), created by the Government of Jamaica and the World Bank, provides cash subsidies to the neediest and most vulnerable members of society. The Government of Trinidad and Tobago established a targeted programme of conditional transfers in 2005 that offers a safety net for temporarily unemployed heads of household and a provisional food subsidy for persons with little education, combined with training programmes to equip them with the skills needed to find paid employment.

Because they make use of beneficiary selection procedures and techniques designed to minimize errors both of exclusion (families who meet the eligibility criteria but do not participate in the programme) and of inclusion (families that do not meet the eligibility criteria but participate), conditional transfer programmes are generally successful in delivering income to the neediest and they therefore represent one of the more redistributive items of public social spending. As can be seen in figure VI.4, for the programmes included there, between 60% and 75% of spending on these transfers (vertical axis) go to the poorest 40% of the population (horizontal axis). Yet on average across the region, these programmes account for only 2.3% of total public social spending and 0.25% of GDP, which means that their impact on the indicators of poverty and income inequality at the national level are modest.

Figure VI.4

LATIN AMERICA (15 COUNTRIES): DISTRIBUTION OF PUBLIC EXPENDITURE ON SOCIAL WELFARE AND EXAMPLES OF CASH TRANSFERS UNDER SELECTED CONDITIONAL TRANSFER PROGRAMMES, BY PRIMARY INCOME QUINTILE, 2005-2008 [a]

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Simple average.

As to the impact of conditional transfer programmes on inequality, programmes such as *Bolsa Família, Oportunidades* and *Chile Solidario* show divergent results. In the case of *Chile Solidario* the impact is small: the Gini coefficient is reduced by only 0.1 percentage point. By contrast, the *Bolsa Família* and *Oportunidades* programmes have more meaningful outcomes: inequality has been reduced by around 2.7 percentage points in both cases. The key to understanding this difference lies in the proportion of total income represented by the respective transfers, which is much smaller in the Chilean case (less than 0.01% of total family incomes)[4] than in the other two (Soares and others, 2007). Clearly, the effect that conditional transfer programmes will have on poverty and distributive inequality of income depends on their degree of targeting, their coverage and the amount of the cash transfers. With limited resources, some tough trade-offs have to be made between broader coverage and larger transfers.

Some of the impacts of conditional transfer programmes on economic and productive dimensions will be immediate, while others will take longer to mature. The immediate impact of providing direct cash transfers to families is to improve their nutrition and their basic mobility so that they can become more productive. Expanded coverage of conditional transfer programmes has in fact been accompanied by a sustained increase in labour force participation rates among low-income sectors, suggesting that fears about destroying incentives to work are misplaced. Such programmes have also placed more cash in the hands of poor communities, and this has encouraged the emergence of local markets and businesses supplying goods and services. Lastly, over the medium and long terms, the conditions attached to these transfer programmes can be expected to boost investment in human capital (health and education), thereby extending the programme's benefits to future generations.

(b) State-coordinated networks for social protection and activation of human and social capital

Coordinated by the State, active employment policies, microcredit and the formation of mixed community and State networks have gained momentum as instruments for building on the resources and capacities of individuals and communities and linking them with State programmes and policies. Employment policies were discussed in chapter V, and microcredit (or "inclusive" financing) in chapters II and III.

The idea of social networking is gaining currency, and has at least two distinct aspects. First, the State seeks to link different services, benefits and support programmes in order to avoid duplications, generate synergies, and move from a scattered array of programmes (often with differing levels of decentralization and serving different social strata) to an integrated protection system for vulnerable population groups. *Chile Solidario* and the Uruguayan *Rutas de Salida* ("Ways Out") programme are examples of such initiatives, as is the linking of programmes in Brazil. Second, networking implies greater articulation between public and private agents, and between those agents and social stakeholders. In other countries these networks are often associated with or subsumed into conditional transfer programmes and they create connections between poor sectors of the population and the State, the resources available on the market, and the communities themselves.

The activation of social capital supported by the State and its translation into local initiatives and community networks has no effect on countries' marginal productivity. But it does

[4] In fact, *Chile Solidario* is not a transfer programme in the strict sense, but rather an attempt to facilitate the poorest families' use of a broader network of support. The transfer is part of an initial contract for these purposes.

help to boost total national output by increasing use of the labour factor and encouraging social protection strategies supported by previously unused community capital.

(c) Non-contributory State mechanisms or subsidized contributions to social insurance systems (social security and health care)

While the development of social security systems has followed different trajectories in the Latin American and Caribbean countries (earlier in the Southern Cone, later in the rest of the region), the labour market has never become a gateway through which the population as a whole could access social protection benefits. Moreover, the reforms of the health-care and social security systems undertaken in the early 1980s tended to privatize insurance, with adverse effects on equality of access and the extent of coverage. In the health sector, the stratification of access is an issue that must be addressed as a strategic priority (see box VI.3).

Box VI.3

HEALTH SYSTEMS: FINANCING AND STRATIFICATION

In the health sector, the system's financing structure is not neutral from the viewpoint of equality. The greater the relative importance of the public subsystem, the greater will be the implicit redistribution in the overall health system, and the more homogeneous will be its coverage. By contrast, greater out-of-pocket spending implies less redistribution and more inequity. As a proportion of total health spending, private spending is higher in the region (45%) than the world average (42%), and significantly greater than in countries of the Organisation for Economic Cooperation and Development (OECD) (28%). The fact that private spending amounts to nearly half of total health spending and that out-of-pocket contributions are around 37% shows how weak public health and social security systems are in the region in terms of providing effective health coverage. On the other hand, the stronger the social security system is in providing and financing health, the greater will be the coverage gap, in principle, between formal workers and the rest of the population who have access only to the public system. Nevertheless, this will depend on the degree of articulation between social security and the public system and the level of financing of the public sector.

Few of the region’s countries have succeeded in integrating public health-care systems and financing them through general revenues. Notable among these are, first, the countries of the Caribbean, which have followed the Anglo-Saxon model; second, the special case of Cuba, where the predominance of public services goes beyond health care; and finally Brazil, which now has a tax burden similar to that of developed countries. Brazil is also the only country to have reformed a segmented system to achieve full integration through the public health-care system. From the point of view of funding, the change in the sources of financing produced by this reform had the advantage of being neutral in terms of public finances. With adoption of the 1988 Constitution, the right of workers to health care provided under social security was made universal and comprehensive. The new government-supported "Single Health System" began to be financed from general revenues (including some taxes specifically earmarked for the health sector). At the same time, the payroll deductions that had previously financed health coverage under social security were channelled into the pension system that had been funded from general revenues. These reforms stand in contrast to those pursued by many countries, which kept their health systems segmented while incorporating funding from general revenues to finance imbalances in their pension systems.

The problems at hand will require a medium-term strategy to pursue a path of reforms that, while producing marginal improvements, will achieve the strategic goal established. There is no single path. If these processes are to be viable, countries will need to undertake major tax reforms so as to reduce dependency on contributions and to finance universal services from general revenues.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Shaping the Future of Social Protection: Access, Financing and Solidarity* (LC/G.2294(SES.31/3)), Santiago, Chile, March 2006.

In light of this evidence, there is growing support for the idea of building or strengthening the non-contributory pillars of the health-care and social security systems. The health-care reform in Uruguay, the universal access and specific health guarantee plan (AUGE) in Chile, the pioneering Single Health System (SUS) of Brazil, the targeted welfare health insurance scheme (*seguro popular*) in Mexico and the health-care reform in Colombia all bespeak a more universal, solidary and rights-based approach to health policy. A similar approach can be seen in the pension system reform in Chile, the universal non-contributory pensions in Mexico City (now extended, with certain variations, to a number of Mexican states), the programme of Mexico's Secretariat of Social Development (SEDESOL) for persons over the age of 70 in towns of up to 30,000 inhabitants, the reform of the retirement benefits system in Argentina, the "continuing benefit" provision in Brazil and other retirement and pension innovations now under consideration or already implemented in the region. Unemployment insurance reforms in Uruguay and Chile also represent policies of income protection or basic threshold replacement that go beyond the contributions rationale.

Non-contributory health and social security systems have a direct, clear and substantial impact on inequality. Given the sharp segmentation of the region's labour markets, social protection systems that are confined to formal contributory formats tend not only to reproduce but to exacerbate inequality in labour markets.

(d) A more pro-active government role in rectifying asymmetries and inequalities worsened by decentralization and the delegation of responsibilities to quasi-markets or private providers

The reforms of the 1980s were intended to combine decentralization of public management with the privatization of services and benefits. With respect to the first objective, as discussed in chapter IV, persistent asymmetries in financing and in management capacities at the subnational levels exacerbate inequalities at those levels. For the same reason, decentralization today poses challenges of regulation, management-capacity-building, and financing alternatives for remedying those asymmetries.

In light of this situation, and following the reforms that delegated health and education services to private sector suppliers, the current decade has seen moves toward greater regulation through the creation or strengthening of superintendencies. There has also been greater redistribution through solidarity funds and transfer formulas that regulate and moderate the regressive and stratifying impacts that decentralization reforms generated or exacerbated.

(e) New areas of action and redistribution with respect to caregivers and the coordination and redistribution of paid and unpaid work from a gender perspective

What is known as the "care economy" has gained prominence on the public agenda in light of evidence that the burden of care work falls disproportionately on women. This is not only unfair, but also prevents women from entering the labour market and gaining autonomy. At the same time, care services are provided almost exclusively through the market, which implies out-of-pocket family expenditure that the poor cannot afford. This leads to women's participation in employment being unequally distributed among socio-economic groups, which doubles the injustice. Lastly, poor households have more children and their care needs are therefore greater, all of which means a higher proportion of dependants to income earners. This mechanism reproduces socio-economic gaps.

This long-standing situation of care provision, in which care has been provided exclusively by the family and the market, is starting to change, as public policy is promoting greater State involvement in care provision. There is greater recognition that collectivizing childcare helps to redistribute the burden between the sexes and between social strata. This has been accompanied by a growing debate over policies for reconciling paid and unpaid work, from a perspective of rights and gender equality.

One pillar of public policy in this respect is to expand the coverage of day nurseries and pre-school facilities and to extend the school day.[5] The intent is not only to improve educational performances but to allow women greater time for remunerated work. Yet in order to take full advantage of this resource a change is needed in the family and in work. On the first score, profound cultural changes are needed in the gender distribution of tasks in order to do away with the double day worked by women who not only shoulder the bulk of care duties but also hold down a paying job. On the second point, remuneration must be made more gender-equitable, and social security systems need to be created that will make allowance for the fact that women's working trajectories suffer greater discontinuities because of their care responsibilities.

These "reforms of the reforms" must not be hobbled by the constraints imposed by the crisis and the new global scene (see chapter I). Indeed, governments have responded to the potential social costs of the crisis by moving ahead more resolutely with these reforms and attributing a more proactive role to the State. Transfers to the most vulnerable sectors have been increased and there has been progress with unemployment insurance and other labour policies. In this sense, the crisis poses not only a threat but also an opportunity for building consensus around these social policy reforms.

While recent measures taken by Governments speak of an active role for the State in addressing the effects of the crisis, their real significance will depend on the amount of resources that can be mobilized, on institutional strengths, and on the degree of coordination among the various initiatives for dealing with the crisis and between those measures and longer-term sector programmes. To address this challenge requires an understanding of the parameters that define well-being gaps and the possibilities of State action.

C. Structural parameters of well-being and social protection

Well-being gaps have two broad dimensions: the capacity of a society to support its members with income earned through the labour market; and the capacities of States to provide support and protection for dependants —those who lack income or earn inadequate incomes in the labour market.

Dependants are defined by two yardsticks. The demographic measure refers to the age structure, while the occupational definition refers to people's position in the labour market. The combination of these two yardsticks reveals a ratio of labour dependency: the number of

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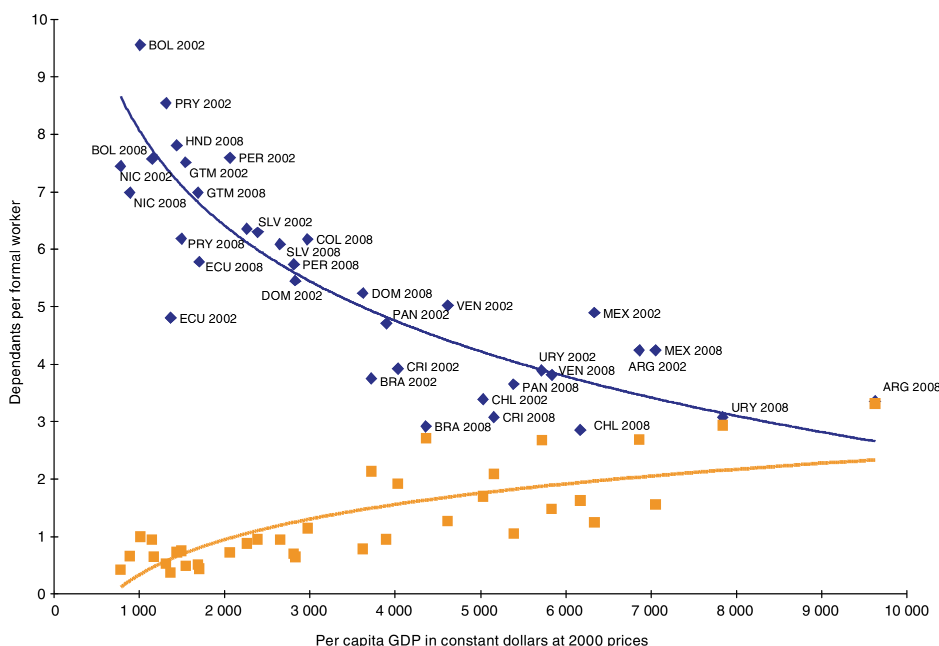
[5] Care work can include a vast range of additional services, such as sporting activities for adolescents, the supply of free or low-cost services for the elderly, care for the disabled, neighbourhood security services, environmental protection, and so forth. These services are provided not only by Governments but also by communities and in European countries they are considered important enough to be measured as a contribution to GDP and employment creation. For the purposes here, however, the analysis has been restricted to the relationship between the care economy and the welfare State, and in particular the link between development and use of human capacities in low-income families: hence the emphasis on child care and support for women.

demographic dependants (persons aged under 15 or over 65) plus those who are wholly or partly dependent because of their labour market status (inactive, unemployed, or employed in low-productivity or informal jobs that do not yield sufficient incomes). This is used to define a first "well-being curve" along which countries can be ranked by the capacity of their labour markets to generate sufficient incomes to cover the needs of dependants.

The second "well-being curve" tracks countries' fiscal capacities, comparing the potential for public transfers against the requirements generated by economic dependency. As discussed in the previous section the tendency since the 1990s has been to give greater priority to the social component of public spending and to increase its share of the total. As will be discussed in chapter VII, fiscal capacities must be increased through reforms that will expand the tax burden and transform its structure (recognizing that various countries have already increased their tax burden in recent years).

Figure VI.5

LATIN AMERICA: NUMBER OF DEPENDANTS PER FORMAL WORKER [a]



Source: Based on Andras Uthoff, Cecilia Vera and Nora Ruedi, “Relación de dependencia del trabajo formal y brechas de protección social en América Latina y el Caribe”, *Financiamiento del desarrollo series*, No. 169 (LC/L.2497-P), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2006. United Nations publication, Sales No. E.06.II.G.29.

[a] Population aged under 15 plus population aged 15 to 64 (inactive plus unemployed plus informal workers) plus population over 65, in relation to the population aged 15 to 65 (formal workers).

A potential tax rate can be estimated for each country, according to its level of wealth. That tax rate then translates into a potential level of social spending. Using the estimated cost of basic benefits, it is possible to calculate the number of dependants who cannot meet their needs from employment income but who could be assisted from the State's fiscal resources (and under what conditions this could be accomplished). This defines a welfare "floor" based on guaranteed transfers to the dependent population from State revenues.

With regard in particular to the age-dependent population and the economically active population (EAP) in the informal sector, the well-being gap also reflects inability to access health and social security systems either through contributory modalities or out-of-pocket spending. Ways must be found for the State, with its institutional capacities and monetary resources, to intervene in the systems to provide a well-being threshold for those who lack it.

These size of gaps can be affected by the political and policy decisions that countries make through their Governments. A country's level of economic development is certainly not the only factor in determining how many women can gain ready access to the labour market, or the human capital stock of the active population, the productivity gaps between sectors and activities, levels of employment and unemployment, or the ways social protection is financed. All these will depend as well on the dominant type of development and on the role played by the State. This distinction in turn will affect fertility and mortality rates, people’s productive capacities, and levels of investment and consumption. The State has a key role in these processes. In Latin America, the State can do much to reduce well-being gaps. It can do much to reduce structural heterogeneity by facilitating women's access to the labour market and boosting the human capital of new generations in low-income families. But to accomplish this, State must adopt a hitherto missing proactive and coordinated role in the productive and economic sphere.

The fact that well-being gaps and whether they grow of shrink are not predetermined by level of economic development does not mean that we can overlook the structural parameters that condition State action. Those parameters, illustrated in the following classification, show very different points of departure for countries in the region. As can be seen in table VI.1, countries can be classified by a set of relevant variables into three broad groups: those with severe, moderate and small gaps.

Table VI.1 illustrates some basic features of well-being gaps. Countries have been divided into three groups. Although there are differences within each group[6] there is relative convergence among the components that have the greatest influence on well-being in each group. The countries with smaller well-being gaps have a higher GDP, lower demographic dependency ratios (that is, a larger working-age population relative to the dependent population), less labour market informality, and greater social security coverage, greater public coverage of health services (lower proportion of out-of-pocket spending), lower levels of poverty and indigence, and public social spending that is not only higher in per capita terms but as a percentage of GDP (priority in social expenditure). All of these parameters are less satisfactory in the relatively less developed countries. Well-being gaps vary substantially, then, in terms of social needs and fiscal capacities. At lower levels of development, labour markets are more insecure, families bear more of the burden of providing themselves with services, the demographic dependency ratio is greater, there is more poverty, and public institutions have fewer monetary resources and management and implementation capacities. Some of the features of these various groups of countries are discussed below in order to shed further light on well-being gaps.

[6] For example public social spending as a percentage of GDP is around 18.6% in the Plurinational State of Bolivia, far above the average for group III.

Table VI.1

LATIN AMERICA (COUNTRY GROUPS): SELECTED WELL-BEING INDICATORS [a]

	Group I	Group II	Group III	Latin America
	Argentina, Brazil, Chile, Costa Rica, Panama, Uruguay	Colombia, Mexico, Venezuela (Bolivarian Republic of)	Bolivia (Plurinational State of), Dominican Rep., Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Paraguay, Peru	
Per capita GDP 2008 (constant dollars at 2000 prices)	6 601	5 320	1 975	4 074
Demographic dependency rate 2005-2010 [b]	52.9	54.8	68.3	60.9
Poor population around 2008 (percentages)	19.7	35.1	52.1	38.4
Indigent population around 2008 (percentages)	6.7	14.7	26.8	18.1
Informal sector employed around 2008 (percentages of total employed population)	41.6	55.3	65.3	55.7
Tax burden including social contributions, 2007-2008 (percentage of GDP) [c]	24.8	13.7	16.4	18.7
Public social spending per capita 2007-2008 (constant dollars at 2000 prices)	1 209	619	181	597
Public social spending 2007-2008 (percentages of GDP)	18.6	11.8	10.2	13.3
Retirement pension coverage (percentages), urban areas	64.4	26.6	14.1	33.0
Percentage declaring out-of-pocket expenditure on health care	23.3	35.1	72.1	49.7

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Simple averages for the countries.

[b] The dependency ratio equals the population aged 0 to14 plus the population aged 65 and over divided by the population aged 15 to 64 multiplied by 100.

[c] For Argentina, Brazil, Chile, Costa Rica and the Plurinational State of Bolivia, figures refer to general government. In the other cases they refer to the central government.

1. Countries with severe well-being gaps

This group includes the Dominican Republic, Ecuador, El Salvador, Guatemala, Honduras, Paraguay, Peru and the Plurinational State of Bolivia. These countries have a demographic structure characterized by relatively high levels of fertility and a young population. Their labour markets are precarious, which means that the dependent population comprises not only the young but also a high contingent of informal workers with low incomes and no employment-related social protection: 75% of the dependents of formal workers are children and informal workers. The other 25% comprises the inactive, the unemployed, and older persons. The level of development of these countries, measured by per capita GDP, averages slightly under US$ 2,000 (at constant 2000 prices). Combined with a low tax burden, this prevents them from allocating

significant resources to meeting the educational needs of the young, the social security and assistance needs of working-age people, and the health needs of the population as a whole.

These countries also register poverty rates exceeding 45%. In many cases two thirds of the population is poor; at the same time, less than 30% of employed have social security coverage. Public financing of welfare programmes may come from general revenues or from royalties or taxes on the exploitation of natural resources. These resources underpin poverty reduction programmes that function independently of the demographic structure or the degree of labour market formality. Yet underemployment rates are high, the State has little capacity to allocate funds, financial markets are narrow and concentrated, and there is little emphasis on training: all these factors limit social mobility and the capacity to change social structures.

In these cases the welfare State is key to speeding the pace at which well-being gaps can be narrowed. On the one hand, these States must expand their taxation capacities. On the other hand, rates of economic activity and employment must rise. Lastly, efforts must be made to build up human capital and distribute it more fairly. Accordingly, the threshold that must be attained in order to build more productive and egalitarian societies consists of targeted investment in care services that will free up the female workforce and measures to expand preschool and secondary education and consolidate cash transfers to poor families with children.

2. Countries with intermediate well-being gaps

This group includes the Bolivarian Republic of Venezuela, Colombia and Mexico. These countries have seen their fertility rates drop since the 1970s, resulting in a lower proportion of young dependents. They have a more formal labour market, but they are at a stage of incipient population ageing. As educational coverage extends beyond the secondary level, the proportion of inactive persons among the dependent population is rising. These inactive persons, together with children under 15 years of age, account for 60% of dependants per formal worker. The remaining 40% are older persons, informal workers (partially dependent because of low incomes and lack of social protection) and the unemployed.

These countries' level of economic development exceeds US$ 5,000 per capita (at constant 2000 prices). While they have low tax burdens, they have higher revenue levels and can therefore afford greater outlays on education, social security and assistance, and health care. Poverty rates vary between 30% and 40%, and their social security systems cover close to 50% of the employed population. The provision of social services is possible almost exclusively because of the higher levels of development achieved by societies with Governments buoyed by natural-resource revenues (the Bolivarian Republic of Venezuela and Mexico). These countries have more leeway to allocate a higher percentage of GDP to public social spending, but these advantages do not translate into significant improvements in their social situation, as measured by poverty rates.

The more educated or the better trained reap the greatest benefits from a more dynamic labour market and this perpetuates social stratification and transmits inequalities to future generations. The State does not have sufficient financial capacity to support both a basic social protection network and the necessary improvements in public education. Access to a quality education is segmented by income. Financial market expansion discriminates by risk, selecting the most creditworthy customers. Institutions in this group of countries have, in short, developed along lines that tend to reinforce the mechanisms that transmit social inequalities.

The great challenges facing these countries are to boost productivity in lagging sectors, raise participation rates among the economically active age groups, and universalize basic forms of social protection that will allow households to cope with external shocks and life changes. The key factors for charting a course of greater equality and productivity are therefore the expansion of non-contributory health and social security systems, monetary transfers and additional investment in preschool and secondary education in vulnerable areas.

3. Countries with small well-being gaps

This group includes Argentina, Brazil, Chile, Costa Rica, Panama and Uruguay. These countries have a greater potential for developing a welfare State. They experienced sharp declines in fertility during or even before the 1960s and they have an older demographic structure. Because a larger proportion of people go on to higher education, there are more economically inactive persons who, together with older persons and children, represent 75% of dependants per formal worker. The remaining potential dependants are informal workers and the unemployed. The level of development, measured by per capita GDP, averages more than US$ 6,500 (at constant 2000 prices), and the tax burden is high, allowing public social spending of close to 20% of GDP (as high as 35% in the case of Brazil). Poverty rates are below 25%, and more than 60% of the employed population has social security coverage.

These countries are far from offering conditions equivalent to those of European social democratic States. The market plays an important role in those countries that overhauled their pension systems to incorporate private fund administrators (Chile and Uruguay), while in Costa Rica this component is only marginal.

Despite their stronger institutional development and the availability of greater fiscal resources, the impact of public programmes on inequality is limited. Social protection systems remain segmented by the contributory capacity of their members, a factor that reproduces primary inequalities generated in the labour market. Changes have been made to make systems universal, but only in basic services, owing to budgetary constraints that limit government's ability to fund programmes directly. Public-private combinations in the provision of education make access to quality education contingent upon ability to pay. Governments still lack the regulatory capacity to create the equality of access that was missing in the original design of social service systems.

The demographic window of opportunity in these countries is narrowing as the population ages. This makes it imperative both to provide more comprehensive social protection for vulnerable groups and to limit subsidies to the socially integrated and well-off sectors. Health and social security systems must be recast and subsidies geared to a basic universal and non-contributory threshold. Another challenge is to de-stratify women’s access to the labour market: the existing stratification poses an enormous obstacle to overcoming inequality and it means that a significant portion of human productive capacities is being wasted. In this respect, it is essential to expand good quality childcare services and preschool education in lower-income areas. Lastly, unless completion of a high-quality secondary education becomes more standardized, these societies will not be equipped to expand their productive horizons or to guarantee equality of opportunities.

D. The components of a welfare State [7]

As discussed in previous chapters, the move towards more integrated societies must be backed by more dynamic economic growth with greater productive and territorial convergence and high-quality employment. On all these fronts, as argued throughout this document, the State has a decisive role to play. It is also an essential factor in fostering well-being, human development and protection from risk. As Segura-Ubiergo (2007) notes, the welfare State may be defined as "a repertoire of state-led policies aimed at securing a minimum of welfare to its citizens —that is, protecting them against the risks of unemployment, sickness, maternity, and old age— and providing an adequate accumulation of human capital through public investments in health and education."

To achieve these objectives, welfare States perform four clear functions:[8]

(i) They decommodify welfare services by providing goods, services and transfers that do not depend on a position in the labour market or capacity to pay market prices for goods, insurance and services.

(ii) They delink welfare access from the family nucleus by providing people with services, benefits and transfers that do not depend on family membership or family rules of reciprocity and distribution.

(iii) They regulate and control certain aspects of the behaviour of market agents and family members, changing the “spontaneous” order in these spheres through incentives and regulation of the labour market, prices, and the rights and obligations of family members.

(iv) They redistribute wealth[9] by collecting and distributing it in the form of goods, services and transfers in proportions that do not relate benefits to contributions but that instead apply the principles of solidarity to financing sources and eligibility criteria. This redistribution occurs between distinct groups (from the employed to the unemployed and inactive, from the healthy to the sick, from adults to children, from men to women, from those who have more to those who have less), and this determines the effects that this redistribution has over time between classes, sexes and generations.

What the State does in these areas must be viewed in relation to what the other two spheres —markets and families— are doing. To these three spheres a fourth must be added: the community, both organized (nongovernmental organizations, churches, volunteer associations) and unorganized (neighbours, friends, networks of relationships).

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[7] There is an important distinction to be made between concept of the welfare state in the concrete form it took in post-war Europe and the analytical idea of the welfare state as a set of policies and actions that are present in all states. The latter concept is referred to here.

[8] For the basis of this concept see Esping Andersen (1990, 1999, 2002). Some variations and further thoughts on the matter are to be found in Orloff (1993), Martínez (2008), Filgueira (2007b) and Filgueira, Gutiérrez and Papadópulos, (2008).

[9] It is not only the State that redistributes wealth. Families do so as well, and even markets. That redistribution may be progressive or regressive. What distinguishes the State in this case is that it has binding power, both over the extraction of revenues and over the principles that determine eligibility.

This analysis highlights the fact that a public strategy to promote equality cannot be confined to levelling the playing field by providing equal opportunities: the function of the State extends to achieving greater equality of outcomes and levels of well-being. This is because the most unequal region in the world can hardly expect to equalize opportunities without at least partially equalizing outcomes.

Markets, the State and families complicate this distinction. And the more unequal the initial situations, the more complex and elusive that distinction will be. On one hand, families tend to amplify initial inequality: material inheritances, class endogamy in the formation of new households, and the social legacy that is transmitted through early socialization all tend to reproduce social differences by concentrating and deepening the unequal distribution of human, physical and social capital. Markets also tend to reinforce distinctions, to the extent that they reward the productivity differential arising from people's differing capacities, thereby exacerbating the original differences through the accumulation of physical capital and segmented social capital.

Government policies, then, have a decisive role to play in overcoming the inertial power of inequality. The State has the ultimate responsibility for guaranteeing the economic, social and cultural rights of its citizens. And precisely because they are rights, they demand an equality that the market and the family, left to their own, cannot guarantee: hence the inescapable responsibility of the State.

E. Towards a redistributive system of monetary transfers: when ethical and pragmatic concerns coincide

To a large extent, it is the structure of deep inequality and low average productivity that explains why a large proportion of the population still lacks an adequate minimum income in most of the region’s countries. Individual and household incomes are insufficient for three essential reasons: unemployment, low wages, and inactivity (not by choice but owing to a number of obstacles). This situation must be addressed in a number of ways, including the direct redistribution of income through non-contributory systems.

Two arguments have been raised against such redistribution. The first is that countries lack the fiscal capacity for it. Yet to varying degrees the countries of the region do have fiscal room for assuming this redistributive role. The range of transfers, their amount and their progressivity will depend on a combination of factors that in each country determine the well-being gap (see box VI.1). In any case, the evidence presented below suggests that in much of the region the problem is not technical but political.

The second argument has to do with the right incentives, inasmuch as the receipt of non-labour income is said to undermine people's willingness to join the labour market. This argument is mistaken on several grounds. In the first place, the transfer amounts proposed barely reach minimum consumption thresholds and, in many cases, are insufficient to bring households across the poverty line. In the second place, the experience of recent years shows that the expansion of non-contributory mechanisms in the region has been accompanied by rising participation rates among beneficiaries. Third, in a region where the income of over a third of the population cannot lift those households out of poverty, it can hardly be argued that the lack of insurance against vulnerability is a matter of incentives.

There are also some good reasons to defend a basic system of guaranteed partial income. The first reason, as discussed above, has to do with respecting equal social rights among citizens. Poor and vulnerable households facing exogenous shocks or personal life changes will become decapitalized beyond the "shock effect" precisely because there are no guaranteed minimums or instruments that would at least smooth out income flow troughs in the face of adversity. It is just as necessary in practical terms, and even more imperative from an ethical point of view, to avoid the collapse of the household economies that represent a large proportion of the Latin American population and production base as it is to avoid the collapse of the financial systems (by subsidizing their inefficiencies). Then too, the region has few automatic stabilizers for dealing with crisis and turmoil. In this respect, basic guaranteed income systems constitute mechanisms for sustaining domestic demand in adverse situations. Lastly, the proposals made here and their choice of target population are designed to reduce the amount of time households with young children spend in poverty, thereby promoting the development of human capacities in a region in full demographic transition, in which the outlook for future growth depends on strong boosts to labour productivity.

It is not the intention here to propose subsidies to encourage people to leave the labour market. On the contrary, basic guaranteed incomes are a mechanism that will promote people's participation in the labour market, now and in the future. With a sound understanding of the circumstances that incline people towards work, Governments can make proper use of the incentives and thresholds that sustain that activity and predisposition over time. This section therefore presents a series of estimates of the costs to Governments of assuming its crucial role in social protection (see box VI.4), including a non-contributory system of income guarantees and redistribution.

These estimates give an idea of the fiscal effort required for these transfers; naturally, that effort will vary in accordance with the width of the well-being gap in each country, as discussed earlier. It cannot be expected that the fiscal resources to set up this array of transfers will become available overnight, or at the same rate in different countries, or that public institutions will have the capacity to use the resources in the most efficient and effective way from the beginning. But it is clear that the fiscal effort to work towards meeting the challenges of providing well-being and social advancement will require tax reforms, dynamic growth and various alternatives for filling the coffers for government policy.

1. Combating inequality and the juvenilization of poverty

Poverty is exacerbated by extreme inequality in income distribution, reflecting great inequalities of origin, a low tax burden, poor redistributive capacity on the part of Governments, and inefficient and unequal labour markets that tend to reinforce initial inequalities —those of class, gender, age or ethnic background. As can be seen in figure VI.6, the incidence of child poverty is much higher than that of poverty among the adult population, with variations between countries. That trend has become more marked over the last 20 years.

Box VI.4

METHODOLOGY FOR ESTIMATING THE COSTS OF TRANSFERS

The simulation exercises were conducted on the basis of microdata from the most recent household surveys and were parameterized using national accounts data in order to estimate costs in GDP terms. The model allocates an amount equivalent to one poverty line to each person eligible under the selected criteria and computes the new household income. On this basis, indicators of poverty and inequality are re-estimated and the scope of household coverage for each measure is determined.

$$Cost\%GDP = \left(\frac{\left[\left(\sum_{i=1}^{q} p_i * B \right) * 12 \right] * ER}{GDP} \right) * 100$$

where, ***q*** represents the eligible population according to the various parameters specified; ***p*** represents the persons eligible under those parameters; and ***B*** represents the benefit stipulated for that population. The figure resulting from this simulation is multiplied by 12 (annualized monthly benefit) and expressed in dollars at the exchange rate (ER). This amount is divided by GDP and multiplied by 100 to express the fiscal cost of benefits as a percentage of GDP.

The basis for the estimates is simple and consists of four broad groups of benefits under two different mechanisms. The measures simulated are:

- Allocate one poverty line for children aged under 5.
- Allocate half a poverty line for children aged between 5 and 14.
- Allocate one poverty line for persons aged over 64.
- Allocate one poverty line for the unemployed (people unemployed for the first time in the formal and informal sectors).

The poverty line is the monetary value of a basic basket of goods and services that includes food, housing, transportation, clothing, communications and a few other items required to meet basic needs. One half of the poverty line is equivalent to the cost of covering nutritional needs only; this is also known as the "indigence line". In Latin America, the poverty line currently varies between US$ 60 and US$ 250, depending on the cost of the basic basket and the purchasing power of the dollar in each country.

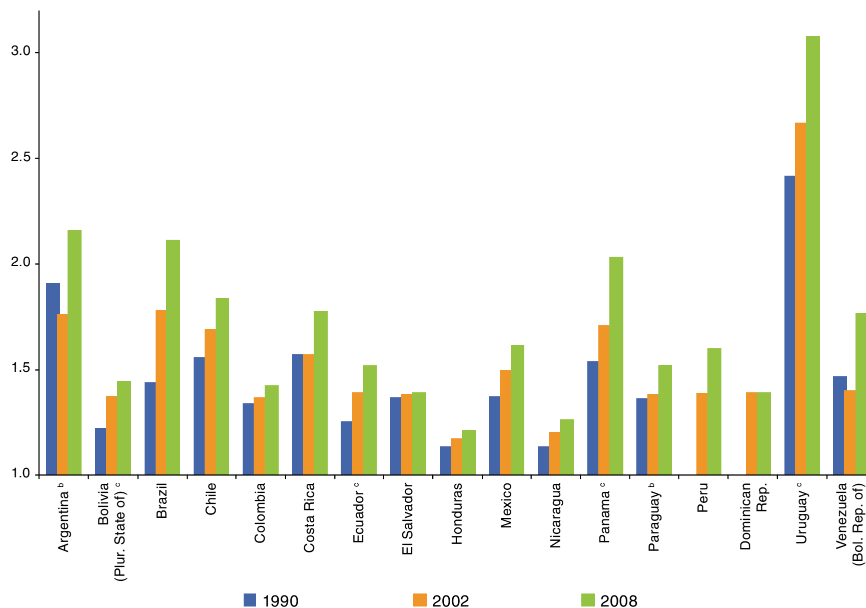
Those benefits were simulated for two universes: on the one hand, benefits flowing to persons in the categories described and, on the other hand, benefits flowing to persons in these categories who also belong to households with an income below 1.8 times the poverty line (or those deemed "vulnerable to poverty"). The population coverage produced using this targeting parameter is almost universal in the poorest countries, but is much more targeted in countries with smaller welfare gaps.

This exercise supports an estimation of the impacts of the alternatives discussed on poverty and inequality, as well as their costs in terms of each country's GDP. Those impacts can also be estimated in relation to each benefit and to all benefits considered together.

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of methodologies developed in ECLAC, *Social Panorama of Latin America, 2009* (LC/G.2423-P), Santiago, Chile, 2009. United Nations publication, Sales No. E.09.II.G.135; and *Social Panorama of Latin America, 2007* (LC/G.2351-P), Santiago, Chile, 2007. United Nations publication, Sales No. E.07.II.G.124.

Figure VI.6

CHILD POVERTY RATIOS AROUND 1990, 2002 AND 2008: CHILDREN AGED 0-14 COMPARED WITH THOSE AGED OVER 14 [a]



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] The survey year used differs from country to country. The period 1990 refers to the available survey nearest to that year; the period 2002, to the most recent survey available between 2000 and 2002; the period 2008, to surveys available between 2004 and 2008.

[b] Metropolitan area.

[c] Urban areas.

A fundamental aspect of any intergenerational social covenant has to do with the amount of money that each society is prepared to pay to support the family's role in the care, development and protection of children. Traditionally, it was assumed that the male breadwinner would provide these resources for the family and that the woman would look after the children. This relationship of dependency became even more precarious in cases where the link was broken, for women nearly always take full responsibility for raising the children. Control over money thus tends to remain in the hands of the person who, ultimately, does not take responsibility for dependants.

The State has recently started to address this situation through cash transfers and reformed systems of family allowances. These are effective redistribution instruments that have focused public debate more closely on the role of the State in levelling the playing field. They have also become a useful tool of overall social protection. It is important, however, not to confuse a single point of support with a complete platform when considering these programmes within the fiscal structure of Latin American social States. Although these programmes have attracted a great deal of technical, academic and public notice, they represent on average only 0.25% of GDP and 2.3% of social spending in Latin American countries, and they are far from achieving satisfactory coverage (see section 2 of this chapter).

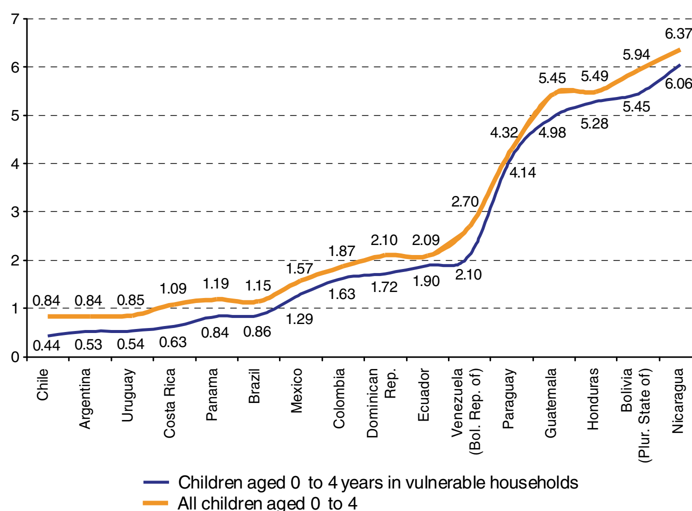
The following simulation exercise (figures VI.7 and VI.8) shows the cost of generating additional income transfers for children from birth to 4 years and from 5 to 14 years, in a universal

format and then in one targeted at vulnerable sectors (see box VI.4). Again, these estimates are calculated without eliminating transfers already received by these families and, consequently, the values estimated here are additional to existing efforts.

Figure VI.7

LATIN AMERICA (16 COUNTRIES): COST OF TRANSFERRING ONE POVERTY LINE TO CHILDREN AGED UNDER 5, AROUND 2008

(Percentages of GDP)

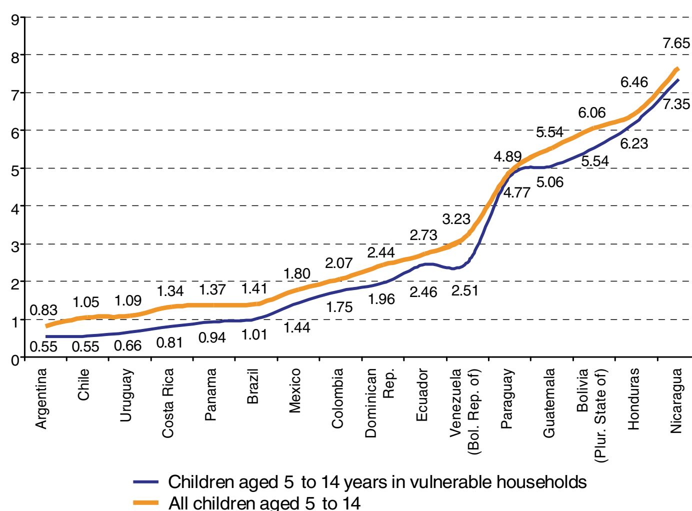


Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries. For single parent households, the transfer amounts to 1.5 poverty lines per child.

Figure VI.8

LATIN AMERICA (16 COUNTRIES): COST OF TRANSFERRING HALF THE POVERTY LINE TO CHILDREN AGED 5 TO 14, AROUND 2008

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries. For single parent households, the transfer amounts to 1.5 poverty lines per child.

Once again, in the case of the relatively more developed countries, the cost of supplementing existing benefits with an additional transfer of one poverty line for each child aged under 5 and half the poverty line for each child aged between 5 and 14 is affordable in both the targeted and universal versions within a relatively short timeframe. Given the sharp juvenilization of poverty in these societies and their low fertility rates, this is a highly recommendable measure, since it means investing in more productive future generations and more egalitarian societies. This recommendation does not necessarily require that benefits be configured as shown here.

Table VI.2

LATIN AMERICA (16 COUNTRIES): COVERAGE, BENEFITS AND POVERTY REDUCTION ACHIEVED BY TRANSFERRING ONE POVERTY LINE TO CHILDREN AGED UNDER 5, AROUND 2008

	Targeted coverage (percentage of total households)	Average monthly transfer per capita to households with beneficiaries (dollars at 2000 prices)	Poor households before transfer (percentage of total households)	Poor households post-transfer (percentage of total households)	Poverty reduction (percentage points)
Argentina	12.5	44.3	14.7	12.2	-2.5
Brazil	13.1	21.3	19.9	16.9	-3.0
Uruguay	8.9	35.7	8.5	6.5	-2.0
Chile	10.7	19.1	11.3	9.1	-2.1
Costa Rica	12.2	20.0	14.8	12.4	-2.5
Panama	26.3	21.6	21.5	18.0	-3.4
Mexico	21.1	34.7	27.9	22.8	-5.1
Colombia	21.6	17.6	35.4	30.3	-5.0
Venezuela (Bolivarian Republic of)	19.9	46.0	23.6	19.1	-4.5
Ecuador	22.0	10.4	36.5	31.5	-5.0
Bolivia (Plurinational State of)	27.9	14.7	47.2	41.8	-5.5
Guatemala	37.3	18.3	46.7	39.3	-7.4
Honduras	35.6	16.6	63.1	57.8	-5.3
Nicaragua	35.4	11.7	54.4	48.6	-5.9
Paraguay	28.2	17.2	50.2	44.6	-5.6
Dominican Rep.	19.6	25.3	40.1	35.7	-4.4

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

The investment in children must be calculated not only in terms of the cost of the transfers made. It is also important to calculate the cost of not doing so: in other words, what will be the cost to the State and society of having children with higher malnutrition rates and lower education levels, two inevitable results of exclusion? Studies by ECLAC in conjunction with the World Food Programme (WFP) and the United Nations Educational, Scientific and Cultural Organization (UNESCO) show that, if the current situation persists, it will impose serious long-term economic costs on countries. While social spending supposes the allocation of budgetary funds, not allocating them supposes aggravation of the problem, with major social and economic consequences.

Table VI.3

LATIN AMERICA (16 COUNTRIES): COVERAGE, BENEFITS AND POVERTY REDUCTION ACHIEVED BY TRANSFERRING ONE HALF POVERTY LINE TO CHILDREN AGED 5 TO 14, AROUND 2008 [a]

	Targeted coverage (percentage of total households)	Average monthly transfer per capita to households with beneficiaries (dollars at 2000 prices)	Poor households before transfer (percentage of total households)	Poor households post-transfer (percentage of total households)	Poverty reduction (percentage points)
Argentina	18.7	31.1	14.7	12.1	-2.6
Brazil	23.0	14.3	19.9	16.5	-3.4
Uruguay	15.7	25.1	8.2	5.7	-2.8
Chile	19.8	13.0	11.3	8.5	-2.7
Costa Rica	22.0	14.1	14.8	11.5	-3.3
Panama	44.7	14.8	21.5	17.2	-4.3
Bolivia (Plurinational State of)	40.8	10.3	47.2	42.1	-5.1
Ecuador	39.4	7.5	36.5	30.2	-6.4
Guatemala	50.2	13.9	46.7	39.5	-7.2
Honduras	55.3	12.6	63.1	56.8	-6.3
Mexico	34.4	23.8	27.9	22.1	-5.8
Colombia	34.8	11.8	35.4	30.3	-5.0
Venezuela (Bolivarian Republic of)	33.6	32.7	23.6	18.2	-5.4
Nicaragua	55.6	9.0	54.4	47.4	-7.0
Paraguay	46.3	12.0	50.2	44.0	-6.2
Dominican Republic	33.2	17.1	40.1	35.0	-5.2

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] For single parent households, the transfer amounts to 1.5 poverty lines per child.

For example, the direct costs of health care and education services plus productivity losses —due to the 5.4 million individuals who did not live long enough to form part of the working age population and the two-year schooling gap of those who suffered child malnutrition— were equivalent to 6.4% of GDP in Central American countries and the Dominican Republic in 2004 and 2.6% of GDP in Andean countries and Paraguay in 2005. Those amounts represent in turn an average of 30% of public social spending in those countries in those years. In some cases, this cost is even higher than the social spending reported by the countries. Moreover, meeting the third target Target 1.C of Millennium Development Goal 1 (which calls for halving the 1990 proportion of children underweight for their age by 2015), would mean savings of US$ 2.329 billion between 2004-2005 and 2015. This amount that could rise to US$ 5.966 billion if the scourge of hunger could be completely eradicated over that time (23% and 60% of average annual public health expenditure and 4% and 11% of average social spending by countries in those years, respectively) (ECLAC/WFP 2007 and 2009).

Preliminary data on the costs of illiteracy indicate that in 2006 the inability to read and write entailed productivity losses amounting to US$ 104 million in Ecuador, US$ 135 million in the Dominican Republic and US$ 802 million in the State of São Paulo. If people who have less than six years of education are included, these figures rise to US$ 392 million in Ecuador and US$ 2.254 billion in São Paulo. These amounts are equivalent, respectively, to 69% and 64% of public spending on education for the year in question. Taking into account the entire future working life of illiterate people, the losses indicated above would be 9 to 11 times higher.

The lack of investment in children can be considered a violation of basic social rights, particularly when there are clear nutritional and educational deficiencies. A malnourished and illiterate child is not only a reflection of ethically unacceptable inequalities but is headed for a life with little prospect of achieving his or her potential. Moreover, the loss of capacities and opportunities through malnutrition and illiteracy degrades society as a whole. It means that much of the human potential of future generations —precisely those that should capitalize on the demographic bonus— will be lost as a result of irreversible nutritional damage or the lack of occupational skills. In addition, the costs of remedying the ills that flow from these problems are incalculably higher than the investments needed to avoid them in the first place. When it comes to the cost of not making social investments in children, the ethical dimension and the practical dimension go hand-in-hand.

2. Dealing with old-age insecurity

As the population ages, the generational focus of social spending will become an unavoidable public issue. Spending on social security, in the form of pensions and health care, may rise to the point of crowding out spending on services for society’s reproductive function, which involves women and children. And, even then, the first type of spending may not adequately cover the needs of the older population.

The countries of the region are facing a critical problem: how can they provide basic cash transfers to older persons who can no longer work or find employment while continuing to facilitate high rates of female labour market participation and to invest in human capital for the generations to come? As illustrated in figure VI.8, retirement benefits and pensions reach varying (but generally very low) percentages of those aged over 65, depending on the country. It is clear as well that it is families with low or very low incomes that are most deprived of such support.

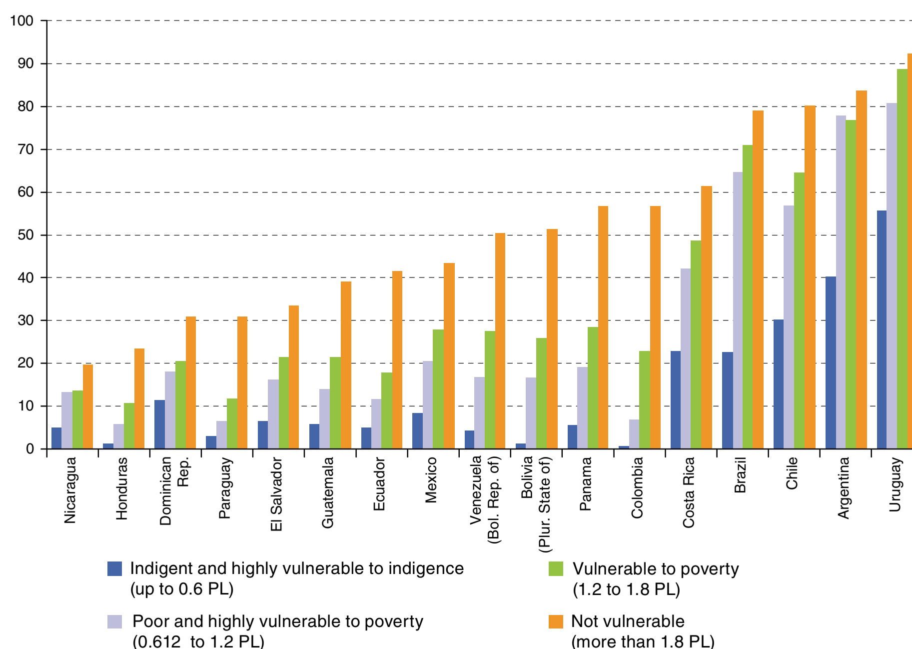
Given the proportion of women among the older population and the fact that few of them have pursued careers that would have entitled them to retirement benefits, pension systems must either recognize the cost in employment continuity and quality foregone by those who shoulder the burden of unpaid work or they must delink a large share of future pensions from the formal labour market.

As ECLAC has proposed (2006b), social protection cannot rely exclusively on contributory systems linked to the labour market, and this calls for a rethinking of redistribution mechanisms. Social security systems have provided only very limited coverage for the rural population. Yet an even greater constraint has been that imposed by the extensive informality in the region's economies. Average social security coverage is below 40%: while it may exceed 45% in urban areas it is lower than 22% in the countryside. Even in those countries with the broadest coverage (Chile, Costa Rica, Panama, Uruguay) barely 60% of urban workers contribute to social security (ECLAC, 2006b).

Figure VI.9

LATIN AMERICA (18 COUNTRIES): PERCENTAGE OF HOUSEHOLDS WITH A MEMBER AGED 65 OR OVER WHO RECEIVES A RETIREMENT BENEFIT OR PENSION, BY INCOME LEVELS, AROUND 2007 [a]

(Multiples of the poverty line)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries

[a] Data for Peru refer to 2003; those for El Salvador to 2004; those for Colombia and Nicaragua to 2005; and those for Argentina, Chile, Guatemala and Mexico to 2006

The reforms pursued in various countries ultimately undermined the public, contributory and social nature of spending of this kind. This is particularly true in the case of pensions policy, especially where individual capitalization systems were introduced. In the wake of those reforms, many Governments have been attempting to offset the negative distributive effects of the reform through new public programmes. In particular they have begun to consider the most reasonable ways to ensure coverage for those who cannot build up the level of contributions required by legislation. This implies significant strengthening of the non-contributory component and generates fiscal pressures, relating in particular to the costs of transition.

Several Caribbean countries have adopted domestic policies to care for older persons and have drawn up strategic implementation plans. Trinidad and Tobago, among others, provides pensions to all older persons through a means-tested system.

Civil society organizations such as HelpAge International have been advocating a basic social (non-contributory) pension that would be provided without a means test to all older persons, as a way of facilitating access. While policymakers in the Caribbean are beginning to recognize the consequences of population ageing for the viability of pension systems, no country has undertaken an in-depth reform in this area.

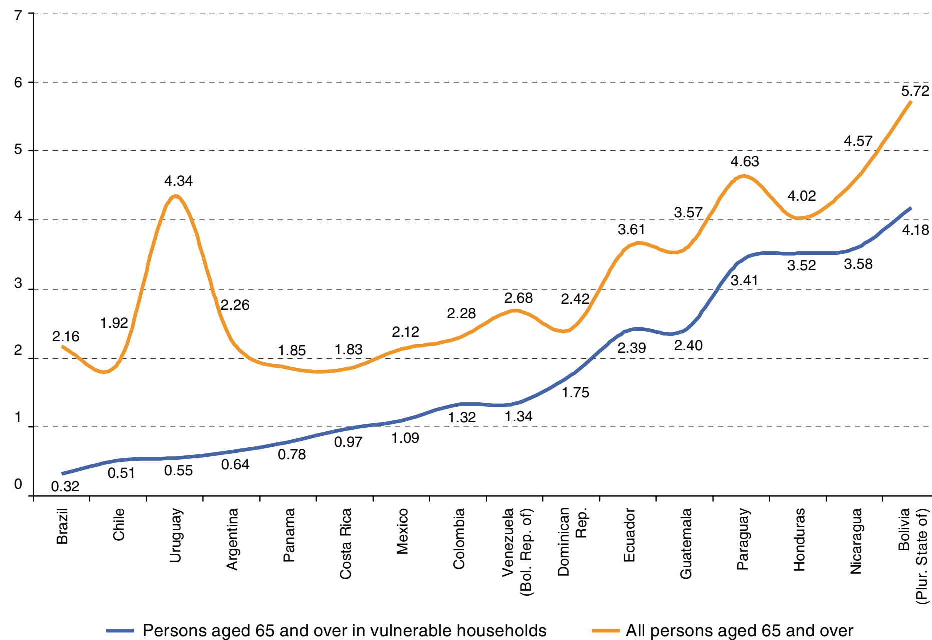
One of the risks in the region is to confuse ageing with the need for traditional pension systems (stratified and contributory). Under this scheme, the population as a whole would soon be called on to finance those few retired formal workers who had stable working careers in the past. Over the long term, it would also imply using the public purse to cover the deficits that this contributory and stratified social security would inevitably generate. On the other hand, the privatization of social security may resolve the deficit problem, but if such systems continue to receive no State subsidy they are bound to exclude a large portion of the older population in the future (Mesa Lago, 2009).

Following attempts to combine stratified pay-as-you-go contributory systems and privately administered individual capitalization models, public debate and policies are now embracing the option of non-contributory uniform pensions, whether universal or targeted (ECLAC, 2006b; Filgueira and others, 2006; Tanzi, 2008). These systems or instruments do not of course resolve the problem of income replacement for active workers: that is not their function. Rather, they are intended to guarantee a basic level of income that is fiscally sustainable and fairer from the intergenerational viewpoint. In Argentina, Brazil, Chile, the Plurinational State of Bolivia and Uruguay (at the provincial and national levels) as well as in Mexico (Federal District and some states) it has been found that a basic guarantee for older persons can be both fiscally prudent and socially desirable if subsidies to the better-off retirees and pensioners (generally men) are limited.

Figure VI.10

LATIN AMERICA (16 COUNTRIES): COST OF TRANSFERRING ONE POVERTY LINE TO PERSONS AGED 65 AND OVER, AROUND 2008 [a]

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries.

[a] Data for Nicaragua refer to 2005; those for Argentina, Chile and Guatemala to 2006; those for the Plurinational State of Bolivia and Honduras to 2007.

A simulation exercise was used to estimate the cost to the region's economies of providing older persons with a universal and a targeted cash benefit (and giving it to all persons over 64 years living in households with per capita incomes below a certain poverty line). As will be seen, for many countries these costs are not exorbitant but merely require the reallocation of available funds. In Argentina, Brazil, Chile, Costa Rica and Uruguay the outlay required represents 1% of GDP or less. This does not mean that these countries should necessarily opt for the benefit examined in this simulation. More targeted or less generous benefits can gradually pave the way for meeting the objective at lower fiscal cost, as is the case in countries where this effort would represent too high a burden on budgets.

The impact of a measure such as the one estimated, in its targeted version, would bring about a clear decline in poverty among the targeted households, since it would reach more than 5% of households in Ecuador and just over 0.5% in Uruguay (a country with very low rates of poverty among older persons).

Table VI.4

LATIN AMERICA (16 COUNTRIES): COVERAGE, BENEFITS AND POVERTY REDUCTION ACHIEVED BY TRANSFERRING ONE POVERTY LINE TO PERSONS AGED 65 AND OVER, AROUND 2008 [a]

	Targeted coverage (percentage of total households)	Average monthly transfer per capita to households with beneficiaries (at constant 2000 prices)	Poor households before transfer (percentage of total households)	Poor households post-transfer (percentage of total households)	Poverty reduction (percentage points)
Argentina	7.6	88.3	14.7	13.1	-1.6
Brazil	3.9	26.5	19.9	19.3	-0.6
Uruguay	5.4	61.3	8.5	7.8	-0.7
Chile	7.8	30.6	11.3	10.0	-1.2
Costa Rica	8.9	41.7	14.8	12.2	-2.7
Panama	23.3	38.3	21.5	18.6	-2.9
Mexico	11.2	55.6	27.9	24.9	-3.0
Colombia	12.0	25.9	35.4	31.8	-3.6
Venezuela (Bolivarian Republic of)	9.1	63.8	23.6	21.5	-2.1
Bolivia (Plurinational State of)	12.9	24.4	47.2	42.5	-4.7
Ecuador	15.8	18.4	36.5	31.3	-5.2
Guatemala	12.2	27.0	46.7	43.3	-3.4
Honduras	17.1	23.0	63.1	58.6	-4.5
Nicaragua	17.2	14.1	54.4	51.0	-3.4
Paraguay	15.0	26.6	50.2	45.1	-5.1
Dominican Republic	14.4	35.2	40.1	35.7	-4.4

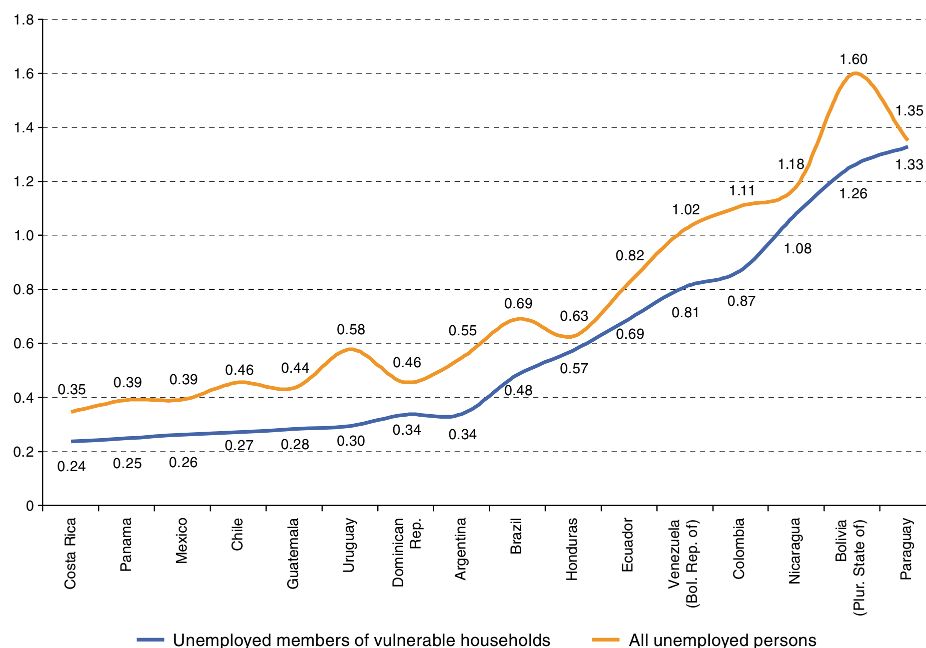
Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries.

[a] Data for Nicaragua refer to 2005; those for Argentina, Chile and Guatemala to 2006; those for the Plurinational State of Bolivia and Honduras to 2007.

3. Towards a less vulnerable labour market: unemployment protection

Unemployment is a scourge not only because of its effect on household incomes but also because of its impact on people's state of mind and their position in society. Government strategies must therefore pay close attention to combating unemployment, especially at times of crisis or when labour markets are sluggish. Yet it is clear that if unemployment insurance is restricted to people who held formal jobs and had sufficient seniority to be eligible, coverage will be insufficient and will not reach the neediest population groups. If programmes are to help the vulnerable and unemployed poor they must be designed to identify and include workers who have no social security. A benefit such as that proposed here could be accompanied by part-time employment in Government-administered works and services and by training. The cost of such a measure would be moderate under several scenarios if it included a selection system to capture those effectively unemployed. As well, given the complexities in identifying unemployed informal workers, the system could be applied only in a typically countercyclical mode, when open unemployment exceeds a predefined threshold or when GDP stalls or contracts. In those cases such mechanisms could be activated to the benefit of all workers who declare themselves unemployed, linking then to Government-sponsored employment and training programmes.

Figure VI.11
LATIN AMERICA (16 COUNTRIES): COST OF TRANSFERRING ONE POVERTY LINE TO THE UNEMPLOYED, AROUND 2008 [a]
(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries.

[a] Data for Nicaragua refer to 2005; those for Argentina, Chile and Guatemala to 2006; those for the Plurinational State of Bolivia and Honduras to 2007.

Table VI.5
LATIN AMERICA (16 COUNTRIES): COVERAGE, BENEFITS AND POVERTY REDUCTION ACHIEVED BY TRANSFERRING ONE POVERTY LINE TO UNEMPLOYED PERSONS, AROUND 2008 [a]

	Targeted coverage (percentage of total households)	Average monthly transfer per capita to households with beneficiaries (at constant 2000 prices)	Poor households before transfer (percentage of total households)	Poor households post-transfer (percentage of total households)	Poverty reduction (percentage points)
Argentina	7.5	48.0	14.7	13.3	-1.5
Bolivia (Plurinational State of)	6.6	14.4	47.2	460	-1.2
Brazil	6.8	23.3	19.9	18.3	-1.5
Chile	5.7	22.1	11.3	10.0	-1.2
Costa Rica	4.7	19.4	14.8	14.1	-0.8
Ecuador	7.3	11.5	36.5	34.8	-1.7
Guatemala	2.4	16.3	46.7	46.3	-0.4
Honduras	4.3	14.9	63.1	62.6	-0.5
Mexico	4.8	31.0	27.9	27.1	-0.8
Colombia	12.2	16.8	35.4	32.9	-2.5
Venezuela (Bolivarian Republic of)	8.0	44.1	23.6	22.2	-1.4
Nicaragua	6.4	11.4	54.4	53.6	-0.8
Panama	8.8	21.5	21.5	20.3	-1.1
Paraguay	8.7	17.8	50. 2	48.6	-1.6
Dominican Rep.	4.5	21.6	40.1	39.3	-0.9
Uruguay	5.1	34.3	8.5	7.5	-1.0

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries.

[a] Data for Nicaragua refer to 2005; those for Argentina, Chile and Guatemala to 2006; those for the Plurinational State of Bolivia and Honduras to 2007.

4. Summing up

The estimates and recommendations offered here are intended to indicate opportunities and tentative roadmaps for reform. They do not claim to propose a single model for the region, with respect to either the design or the scope of reform. They should be treated as a starting point for considering direct income transfer systems and how they could be designed and funded, not as a uniform prescription.

In looking at the total cost involved in direct transfer systems, there are some relevant data to be considered. As shown in figure VI.12, even if the transfer is targeted solely at vulnerable households (with incomes below 1.8 poverty lines), countries with smaller well-being gaps would need to commit between 1.8 and 2.7 percentage points of GDP in order to transfer income equivalent to a basket of food and non-food goods to the unemployed and to those aged over 65 or under 15. While this represents a significant effort, it is not unreasonable if those targets are projected over time. By way of illustration, if coverage were restricted or benefits reduced (for example by half) the effort would in no case tie up more than 1.5% of GDP. In many of these

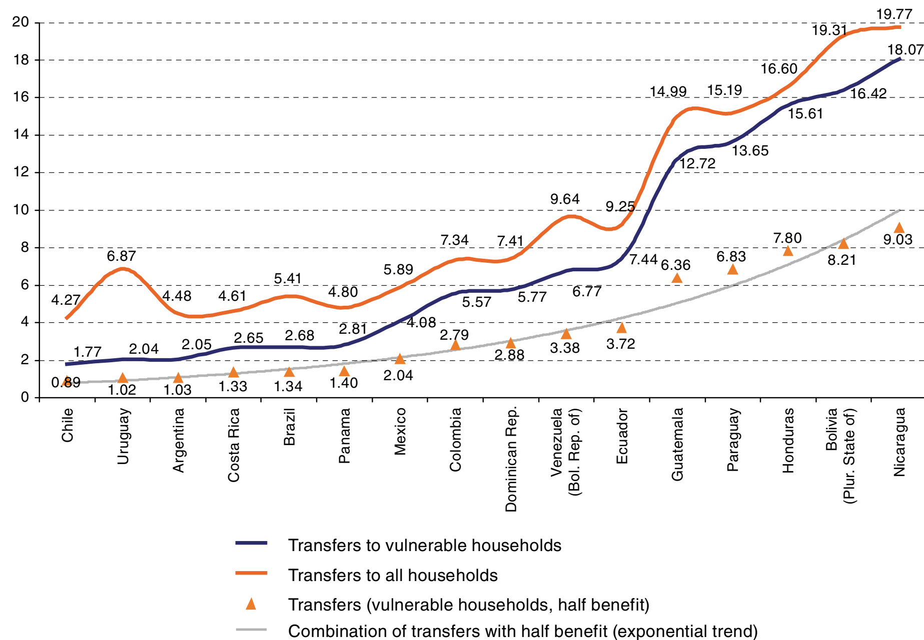
countries the measures proposed here already exist, but not with the simplicity and the scope with which they were simulated in the exercise. This suggests that a relatively simple design of a basic guaranteed income supplement is fiscally feasible.

As we move towards countries with intermediate or large welfare gaps, the challenges become more complex. In countries with a serious welfare gap (see figure VI.12) fiscal reality and social needs clearly imply starting from different bases and prioritizing among options, and they will demand strong political will and renewed social covenants (particularly for increasing the tax burden, reforming its structure and strengthening public institutions). It seems essential at least to progress towards providing basic income coverage for households with young children, since this would have the greatest impact on human capital.[10]

Figure VI.12

LATIN AMERICA (16 COUNTRIES): COST OF ALL INCOME TRANSFERS TO VULNERABLE HOUSEHOLDS AND ALL HOUSEHOLDS

(Percentages of GDP)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the countries.

Lastly, as shown in table VI.6, the impact on poverty reduction and income distribution from this set of transfers is very significant, particularly in countries of the third group with relatively lower levels of development, more poverty, weaker social protection systems and more precarious labour markets.

[10] It should be recalled that the simulation exercise for the targeted alternative referred to the entire population under 1.8 times the poverty line, which represents between 70% and 80% of the population in the group of countries with the widest well-being gap.

Table VI.6

LATIN AMERICA (16 COUNTRIES): IMPACT OF A BASIC TRANSFER ON POVERTY AND EQUITY [a]

	Coverage (percentage of total households)	Average monthly transfer per capita to households with beneficiaries (at constant 2000 prices)	Poverty before transfer of one poverty line (percentage of total households)	Poverty after transfer of one poverty line (percentage of total households)	Poverty reduction (percentage points)	Gini without transfers	Gini after transfers
Argentina	30.2	71.8	14.7	6.7	-8.0	0.52	0.48
Bolivia (Plurinational State of)	59.3	20.9	47.2	29.2	-18.0	0.58	0.48
Brazil	32.4	26.9	19.9	11.2	-8.7	0.61	0.58
Chile	28.7	28.8	11.3	4.5	-6.8	0.54	0.51
Costa Rica	33.5	30.4	14.8	5.9	-9.0	0.49	0.45
Ecuador	56.9	15.8	36.5	18.1	-18.5	0.52	0.44
Guatemala	65.6	26.7	46.7	26.7	-20.0	0.59	0.50
Honduras	72.9	23.9	63.1	44.1	-19.0	0.58	0.46
Mexico	49.1	47.3	27.9	13.0	-14.9	0.54	0.49
Colombia	51.8	25.2	35.4	18.0	-17.4	0.59	0.58
Venezuela (Bolivarian Republic of)	45.9	64.3	23.6	10.0	-13.6	0.42	0.36
Nicaragua	70.3	17.5	54.4	34.6	-19.8	0.55	0.45
Panama	73.3	31.8	21.5	9.9	-11.6	0.52	0.47
Paraguay	64.6	24.7	50.2	29.2	-21.0	0.54	0.45
Dominican Rep.	50.1	33.2	40.1	23.6	-16.5	0.58	0.50
Uruguay	23.0	52.7	8.5	2.6	-5.9	0.44	0.41

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Data for Nicaragua refer to 2005; those for Argentina, Chile and Guatemala to 2006; those for the Plurinational State of Bolivia and Honduras to 2007.

It is essential to steer social investment towards the lowest-income groups, with long-term countercyclical policies that will offset the swings of the economic cycle, and with explicit guarantees and assured quality levels. Social protection and promotion systems should be seen as a comprehensive alternative of great utility. But they require significant progress in the areas of financial security and institutional stability, for which reason they need to be backed by a social covenant. This will be explored in greater depth in chapter VII.

F. The lever of education

Education is a multifaceted lever for development. A society with higher education levels will be better equipped to take prompt advantage of technical progress, it will produce more innovation and it will be more competitive and productive. Political action will also benefit from a better-educated population, for the knowledge society and democratic life require broader political participation by an informed citizenry with critical capacities and a civic mindset.

Education plays a decisive role in the search for equality. Learning that is less segmented by socio-economic level, gender, territory and ethnic origin will help reduce the inequality gap from one generation to the next. It will prepare new generations to take their place productively in the

labour market and it will offer them greater opportunities for social and occupational mobility throughout their lives, thereby reducing future wage and well-being gaps. In addition, knowledge and information are today the keys to expanding social capital and participating in distance communication, which are in turn fundamental to social inclusion and life plans. Today's greater educational achievements will result tomorrow in households with greater cultural capital, which in turn is a key condition for the educational success of future generations. There is here a virtuous circle that helps to reduce educational divides. Lastly, evidence shows that in families with higher education levels there is less risk of child malnutrition and adolescent pregnancy, which reproduce exclusion from one generation to another.

A strategy to achieve equality in education must give priority to expanding the coverage of preschool education and lengthening the school day in public schools, improving secondary completion rates in socio-economic sectors with lower achievement levels (considering that coverage and completion are now almost universal for primary education) and reducing the learning and knowledge gaps built up over the education cycle from preschool to the end of secondary.

1. Universalizing preschool education and extending the school day

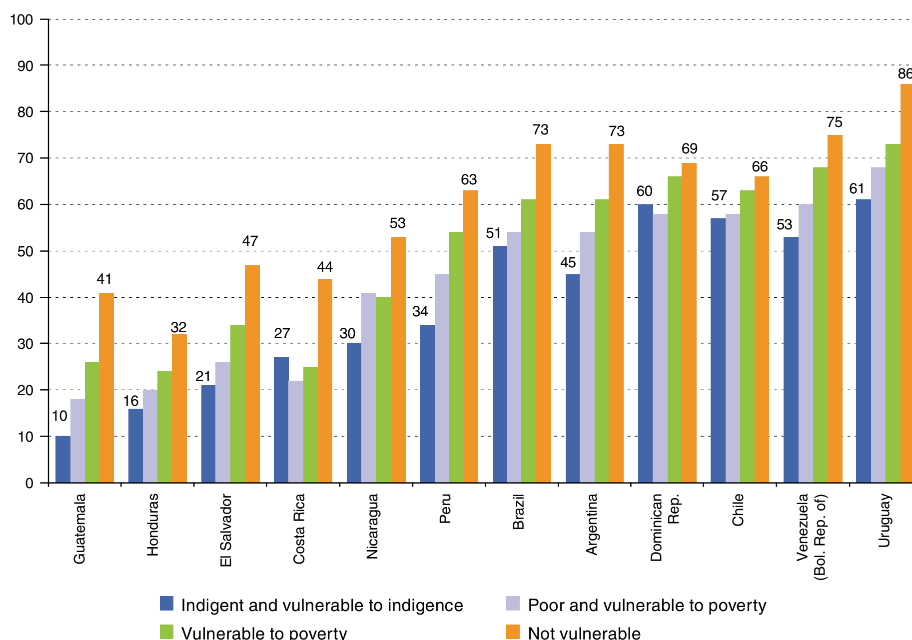
Preschool education serves a double purpose. First, it evens out learning abilities at the outset of the educational career, which has a strong bearing on outcomes at later levels of education. Early stimulation and preschool preparation have been shown to make a substantial difference in performance at the subsequent levels, particularly primary and secondary. Ensuring preschool education within the public system can help counter differences of family background and promote equality of opportunities for learning. Second, increased preschool coverage, like the lengthening of the school day, reduces the hours that adults, especially women, have to devote to child care. This facilitates the emancipation of women, enhances their access to the labour market, boosts household incomes (particularly for poor households, with a positive effect on equality and reducing monetary poverty) and promotes gender equality.

Although significant progress has been made, the coverage of childcare services is still poor and fairly dispersed. In most countries the majority of facilities offering high-quality, full-day childcare are private, and their coverage is segmented by ability to pay. Participation rates in childcare and preschool education programmes are higher in urban areas, a factor that reproduces inequality since, according to a wealth of international empirical evidence, it is children from the most disadvantaged social groups who are most in need of early education programmes (ECLAC, 2008a).

In recent years policies to expand education programmes have been gaining ground in public agendas in various countries. Costa Rica, Peru, Uruguay and the Caribbean countries, for example, have made significant progress in preschool education (birth to 5 years). Nevertheless, much remains to be done to make early childhood and preschool education into building blocks for redistributing opportunities for young children and for re-balancing care responsibilities between the sexes. In the countries with greatest coverage, participation in preschool education is two thirds of the primary school enrolment rate (with the sole exception of Uruguay, where it is 74%), while it ranges from 20% to less than 50% in other countries. As figure VI.13 indicates, preschool attendance by children from 3 to 5 years is highly stratified, with access proportional to household income: participation is lowest among children from poor households and those vulnerable to poverty (with incomes up to

1.8 poverty lines). There is no systematic information available to assess coverage for children from birth to three years of age. However, coverage is very low in those countries that do have such data.

Figure VI.13
LATIN AMERICA (12 COUNTRIES): CHILDREN AGED 3 TO 5 ATTENDING AN EDUCATIONAL ESTABLISHMENT, AROUND 2007 [a]
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Data for Peru refer to 2003; those for El Salvador to 2004; those for Nicaragua to 2005; and those for Argentina, Chile and Guatemala to 2006. Information on the Dominican Republic refers to attendance by children aged 4 and 5.

International research has shown that a longer school day creates the conditions to enhance learning processes. It also creates positive externalities for families, by alleviating concerns over after-school care, including nutritional needs, and freeing mothers to join the workforce. When children are kept longer in school they are less likely to be exposed to the risks associated with spending several hours of the day in the street. This in turn helps to reinforce family life, giving parents greater assurance that their children will be safe in their activities (ECLAC, 2008a). In Chile, Colombia and Uruguay, for example, there have been significant efforts to extend the school day, at least at the primary level (and also at the secondary level in the case of Chile). However, such moves are still pending in most countries.

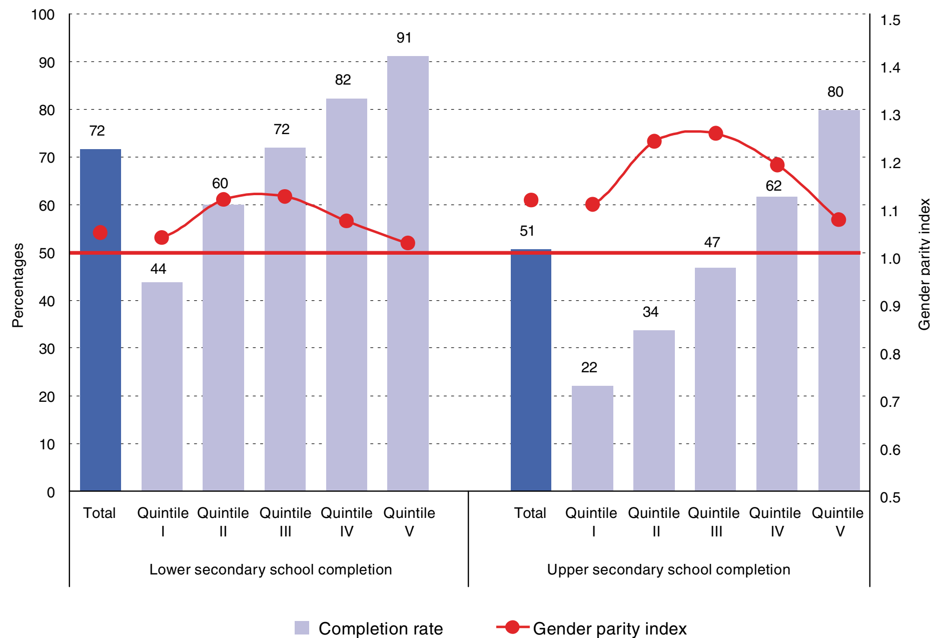
2. Greater equality in secondary education outcomes, with smaller learning gaps

According to ECLAC estimates, secondary school completion is a key to social inclusion. With a education credentials, young people are better equipped to find a job and hence to avoid or escape from poverty. Yet the pattern of secondary school graduation in the region is highly stratified. Figure VI.14 illustrates this stratification in secondary and tertiary completion rates in Latin America around 2006. While gender parity has been more than achieved (a greater percentage of young women then men complete secondary school), in general the average graduation rate is very low (51%), and this perpetuates low productivity in economies. The secondary graduation gap by income quintiles is extremely significant: in the first quintile one in five youngsters will complete secondary school, while four in five will do so in the fifth quintile. These contrasts show that education in its current form reinforces the intergenerational transmission of inequality instead of reversing it.

Figure VI.14

LATIN AMERICA (18 COUNTRIES): LOWER AND UPPER SECONDARY SCHOOL COMPLETION AMONG YOUNG PEOPLE AGED 20 TO 24, BY HOUSEHOLD INCOME QUINTILE AND SEX, AROUND 2006 [a]

(Percentages and ratios)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the respective countries.

[a] Regional totals may differ from those shown in other figures because in this case the widest available geographic coverages were used. The right-hand axis here represents the ratio of female to male graduates: values exceeding 1.00 indicate a higher percentage of female than male graduates.

In the English-speaking Caribbean, secondary school enrolment rates have risen considerably, but it is still the case that only 75% of primary school leavers go on to secondary school. Major challenges remain in terms of the quality and equity of the education provided. Constraints on the capacities of the teaching body[11] contribute to the fact that many young people leave the school system without the basic knowledge needed to play a productive role in society. A school completion certificate is often the only official document that a young person in the subregion will have. The content of secondary education continues to be abstract and remote from current social and economic needs in the Caribbean. This poses a serious constraint on the development of the Caribbean subregion, for knowledge demands are growing sharply with the expansion of services, construction and tourism, which require employees with intermediate or higher instruction.

Latin America and the Caribbean must therefore improve coverage, grade promotion and completion in secondary education, as well as enhancing the quality of its contents. This is essential, first, from the viewpoint of socially equitable economic development. Second, it also represents a sociodemographic opportunity. These societies are moving towards having a smaller relative (and absolute) child population, while the numbers completing primary school will rise steadily (ECLAC, 2008a). This offers an opportunity to increase financial and political efforts to improve the coverage and advancement rates in public secondary education. Yet this window of opportunity will close as the proportion of older people increases, with the attendant financing demands for health care and pensions. For the same reason, in most countries of the region now is the time to focus efforts on secondary school advancement and completion, particularly for those sectors of society that face the most obstacles in this regard. There is a need, then, to review the composition of education expenditure by levels and to boost investment in secondary education. Coherent incentives also needed to increase the system's human resources (teachers, managers, planners), to encourage students to stay in school, and to enhance the quality and relevance of schooling by updating contents, technologies and knowledge transmission methods.

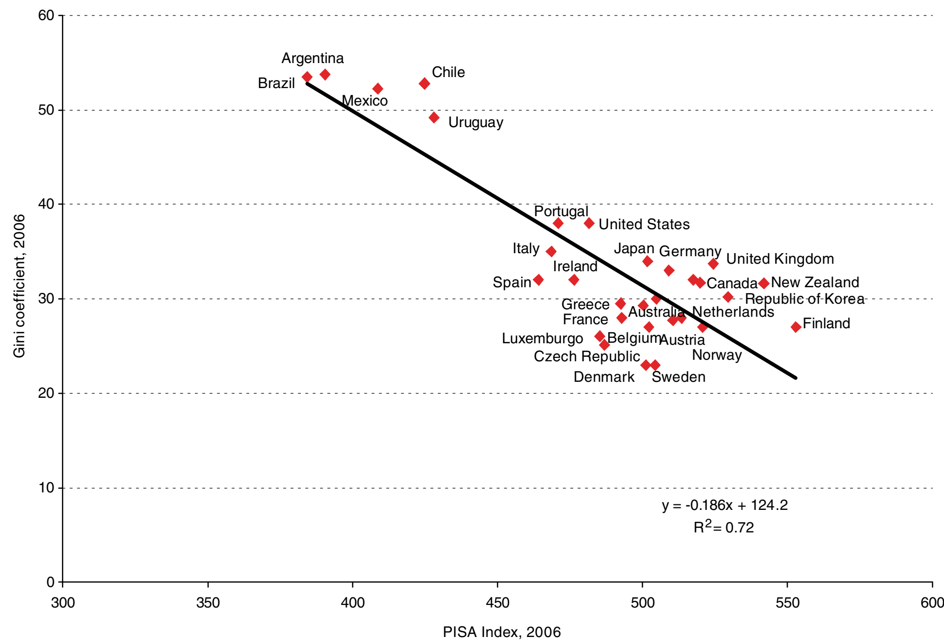
Secondary school completion is today a minimum requirement for finding employment that will support an acceptable standard of living. It is also a condition for participating effectively in the information society and exercising citizenship. Improving the quality of education will offer lower-income youth more equitable access to higher education and training. This will give young people a greater sense of belonging and a stronger belief in meritocracy, both of which are key aspects of social cohesion (ECLAC/OIJ, 2008).

Finally, education gaps by socio-economic group are found not only in access to preschool education, secondary school completion, and access to vocational or technical education. The quality of education offered to different socioeconomic groups throughout the education cycle is also very uneven, as are learning outcomes. Figure VI.15 compares the findings of the Programme for International Student Assessment (PISA), which measures learning in the education system. It shows that countries with less income inequality have much higher effective learning scores. In

[11] With World Bank support, member states of the Organization of Eastern Caribbean States (OECS) have been pursuing an education reform strategy adopted by their ministers of education in 2000. The strategy seeks to develop a regional approach that will make more efficient use of scarce institutional capacities and financial resources so as to improve the quality and accessibility of secondary education in a selected number of OECS member countries. The initiative is based on earlier reforms of basic education undertaken in Dominica, Grenada and Saint Lucia, and the secondary education reforms in Dominica and in Saint Kitts and Nevis.

other words, more egalitarian countries exhibit greater synchrony, with much higher aggregate learning achievements. There is no more compelling relationship between educational equality and development dynamics.

Figure VI.15
EDUCATIONAL OUTCOMES AND THE GINI COEFFICIENT



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of Antonio Afonso, Ludger Schuknecht and Vito Tanzi, "Income distribution determinants and public spending efficiency", *Working Paper*, No. 861, European Central Bank, 2008 for countries of the Organisation for Economic Co-operation and Development (OECD); Ivonne González and Ricardo Martner, "Del síndrome del casillero vacío al desarrollo inclusivo: buscando los determinantes de la distribución del ingreso en América Latina'', document presented at the twenty-second Regional seminar on fiscal policy, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 26-29 January 2010, for Latin American countries.

Available data from standardized tests measuring the quality of education show a systematic and persistent learning gap in some Latin American countries in favour of students in private schools compared to those in public schools. This indicates that the quality of the education available is stratified according to families' ability to pay for education from their own pocket. Moreover, the educational level of parents plays an important role in their children's academic achievements, and this is also correlated with family income. On demand and supply sides alike, then, the status quo reproduces gaps in knowledge and skills.

Public policies face many complex challenges in closing social gaps. When it comes to education policy, the array of challenges is wide and well known: to improve teachers' skills and rewards, to make greater instructional use of information and communications technologies (ICT) in the public education system, to improve management at the level of the school and also of central and decentralized agencies, to work with families to keep young people in the school system and ensure they progress through it in a timely fashion, to lengthen the school day while

making the contents of instruction more relevant, and to provide universal preschool education.[12] These achievements are the springboard for a qualitative leap towards greater equality, better educational outcomes, and less segmentation of abilities to absorb knowledge and acquire skills through education.

Yet it is not just a question of investing more money. Those additional resources must be applied in ways that will achieve greater impact and efficiency. The evidence suggests that nearly all countries of the region experience a persistent problem in translating spending into better indices of learning, advancement and completion. Public education spending has risen steadily in nearly all countries of the region over the last two decades (see the case of the Caribbean in table VI.7). The bulk of this increase has gone to primary education, followed by secondary. However, this financial effort has not produced any significant progress in learning outcomes or in the quality of public education. Progress at the secondary level is inadequate both with respect to grade advancement and completion rates. The region thus faces the challenge of understanding and dealing with the "lag effect" in education investment. It is known that the fruits of such investment take a long time to mature, but it is also true that many countries of the region have been boosting investment and reforming management in education for two decades now.

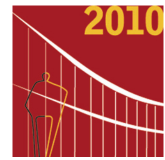
Table VI.7
THE CARIBBEAN: PUBLIC SPENDING ON EDUCATION
(Percentages of GDP)

Country	1991	2000-2007
Bahamas	16.3	19.7
Barbados	22.2	16.4
Belize	18.5	18.1
Grenada	11.9	12.9
Guyana	6.5	15.5
Jamaica	12.8	8.8
Saint Kitts and Nevis	11.6	12.7
Saint Vincent and the Grenadines	13.8	16.1
Trinidad and Tobago	12.4	13.4

Source: United Nations Development Programme (UNDP), *Human Development Report, 2009*, New York, 2009.

What is needed now is a concerted effort in the institutional sphere and in the public management of education. Today the sociodemographic window of opportunity is open for addressing productivity and equality needs. The wind is blowing is favour today, but if the region fails to grasp the opportunity, it may blow against tomorrow.

[12] In this respect, conditional cash transfer programmes seek to have a positive impact on low-income families by requiring their children’s attendance at school as a condition for the transfer.



Chapter VII

State, political action, fiscal policy and social covenants: an equation in the making

A. Where we are coming from

It has been said with some justification that the end of the twentieth century came not in 2000 but in 1989, with the fall of the Berlin wall. This is partially true if we think of the profound change in political parameters which led to this historic milestone and which redesigned the political and economic architecture of the planet. These changes occurred in the context of consolidation of a new production paradigm, based on the acceleration of scientific and technological knowledge and the increasing globalization of markets and communications, as well as the intensification of competition.

At the time, Kenichi Ohmae (1995), one of the business strategy gurus of the contemporary world, prophesied the end of the Nation State and foresaw that this category would be relegated to the museum of history and be replaced by four irresistible forces: capital, corporations, consumers and communication. He also anticipated that, at the international economic level, "business units" or "region States", meaning globalized economic zones in various parts of the planet, would replace States as such. In addition to this academic vision, the Washington Consensus on "reform and modernization of States" defined concepts setting limits on State action in the economic and social sphere (Bárcena, 2009b).

In Latin America and the Caribbean, the early 1980s were marked by the debt crisis, which coincided with the above-mentioned reorientation of politics and the economy, the new model of globalization and the predominant social model based on self-regulated market mechanisms and predominance of private agents. In the diagnosis of the reasons for the Latin American crisis given at that time, particular blame was assigned to the excessive growth of government in the

preceding decades and to the inability to control the public deficit and the wage demands of the public and private sectors. This criticism coincided with economic globalization, or the “wave of openness”, the trend towards deregulation of global trade, both financial and commercial, and offshoring for cost reasons. In this context, two main types of measures were promoted in the region: measures designed to promote stability through public policies dictated by market mechanisms and measures aimed at reducing the size of government and the extent of its intervention in the economy.

The policy package put in place in almost all countries in Latin America and the Caribbean reflected this vision of development and included resizing the public sector, reducing the para-State sector and eliminating expenditure and transfers not considered to be priority or strategic (which unfortunately included some in the social sector). Admittedly, during this period significant progress was also made as regards macroeconomic institutional policy and adoption of measures to achieve greater fiscal prudence. In the process, however, institutions were dismantled that were essential to the development of sectors such as agriculture or industry and that played an important role in long-term policymaking and productive development.

Today the States in the region are facing a considerable deficit. This is also a reflection of our contradictions, of structural heterogeneity, of our history of inequalities and inequities, of a chequered political path on which progress is still needed towards better-quality democracy, and of our unfinished fiscal reform. Our States have not achieved sufficient credibility as providers of public goods, raisers of fiscal revenue, guarantors of social well-being or promoters of productivity and employment. However, there is growing consensus about the fundamental role played by the State and the inability of markets to perform these tasks. In addition, the current financial crisis, considered to be the worst since the Great Depression, marks the end of a cycle of growth and prosperity and an opportunity to chart a new course for development. Over the past two decades, the globalization of markets and the accompanying dominant ideology projected a one-sided and partial image of progress. Now this image is being questioned in the light of the profound instability revealed by the crisis, the uncertainty about future growth and the exacerbation of social vulnerability.

The market/State/society equation prevailing for the past three decades has proved incapable of responding to the global challenges of today and tomorrow. The goal is therefore to make sure that the State is in the right place to face the future.

B. Where we want to go: recreating the link between the State and society

The political democratization of Latin America and the Caribbean unified the ethical principles of liberty and equality. Nowadays, both these principles are essential: one cannot take priority over or be sacrificed to the other. However, while balance and mutual reinforcement between these principles has been achieved at the level of values and norms, in practice political democratization seems to have progressed much further than social democratization, although not all the problems of the former have been solved. In addition, it must be acknowledged that the flourishing of the liberal and individualist tenets essential to legitimize political democracy does not necessarily create a climate conducive to the principles and mechanisms of equality.

Today, both nationally and regionally, we see the tentative emergence of a new "polis", of a process of reconstruction of the relationship between State and society. Renewal of the Nation State model assumes that an ethical, political and socio-economic community is to be reconstituted. This too means putting the issue of equality at the heart of the agenda.

In this approach to development, societies must refocus on the following three essential values.

First, the general good and the provision of public goods, involving the creation and provision by the State of goods that benefit the whole of society. These require considerable investments, which may not show results for some time. Public goods can be found in areas as diverse as education and health, production infrastructure, transportation, communications, energy, the environment, investment in science and technology, social peace at home and abroad, administration of justice, democratic elections and public security. Macroeconomic equilibrium – in its broad sense of price stability, employment, work and instrumental capital and macro-prices such as the exchange rate – is also a public good which can be shared simultaneously by the various economic agents. As well as providing public goods, States will have to be able to participate responsibly in the international arena in order to provide global goods such as financial stability, pandemic control and climate security. In this connection, a new State architecture is needed so that the State can play a more significant role in ensuring general well-being and spearheading our countries' development strategy, over and above the functions defined by the subordinate State paradigm.

Second, the value of the concerted strategic vision. Societies have memory and build a future. In order to think and act on development, one must learn from past experience and approach development from a strategic viewpoint. Like the life of people, the future of societies is created over time: a society that does not educate itself, that does not invest in social cohesion, that does not innovate, that does not build consensus and that does not have solid and stable institutions has little chance of thriving. In this connection, the State must be able to provide strategic management with a long-term vision, to play a prophetic role and to intervene in the design of policies geared to national development. Here it is important to remember that the State acts in a context of shared power, so that the negotiation and creation of strategic national consensuses are both the means and the end. For this reason, the State must be able to promote a dialogue giving it greater legitimacy to reconcile the various interests with clear socio-economic goals through regulation, which implies a need to improve its own regulatory abilities.

Third, enhancing the previous two, is the value of political action. The model focusing on market self-regulation placed too much emphasis on the consumer, to the detriment of the citizen, as well as on the political neutrality of technical criteria. But consumers are not all equal before the market and they therefore have unequal access and power. On the other hand, in a democratic society citizens have the same rights and duties and voting does not depend on consumption capacity. Ultimately, democracy is the way citizens decide which public goods should be guaranteed to the entire population and to what extent they should be provided. This civic will is expressed through the democratic institutions and must be constructed and preserved as a common good by the State entities. The public domain must revert to the community and be accessible to all citizens and not only to the Government or the State.

These three values require a new role for the State and full enjoyment of democracy. It is only on the basis of civic democracy that the State can refocus on the concept of general interest, rethink the meaning of the common good, invest in the production and provision of public goods and again become involved in building the future.

C. Towards a new State architecture: the main approaches for closing gaps and opening trails

A new State architecture must be created that will allow the State to play its rightful role as leader of our countries' development strategies. By casting a critical eye on its historical performance, we should be able to define that role, give the State the proper tools and determine its precise place in conjunction with the market and the citizens, achieving an optimum balance of this trilogy in the development dynamic.

In order to do this, we must abandon assumptions now disproved by historical evidence, which at the time alternated between condemnation of the market and condemnation of the State. The excellence and efficiency of our markets will depend to a large extent on the quality and probity of States to regulate them with appropriate oversight mechanisms, incentives and guidance. Above all, it is clear that there are functions for which responsibility lies with the State, working for the common good and social cohesion.

The market alone does not produce equality or public goods; nor is it concerned with the situation in the long term. This is not to deny the usefulness of market mechanisms or of a suitable public-private mix for resource allocation and provision of services. In this connection, advocacy of greater State involvement does not minimize the importance of market functions.

Previous chapters described major challenges as regards State policies for boosting growth, promoting productivity, encouraging greater territorial coordination, achieving better employment conditions and better labour policy and providing public goods and social protection with a clear universalist and redistributive focus. These are complex tasks, in which there can be no overnight success. They require arduous technical work, the creation of social covenants and development financing. They respond to a threefold challenge: to boost the economies of the region in order to achieve development, to deal with the crisis and its antecedents using new policy instruments, and to eliminate the region's long-standing legacy of inequality and social exclusion. This in turn means that it is now urgently necessary to reform the tax and transfer system with a view to generating more revenue-raising power and —in contrast with the individualist market model— to making social solidarity the focus of collective life. It will then be possible to move towards real equality of rights and opportunities, recognizing growth as a prerequisite for development, for which purpose it must be accompanied by decent work, social cohesion and environmental sustainability.

Earlier chapters described the central functions of a new State in order to revitalize the strategic vision of development, closing gaps and opening avenues, with the maxim of equality for growth and growth for equality. To sum up, these are the main proposals made in each of the earlier chapters.

1. The macroeconomic environment

The macroeconomic environment has repercussions for both growth and equity, since it affects the investment rate and its impact on future development trends, the value added content of exports and how they tie in with the rest of domestic production (GDP), innovation, development of small and medium-sized enterprises (SMEs) and the formality or precariousness of the labour market. The greater the macroeconomic instability, the more adverse will be its effects on GDP, productivity, the investment rate and employment formality. Macroeconomic-policymaking style therefore has clear implications for all these variables.

Macroeconomic strategies must be designed to bring economies closer to their potential frontier, to protect them from external volatility and to make them stronger by proactive use of the available instruments (in the areas of finance, taxation and foreign exchange). As a corollary, it is argued that the design and alternative implementation of such instruments affect the various firms and workers in different ways, with substantive consequences for the degree of inequality. Gradual and comprehensive application of macroeconomic policy can and must contribute to the creation of decent employment and to the necessary progress towards production convergence and productive development.

The earlier analyses provide a set of guidelines. First, in order to achieve less volatile economies, closer to their growth potential, oversight of the capital account must be improved. This is not the same as adopting generic protectionist measures or blocking transnational financial flows. The instruments may include measures ranging from regulation of its size to a mix of incentives and disincentives to localization and mobility of foreign capital depending on types, cycles and size of flows. Second, the necessary soundness and technical autonomy of central banks must be ensured through clear forms of macroeconomic coordination by Governments and an institutional structure that is responsive to indicators from the non-financial economy. In recent history, among the mechanisms and goals of central banks, inflation is usually considered to be the most important parameter compared with others such as growth, employment and productive investment. The type of investment is important, since the central bank and economic entities must contribute to the creation of a production structure that gradually creates a more equitable market, so that productivity and earning gaps between firms of different sizes and workers of different social origins can be gradually narrowed. More significant and ongoing liaison between central banks and ministries of planning, finance, industry and agriculture, forestry and livestock farming is not only desirable but essential in a productive development project.

Third, fiscal equilibrium and countercyclicality require a strong determination to expand countries' fiscal capacity, which in most cases means increasing the tax burden. In a recent study, Woo (2009) shows that inequality measured by income and educational capital is strongly linked to three key variables: fiscal volatility, fiscal procyclicality and low economic growth. To unravel this nexus requires clear and countercyclical fiscal rules aimed at reducing added volatility and expanding the fiscal base in order to increase spending and egalitarian social investment. Monetary and exchange policy should reflect these general objectives, promoting macro prices that will encourage agents to invest in activities that help to reduce structural heterogeneity.

There will be no significant and sustained improvement in poverty and income distribution in Latin America and the Caribbean unless active fiscal policies are adopted to influence the efficiency and distributive potential of markets. In other cases, the priority might instead be to improve the quality of spending, as regards resource allocation as well as efficiency and effectiveness, in order to achieve a sustained reduction in inequality in the social and economic structure.

The design and construction of an inclusive financial system aimed at productive financing require expansion and development of the instruments available for managing risk, diversifying access and extending relevant deadlines. This involves a considerable increase in SME financing and expansion of the role of microfinance, with varying coverage and institutional arrangements. The incomplete state of existing capital markets has been an insurmountable barrier preventing many SMEs from making development strides, which are an essential ingredient for achieving

growth with equality. Reform of the capital market along these lines requires strengthening of public banking and especially of development banking, as an instrument to facilitate and democratize access to credit, particularly long-term credit for investment financing.

In short, a reform of the Washington Consensus reforms should promote linkage of the financial system to the process of domestic investment and thus to the domestic economy rather than to foreign financial markets. It must also contribute to greater economic stability, avoiding dissociation of the exchange rate from real interest rates in order to reduce the frequency and severity of cyclical fluctuations and to prevent real interest rates from being consistently negative or too high. Lastly, the aim should be to deconcentrate economic power through inclusive financing mechanisms facilitating SME access. Avoidance of an accumulation of imbalances in aggregate demand, the current account or the exchange rate by timely application of countercyclical policies requires continuous mini-adjustments of macroeconomic variables. There will then be no need for traumatic major modifications, which usually involve over-adjustments of macro prices and recessions that exacerbate inequality.

In turn, foreign capital can play a useful role by supplementing national savings. The composition and stability of flows are important, and it is essential to distinguish between foreign investment creating new productive capacity and financial flows which are purely speculative and highly procyclical. Indiscriminate financial liberalization proved ineffective in achieving productive development and real macroeconomic stability, and prejudicial to the goal of reducing inequality. The global crisis, an example of the risks of unregulated financierism, has created space for the application of more pragmatic policies for countercyclical regulation of the capital account in the countries of the region.

Development sustainability requires public policies compatible with social inclusion, with countries participating in the international economy in a manner that is increasingly integrated domestically and socially. How to tackle the reform of national capital markets and their link with international financial markets is a crucial challenge to be met in order to achieve a macroeconomy that underpins sustained economic and social development.

2. Production convergence

The State must play a very active role in the sphere of productivity. This is necessary, on the one hand, to draw closer to the international production frontier and craft a more dynamic structure that can drive growth and learning. On the other hand, an active State role is needed to close the domestic productivity gaps that perpetuate inequalities through structural heterogeneity. In this connection, this document has emphasized the need for public policies on industrial development, technological innovation, financing for less productive sectors, and promotion of SMEs, as well as enhanced coordination between the State and production agents to close the energy gap and achieve more sustainable and lower-carbon production and consumption.

In this context, the production structure should be transformed on the basis of three integrated policy axes: (i) industrial, with a focus on innovation-intensive sectors (closing the gaps between sectors); (ii) technological, involving strengthening of supply and linkage of supply with demand in order to create and disseminate knowledge (closing the gap with regard to the international frontier), and (iii) support for SMEs, recognizing asymmetries between enterprises in responding to price signals (closing gaps between agents).

In order to give priority to the development of knowledge-intensive sectors and break the vicious cycle of factor endowment related to natural resources, States must create new institutional policy, fiscal policy and strategy for the production framework and its agents.

As stated above, sound development banking, with long-term financing and planning capacity, can achieve a sustained increase in investment in knowledge-intensive sectors and encourage innovation. It also promotes a substantial increase in investment in SMEs to increase their productivity and linkages to larger enterprises and bigger markets. Lastly, efforts should be made to finance innovative projects linking academia and business in long-term commitments.

Support for the development, stability, productivity and profitability of SMEs requires institutional change, to which greater fiscal priority should be given. SMEs are not a foot-note in the strategy of development with equality but one of its cornerstones. As part of this institutional reform, the State should be given instruments to enable it to eliminate asymmetries between agents as regards access to information, credit and technology.

Numerous instruments exist for moving the production frontier of Latin American and Caribbean societies: sectoral technology funds, systems of public ownership or revenue for mining activities involving strategic resources and a mix of trade-related and fiscal instruments such as tariffs, selective tax waivers and taxes, designed to support key export sectors or those which are linked into transnational platforms.

Lastly, there must be a strong medium- and long-term commitment to significantly increase public investment in research and development and infrastructure creation. Without production capacity linked to output and without logistics to convert opportunities into real platforms for generation of wealth and communications, growth bottlenecks cannot be eliminated. It will not be possible to leverage the growth cycles stemming from changes in the structure of relative international prices into qualitative leaps in output and productivity.

Of course, what is proposed here involves creating and allocating revenue on the basis of government decisions and requires a fiscal and institutional commitment that is difficult to maintain in the long term. Regarding the first point, when the State provides revenue to the private sector, it must do so solely on the understanding that the return in public value from the use of the aid will be greater than the initial cost of providing it. It is never easy to discipline the recipients of government revenue, but the twentieth century provides no examples of strong growth in which real strides were made without instruments of this type. Covenants between public and private agents are crucial in this area, as will be seen at the end of this chapter. As regards fiscal sustainability, it must be understood that institutional and fiscal capacity-building for States specifically means increasing their capacity to play a leading role in the network of private agents which development requires.

3. Territorial convergence

Because of the diversity of institutions and actors influencing territorial development, it is essential to build territorial cohesion covenants allowing top-down and bottom-up coordination of efforts to promote regional and local development. In order to reverse territorial inequality, it is also necessary to resolve general inequality, initially by linking the most marginalized spaces with hubs of natural-resource-based exports. Hence the importance of public policies backed by covenants between stakeholders in the various territorial subdivisions, designed to promote greater equality in this sphere.

The State must play a central role, if the strategic focus of improved territorial equality is to be the creation of territorial cohesion funds, which here serve at least three purposes. First, they transfer funds from the central level to the subnational levels, with a commitment to use them for the creation of synergies between spheres of production, for capacity-building and for correcting basic lacks. The second purpose is redistributive, taking the form of transfers or cross-subsidies, in the same way as income tax is used to transfer resources or provide services to those who are unable to pay for them. Redistribution to achieve greater equality of opportunities and rights is part of the role of the State advocated in this document. Third, a territorial cohesion fund serves as an instrument for coordinating sectoral and spatial policies, in order to avoid duplication and promote more integrated forms of participation. It is thus a mechanism of intersectoral planning applicable to areas in which sectoral decentralization usually leaves many gaps.

Intergovernmental transfers can play an important role in the correction of territorial disparities, in conjunction with regional development policies established at the national level, operating in both a top-down and a bottom-up manner with local or provincial authorities. The financing of territorial development and the resulting elimination of disparities must be based on the fiscal efforts of the subnational levels themselves —such as better tax collection— and on transfer systems applied in the context of carefully coordinated development programmes.

The provision of basic services in segregated cities, with municipal financing arrangements based on territorial taxes, is very unequal and exacerbates disparities. The State is in a position to break this vicious cycle by pursuing direct policies such as territorial tax redistribution funds, extra resources, zoned allocations and special programmes in vulnerable districts.

4. More and better employment

We are proposing active State policies geared to improving the quality of employment and the capacity of the labour force, such as minimum wage policies, production support and protection of the economically active population (EAP) in the informal sector, assistance to population groups with major labour-market-integration problems and coordination between labour policy and social protection. A more active role is advocated for the State in promoting labour negotiation forums, both in order to improve income distribution through negotiated wage increases and in order to facilitate sustainable agreements linking increased productivity to improvement of working conditions.

Labour policy must serve a dual purpose: to promote the efficient functioning of the labour market and to protect its weaker stakeholders. The central problem of labour market rigidities and their impact on formality does not lie with hiring and firing costs. The real reason for lack of formalization is the cost of social security contributions. Disincentives to firing and incentives for retaining and training workers are positive, inasmuch as they are reflected in higher productivity and greater capacity-building for workers. Programmes are also needed to evaluate exemption or subsidy systems for contributions by SMEs and individual entrepreneurs in order to achieve a better balance and avoid informality as an extreme form of flexibilization. In a broader context, it is essential for labour policy to be linked to a long-term development strategy.

In addition, it is important for the State —in partnership with representatives of business and academia— to promote the creation of a national training system. This is doubly important, because it will provide a dynamic response taking into account demand characteristics and the people’s needs and aspirations.

A minimum wage policy is advisable. The lowest price of labour should not be set by the market. It could be slightly above the price that the market might naturally set. Be that as it may, minimum-wage-setting must be a long-term policy, with a gradual increase in the minimum wage, which must be compatible with production and credit policies.

There is also a need to broaden the base for funding unemployment insurance (ranging from contributions to general revenue) and its eligibility criteria (ranging from formal workers with considerable seniority to the most precarious and temporary forms). A countercyclical unemployment fund is also necessary for times of recession and crisis, with eligibility further broadened to include unemployed workers in the informal sector. In these phases of the cycle, these strategies should be accompanied by active employment policies such as direct job creation by the State. This should be supplemented by more permanent training policies and linkage of labour supply and demand.

There should also be movement towards basic minimum health and income protection that is not solely contingent on belonging to the formal sector and making the relevant contributions. The transition from social protection with an eligibility criterion based on formal employment to an approach based on rights and citizenship also requires a shift in social protection financing, with less emphasis on payroll funding and more importance given to the universal and progressive tax bases providing general revenue.

The following measures should also be adopted: (i) arrangements to protect and promote labour market integration, particularly for the weakest, including standards on the length of the workday and occupational health or programmes to promote labour integration for groups facing special obstacles; (ii) enactment of anti-discrimination legislation, if it does not already exist; (iii) promotion of social-labour dialogue to improve labour policy; (iv) development of a strategy to gradually increase the coverage of labour policy; (v) organization of a modern and efficient labour inspection system, and (vi) creation of efficient and expeditious labour courts.

5. Closing social gaps

In the social area, emphasis has been placed on the central role played by the State in providing the equality agenda with its pillars of social protection and promotion. This is of fundamental importance, because here the market, left to its own self-regulation mechanisms, has widened quality and achievement gaps instead of closing them. For this reason, progress is needed in charting a new course for the State as regards social issues, towards a more active role in well-being with a sustained increase in social spending, capacity-building in social institutions in order to improve public management and income transfer systems with a clear distributive impact. In other words, programmes should be designed around an integrated social protection system, with strong non-contributory solidary pillars and a clear universalist approach, compatible with the principle of equal rights. In the area of education, where inequalities of origin have long been perpetuated instead of being reversed, the State should play a strong role in promoting greater access to pre-primary education, especially in groups that cannot pay the costs out of pocket. It is also necessary to extend the school day in public schools, to enable lower-income groups to move towards completion of secondary education and to ensure that quality and learning gaps within public supply and between public and private education are gradually closed.

The design of a basic universal social protection system —income security and health— inevitably involves upgrading non-contributory social protection solidarity mechanisms, expanding assistance programmes, balancing paid and unpaid work and facilitating women's entry in the labour market. Otherwise the demographic window of opportunity will be wasted or missed.

Public social spending must be increased and its countercyclical bias enhanced.[1] However, it is not enough simply to spend more. A new expenditure architecture is needed that is more egalitarian, suited to existing risk structures and geared to enhancing countries' production capacity.

This requires, first of all, a system of targeted or universal income transfers based on a minimum general income for older persons, with limitation or abolition of pension subsidies and large pensions. There is a great need for complementary systems of guaranteed income that are not dependent on the labour market and which are flexible and expandable at times of recession. Particular attention should be paid to the creation or expansion of non-contributory income transfers (basic supplement) to vulnerable families with children, as well as subsidies to vulnerable households which lose contributory coverage in a crisis.

Of course, the State cannot and should not do everything itself, even as regards assistance and redistribution. Hence the need to enhance social networks providing various services, benefits and support programmes, linking public and private agents with social stakeholders.

However, while transfers to equalize, protect and stabilize the well-being of households are necessary and positive, they do not suffice to create more egalitarian and productive societies. The region is faced with productivity and equality bottlenecks caused by both demand and supply problems. Many counties have not succeeded in pushing back their well-being frontiers even when demand-side economic opportunities have arisen. This is because the production framework creates opportunities but is not fully able to take advantage of them. For this reason, it is crucial to invest in actions that promote the activation and accumulation of capacity and know-how. Social spending should increasingly become social investment. In this connection, promoting universal preschool education would serve the threefold purpose of equalizing opportunities, increasing the productivity of future workers and freeing up the female workforce, whose participation in the labour market is limited by caregiving responsibilities. Something similar occurs when daycare coverage is expanded and the school day is extended.

Lastly —although it has been said before, it is no less true now— a key challenge in the short and medium terms is to invest in primary education quality and expand secondary education coverage and access, improving teachers' skills and knowledge. This is the only way for societies to expand frontiers and close gaps at the same time. Today these education strategies have both an ally and a challenge in the expansion of the use of information and communication technologies (ICT) in the public education system.

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[1] Given their GDP levels, most Latin American countries' social spending could be far higher. As will be seen below, this because they also have a much lower tax burden as a percentage of GDP. In a recent financial year, Sabaini identified a gap of almost 3% of GDP between the actual and the potential tax burden in the region. In the most extreme case, the gap was as much as 14% of GDP. Even without reaching these levels, the large majority of the countries of the region clearly can and should increase the tax burden, preferably using progressive instruments.

This raises the question of the amount of resources available to government authorities. The level of public spending depends on countries' revenue-raising ability. Here, taxation is the means by which the State's financial capacity can be increased so that it can play its proactive role in the promotion of development and social equality.

Finally, in the political sphere the State plays a leading role which it cannot abdicate. The goal here is to ensure more democracy and more equality, which are two sides of the same coin. As regards democracy, the State must strive to improve the quality of political action in its procedures, through a strategic agenda reflecting the deliberations of a broad spectrum of stakeholders and through popular will expressed in covenants that provide political legitimacy and ensure the application of medium- and long-term policies. As regards equality, the State must focus on increasing the participation of the excluded and vulnerable sectors in the fruits of growth. For this purpose, equality of citizenship —of rights, of voice representation, of full subjects of law— is the link between political action and social equality.

Although it has been mentioned, the topic of climate change has not been addressed in-depth here. Climate change will undoubtedly occupy an increasingly important place on the international agenda and among countries' responsibilities. This agenda requires us to change how we produce, consume, generate and use energy, making the carbon footprint one of the main variables of competitiveness. Climate change also has an ethical dimension, one of intergenerational solidarity, in view of the looming threats to the planet unless appropriate action is taken today. Adaptation and mitigation policies involve long-term planning, particularly as regards infrastructure, transport, land use and energy production. What is required here is strong and decisive action by the State, long-term investments and incentives to change cultural habits and daily life.

D. Taxation as the key to linking the State with equality

1. The place of public spending in development

As documented in chapters I and II, the region's fiscal spaces have benefited from the steep debt reduction achieved by Governments during the boom period. Of course, in the next few years, the difficulty of obtaining resources in a context of slow growth (see chapter I) and considerable expenditure needs will again put pressure on public finances. The discussion of expenditure efficiency and revenue-raising ability is even more relevant if equality becomes a priority goal of development strategy.

On the expenditure side, it is worth recalling the three traditional functions of fiscal policy (Musgrave, 1959 and 1998): allocation of public goods (that is, by encouraging the political process by which they become available); redistribution of income; and promotion of macroeconomic stabilization. Although the region has unfinished business in all these areas (chapter II deals with the countercyclical role of fiscal policy), the functions of public goods allocation and income redistribution certainly deserve special attention.

The dilemma of the dichotomy between growth and equality, always latent, becomes less relevant when priority is given to spending that has positive effects on economic growth, formal employment and access to public goods. Empirical evidence shows that the repercussions of public spending on growth vary depending on its composition. What is important is to adopt a

comprehensive and strategic approach, which considers effects both on well-being and on production convergence, in order to choose the right level and structure of spending in the light of the equality and productivity goals proposed in this document.

The non-linear relationship between public spending and growth varies depending on the type of expenditure (European Commission, 2008). First, it is important to distinguish between public spending and public investment and, to the extent possible, to emphasize the latter. Second, a distinction must be drawn between various types of disbursement. For example, interest payments will always be negative for growth and employment, inasmuch as they are resources that could have been used for productive purposes. In countries with large financing needs, multiple financing sources must be considered, including borrowing, in order to build physical and human capital. However, public spending financed at high interest rates in a context of low growth is to be avoided or treated as a last resort. For this reason, in order to achieve fiscal balance with appropriate public debt levels, numerous variables must be considered on the basis of fiscal sustainability criteria.

Government consumption, wages and salaries and pensions to a certain extent represent efficient expenditure, but their excessive growth may negatively affect savings and investment. Transfers to deal with social exclusion and unemployment, housing, and the family and children increase macroeconomic efficiency to the extent that they promote women’s participation, labour integration of excluded persons and private consumption. This confirms one of the main messages of this work: pro-welfare social spending must be seen as a social investment that helps to reduce structural heterogeneity and to encourage production convergence.

Spending on education, active labour market policies, health, research and development, and gross fixed capital formation is strongly pro-growth. Thus the production of public goods has the dual advantage of creating conditions propitious to growth and creating employment in the formal sectors of the economy, guaranteeing both equality of access and equality of opportunity.

The non-linear macroeconomic effect of public spending must be emphasized. This is not to say that it is inefficient to increase public spending, but it cannot be relied upon as the sole engine of development either. In the vast majority of the countries of the region, the level of spending on public goods is still far from optimal, even if the goal were solely economic growth. This potential for increased public spending is accompanied by a need to improve its productivity. The two are not mutually exclusive but complementary.

Thus improvement of public spending quality in Latin America and the Caribbean requires sustained investment in physical and human capital and innovation. In some countries of the region, the effort to carve out the fiscal space for reducing poverty and inequality would benefit much from a better quality of public spending, in the form of increased investment in education and knowledge and expedited spending on physical investment, innovation and knowledge. At the same time, as seen in chapter VI, efforts must continue to be made to universalize rights and emphasize the most progressive categories of social spending.

In many countries, this need for quality is accompanied by a need for increased coverage, since the provision of essential public goods is insufficient. The poverty reduction strategy of the most vulnerable countries of the region has focused too much on welfare spending and has not sufficiently emphasized other aspects inherent in a broader strategy, such as public investment in infrastructure, in order to stimulate growth by reducing poverty and inequality.

Reorienting public spending and increasing programme coverage are long-range tasks. In fact, government plans and national development strategies are increasingly including fiscal goals that are beyond the time frame of a single administration and therefore constitute State policies. As discussed below, the work of enhancing the foundations of the State's financial administration is an integral part of a broad fiscal covenant.

Use of explicit comprehensive planning instruments and of a medium-term public spending framework can facilitate the necessary reassignment between functional categories. The key to a successful multi-year framework is institutional mechanisms that allow decision-makers to balance total available resources with country priorities. For example, multi-year budgeting —the financial expression of the development plan in terms of economic and functional classifications— is a powerful programming tool and illustrates the ability to set public priorities in a democratic system.

2. The progressive effects of income and expenditure

In Latin America and the Caribbean, fiscal policy does not have the same progressive impact on equality as in the countries of the Organisation for Economic Co-operation and Development (OECD), which partly explains the great inequity in the region in terms of income distribution and quality of public goods. As regards both income and public spending, the redistributive function of the State is a work in progress.

The effects of fiscal policies may be direct or indirect. On the spending side, measures to increase income in the lower deciles have a direct impact on poverty and probably also on income distribution. Mechanisms such as conditional cash transfers are also used to improve the social inclusion of the most vulnerable sectors. Large enough spending of this kind is an important factor in explaining Gini index variations. There are also indirect and longer-term effects when resources are invested in public goods, since public policies affecting the productivity of the poorest pay back in the form of growth and equity. There is no doubt that public spending on justice, public safety, infrastructure and public transport, health, training, social inclusion and many other areas benefits the poor most, by improving the conditions under which they are integrated into the labour force.

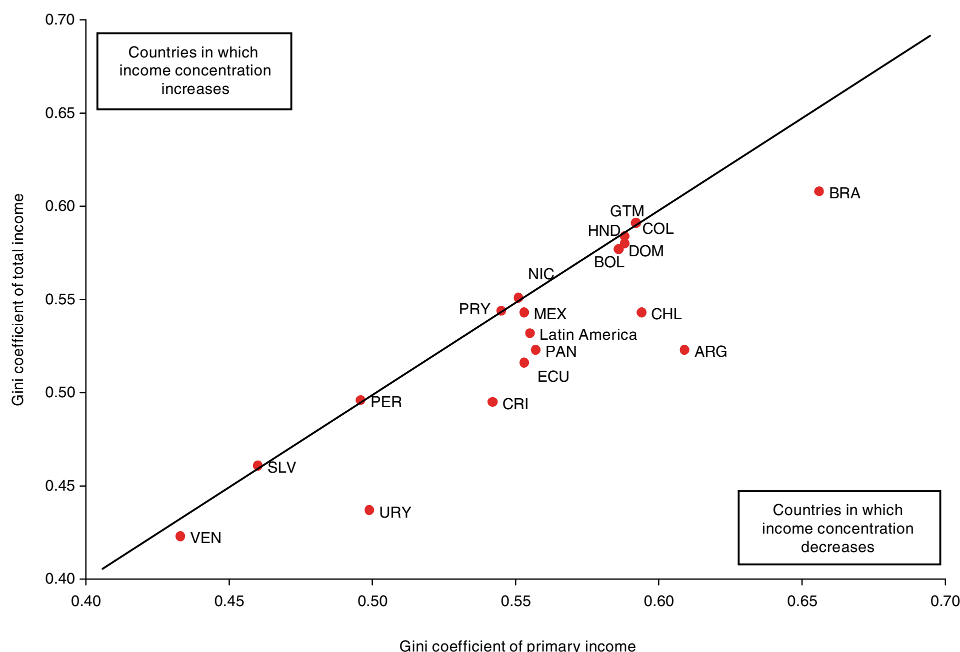
With regard to revenue-raising, the level and progressiveness of taxes directly affect income distribution. The ability of the tax system to correct unequal distribution will depend on the volume of resources raised and how the rates are structured by income level, and also on income tax evasion and the number of exemptions. In the medium term, the tax system can also influence labour supply (for example, if employers bear a heavy burden), individual effort and family size, all of which affect income distribution trends.

Thus direct State intervention through cash transfers and tax level and structure can be said to have a significant impact on poverty and income distribution. For example, in OECD the estimated Gini coefficient before taxes and transfers is 0.45, dropping to 0.31 following direct redistributive action by the State, including the progressive component of the tax system which accounts for one third of the impact, and cash transfers to lower-income groups, especially those over 65 years of age (OCDE, 2009d).[2] As can be seen in figure VII.1, in some Latin American countries the respective Gini variation is much smaller.

[2] The impact on poverty is also direct and striking: in the OECD countries, before taxes and transfers relative poverty was 50%, whereas after fiscal measures it was only 15%.

Figure VII.1

LATIN AMERICA (18 COUNTRIES): GINI COEFFICIENT FOR PRIMARY PER CAPITA INCOME AND TOTAL PER CAPITA INCOME OF HOUSEHOLDS, AROUND 2008 [a]



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from household surveys conducted in the relevant countries.

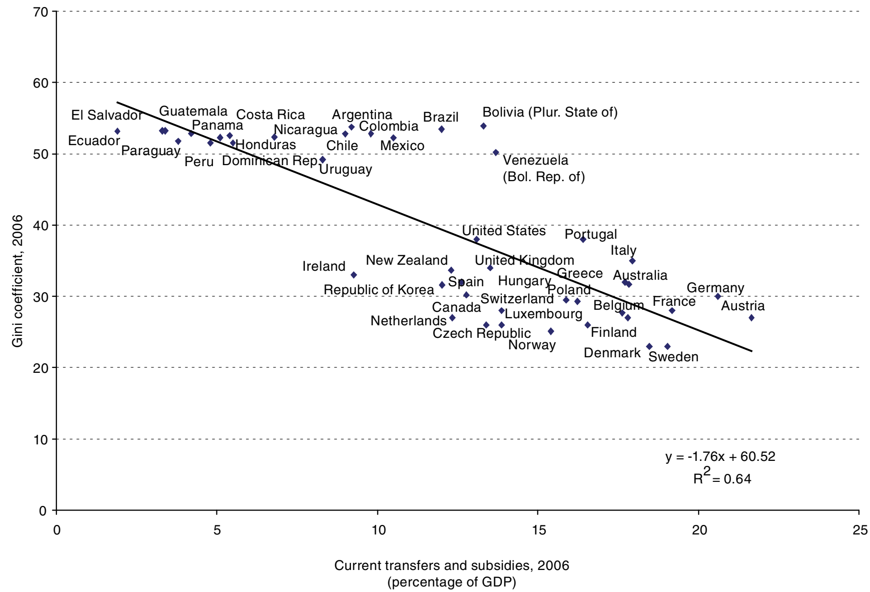
[a] Refers to primary income, after taxes and social security contributions.

Another way to illustrate this distributive effect is to estimate directly the impact of the variables which significantly affect the Gini coefficient, including social spending and tax composition (see Afonso, Schuknecht and Tanzi (2008) for the OECD countries). Application of this methodology to the countries of Latin America gives very similar results (Gonzalez and Martner, 2010) (see figures VII.2 and VII.3).

Figures VII.2 and VII.3 eloquently demonstrate, first, a marked synchronicity between the more egalitarian countries where transfers and subsidies account for a much larger percentage of GDP and, second, a definite link between equality and higher income tax. This does not mean that that there is a one-way causal relationship between these variables. As has been seen in earlier chapters, other factors have a considerable effect on equality, such as greater productive and territorial convergence and "historical accumulation" of capacity and knowledge, culture and provision of public goods.

Figure VII.2

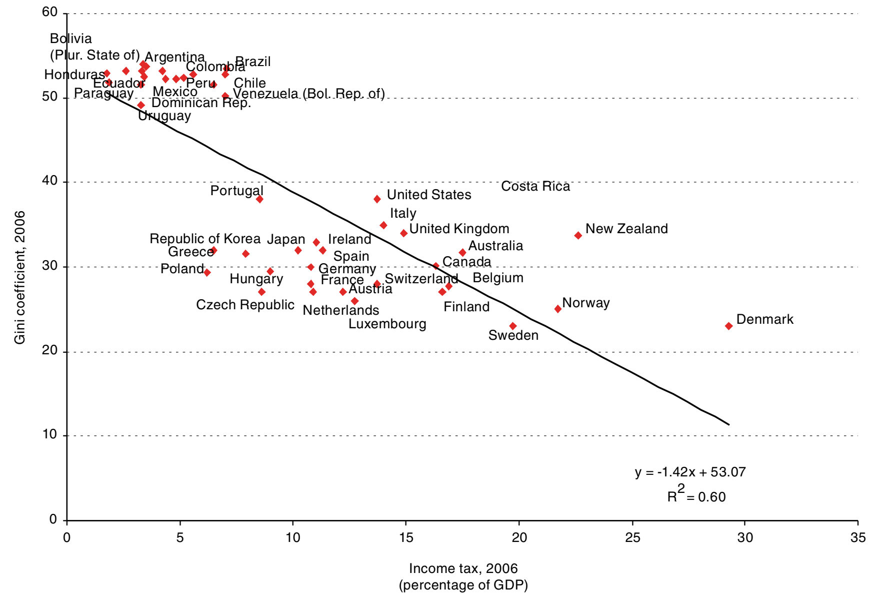
LATIN AMERICA AND THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD): PUBLIC TRANSFERS AND GINI COEFFICIENT



Source: Ivonne González and Ricardo Martner, "Del síndrome del casillero vacío al desarrollo inclusivo: buscando los determinantes de la distribución del ingreso en América Latina", document presented at the twenty-second Regional Seminar on Fiscal Policy, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 26-29 January 2010.

Figure VII.3

LATIN AMERICA AND THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD): INCOME TAX AND GINI COEFFICIENT



Source: Ivonne González and Ricardo Martner, "Del síndrome del casillero vacío al desarrollo inclusivo: buscando los determinantes de la distribución del ingreso en América Latina", document presented at the twenty-second Regional Seminar on Fiscal Policy, Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 26-29 January 2010.

3. A progressive and efficient tax structure

Three factors affect fiscal revenue-raising capacity and how these resources are distributed throughout society: tax burden, tax structure and measures to combat tax evasion.

The average tax ratio in Latin America is about 18% of GDP. This is very low, in view of the region's relative level of development and, above all, of the resource requirements implicit in the public policy demands facing the Latin American States, to which reference has been made in previous chapters. That said, the tax burden in the region, including social security, increased on average from 12.8% in 1990 to 18.4% in 2008 (see table VII.1.A). In addition, fiscal resources from the exploitation of natural resources surged in some countries, including the Bolivarian Republic of Venezuela, Chile, Ecuador, Mexico and the Plurinational State of Bolivia. Although revenue from this source is rather more volatile than other revenues, it increased the region's total average tax receipts to about 23.5% of GDP in 2008. In the Caribbean countries, tax receipts average 26.3% of GDP, as shown in table VII.1.B, which is significantly higher than the figure for Latin America.

One way of judging whether tax receipts and the tax structure are "right" is to compare the ratio of taxes to GDP in a number of countries. The situation of Latin America and the Caribbean compared with other regions of the world is very revealing. In 2007, the tax burden of OECD was almost twice that of Latin America as a percentage of GDP. In addition, various studies on the subject show that potential tax receipts in the countries of the region are much higher than the actual level. On the basis of a recent work by Gómez Sabaini, Jiménez and Podestá (2009), figure VII.4 shows that only Argentina, Brazil, Nicaragua and the Plurinational State of Bolivia have a high tax ratio in relation to per capita GDP, whereas in Uruguay and Costa Rica the tax ratio seems compatible with their level of development (see figure VII.4). In the other countries of the region, the tax ratio is clearly lower than it should be in view of their level of development. This means that there is scope for increasing public revenue and therefore the redistributive capacity of the State through the provision of more resources.

However, the Latin American and Caribbean region not only fails to collect enough; it also collects poorly. Less than one third of tax revenues come from direct taxes, while the bulk comes from excise tax and other indirect levies.[3] Accordingly, it is not surprising that the distribution of income after tax is even more inequitable than primary distribution. The tax ratio difference between the OECD countries and the Latin American countries can be explained mainly by the low burden of tax on income and net worth in the region, since the level of excise taxes is quite similar. Although corporate income tax is quite similar in the two groups (just over 3% of GDP in OECD), there are significant differences in income tax (0.9% of GDP in Latin America, compared with almost 9% of GDP in OECD). Since personal income tax is the most progressive kind of tax, this would indicate that the Latin American countries' tax structure is more regressive than that of the developed economies, which adversely affects income distribution and is one of the reasons why the Latin American and Caribbean region is among the most unequal on the planet.

[3] Although in the Caribbean indirect taxes also account for most of the total, resources from foreign trade duties are more important.

Table VII.1

LATIN AMERICA: TAX REVENUE OF CENTRAL GOVERNMENT, INCLUDING SOCIAL SECURITY CONTRIBUTIONS

(Percentages of GDP)

	1990	2000	2008
Argentina [a]	16.0	21.5	30.6
Bolivia (Plurinational State of) [a]	9.3	17.9	21.7
Brazil [a]	26.4	30.4	35.5
Chile [a]	15.5	18.9	20.9
Colombia [a b]	9.5	14.9	18.4
Costa Rica [a]	16.9	18.9	23.1
Cuba	…	27.5	25.2
Ecuador	10.1	11.6	16.5
El Salvador	10.5	12.4	14.6
Guatemala	7.6	10.9	11.6
Haiti	7.3	7.9	9.5
Honduras	12.9	14.3	15.9
Mexico	11.4	11.0	9.4
Nicaragua	9.0	17.5	21.7
Panama	14.7	16.0	16.5
Paraguay	9.9	12.0	13.7
Peru	11.7	14.1	17.4
Dominican Republic	7.1	11.3	15.0
Uruguay	21.2	22.5	23.3
Venezuela (Bolivarian Republic of)	18.7	13.6	14.2
Average for Latin America (excluding Cuba)	12.9	15.7	18.4
Average for Latin America	12.9	16.3	18.7

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] General government.

[b] The 2008 figure corresponds to 2007.

Table VII.2

THE CARIBBEAN: TAX REVENUE OF CENTRAL GOVERNMENT, EXCLUDING SOCIAL SECURITY CONTRIBUTIONS [a]

(Percentages of GDP)

	1990	2000	2008
Antigua and Barbuda	18.4	15.8	21.3
Bahamas [b]	15.7	15.5	15.5
Barbados [b c]	28.2	31.1	34.1
Belize [b]	…	23.9	21.2
Dominica [b]	22.9	24.9	28.9
Grenada	22.3	22.7	23.7
Guyana	27.6	29.1	32.0
Jamaica	20.7	22.6	26.5
Saint Kitts and Nevis	19.9	21.2	27.0
Saint Vincent and the Grenadines	24.0	24.0	28.1
Saint Lucia	26.0	22.5	27.1
Suriname [b]	…	34.1	22.8
Trinidad and Tobago [b]	22.4	25.3	33.8
Average for the Caribbean	22.6	24.0	26.3

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

[a] Fiscal years. Excluding social security contributions.

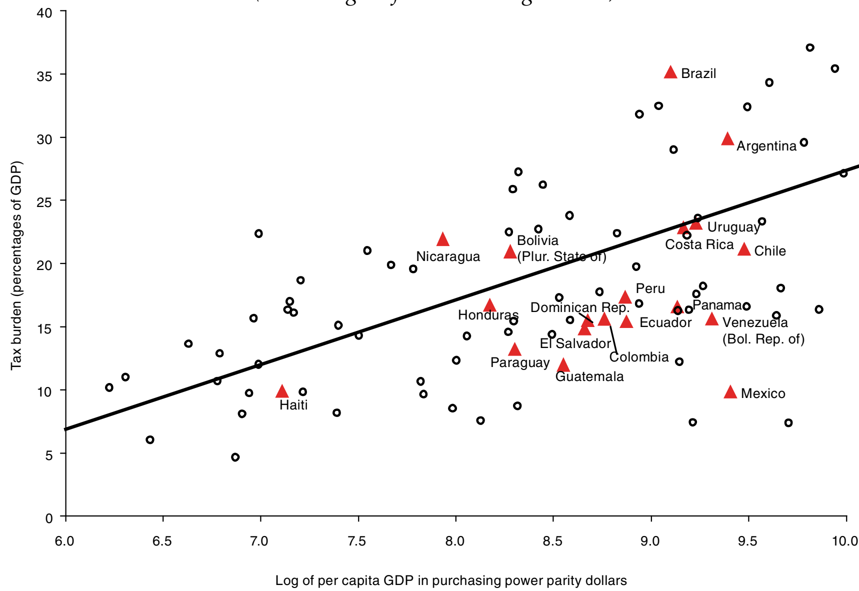
[b] The 1990 figures in the case of the Bahamas and Barbados refer to 1995, in the case of Dominica to 1993 and in the case of Trinidad and Tobago to 1999. The 2000 figures for Belize and Suriname correspond to 2001.

[c] Non-financial public sector.

Figure VII.4

GLOBAL COMPARISON OF TAX BURDEN AND PER CAPITA GDP IN PURCHASING POWER PARITY

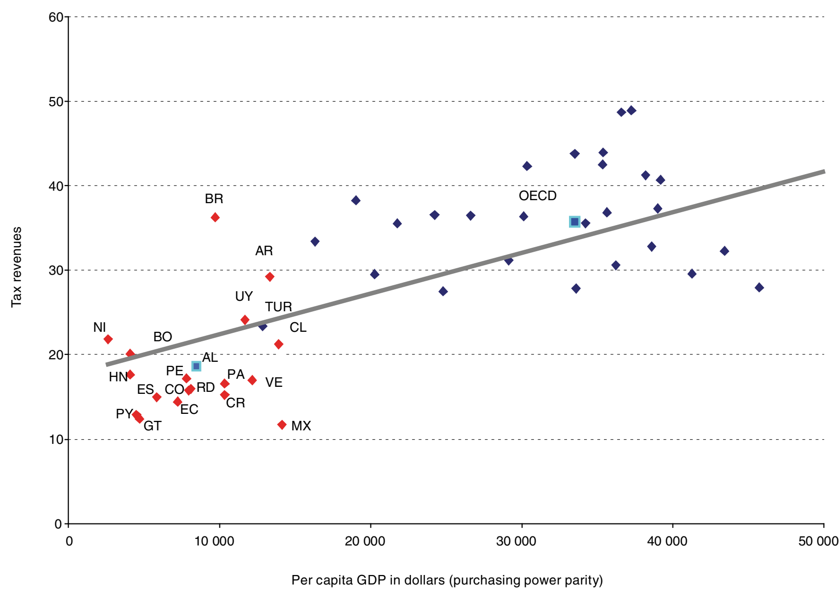
(Percentages of GDP and logarithms)



Source: J.C. Gómez Sabaini, J.P. Jiménez and A. Podestá, "Tributación, evasión y equidad en América Latina", *Evasión y equidad en América Latina*, Project document Nº 309 (LC/W.309), J.C. Gómez Sabaini, J.P. Jiménez and A. Podestá (comps.), Santiago, Chile, Economic Commission for Latin America and the Caribbean (ECLAC), 2010.

Figure VII.5

LATIN AMERICA AND THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD): TAX REVENUE AND PER CAPITA GDP, 2007 [a b]



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures.

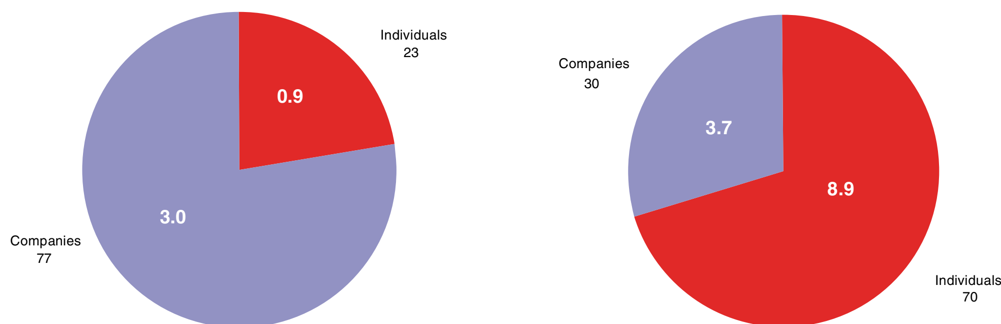
[a] GDP is expressed at 2000 constant prices.

[b] Tax revenue data include social security contributions and cover general government in Argentina, Brazil, Chile, Costa Rica, the Plurinational State of Bolivia and Uruguay.

However, the Latin American and Caribbean region not only fails to collect enough; it also collects poorly. Less than one third of tax revenues come from direct taxes, while the bulk comes from excise tax and other indirect levies.[4] Accordingly, it is not surprising that the distribution of income after tax is even more inequitable than primary distribution. The tax ratio difference between the OECD countries and the Latin American countries can be explained mainly by the low burden of tax on income and net worth in the region, since the level of excise taxes is quite similar. Although corporate income tax is quite similar in the two groups (just over 3% of GDP in OECD), there are significant differences in income tax (0.9% of GDP in Latin America, compared with almost 9% of GDP in OECD). Since personal income tax is the most progressive kind of tax, this would indicate that the Latin American countries' tax structure is more regressive than that of the developed economies, which adversely affects income distribution and is one of the reasons why the Latin American and Caribbean region is among the most unequal on the planet.

Figure VII.6

LATIN AMERICA AND THE CARIBBEAN AND THE ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT (OECD): COMPARISON OF INCOME TAXATION



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of official figures for Latin American and Caribbean countries: Organisation for Economic Co-operation and Development (OECD), *Revenue Statistics 1965-2007*, Paris, 2008 and International Monetary Fund (IMF) *World Economic Outlook* (WEO), October 2008 for OECD countries.

The weakness of direct tax collection in Latin America and the Caribbean is basically due to two factors: the narrow tax base and high non-compliance levels. Both of these are also the result of the preferential treatment and tax loopholes that characterize the region's tax systems, resulting in considerable forgone revenue. As regards income tax, most of the countries afford preferential treatment to capital income through a series of exemptions or special incentives for financial placements, interest on government securities, mutual fund earnings, capital gains from immovable property and shares. Favourable treatment is also often given to reinvested profits. This forgone revenue reduces the tax base and increases the complexity of tax systems.[5] This not only violates the basic requirements of equity, which are that persons with equal capacity to pay

[4] Although in the Caribbean indirect taxes also account for most of the total, resources from foreign trade duties are more important.

[5] For more details about regional experience with the use of tax exemptions and incentives, see Jiménez and Podestá (2009).

should pay the same amount in taxes (horizontal equity) and that those with greater capacity should pay a proportionally larger amount (vertical equity) but also creates economic distortions in resource allocation which undermine the global efficiency of the economy and make countries less competitive internationally.

In the Caribbean, tax incentives also result in efficiency losses through preferential tax treatment, costs of forgone fiscal revenue and the cost of revenue mobilization resulting from the abuse of concessions. Nassar (2008) shows that, although in the Caribbean corporate income taxes have tended to converge, in the larger economies they have declined more significantly than in the smaller ones, suggesting a certain amount of tax competition. A decrease in corporate tax, combined with generous concessions, makes it difficult to increase revenue by expanding the tax base. Analysing the effects of the tax burden on investment in the zone of the Organization of Eastern Caribbean States (OECS), Nassar (2008) showed that marginal effective tax rates are substantially lower in the case of firms granted tax incentives than for other firms. Tax exemptions wiped out the tax effect on capital and, in some cases, turned into subsidies. To the extent that in some cases tax incentives are granted with a considerable degree of discretion, this impact may imply a misallocation of resources. Accordingly, the productivity of certain investment projects is distorted by the number and type of incentives.[6]

In Latin America and the Caribbean, the most progressive tax —personal income tax— has too small a share in total taxes to offset the regressive force of the remaining taxes. By contrast, in the industrialized countries fiscal policy has been instrumental in redistributing market rents to benefit the lowest-income groups, especially through the significant equalizing function performed by transfers and social spending. As can be seen in table VII.3, this redistributive effect is much stronger in Europe than in Latin America. In the former, States succeed in substantially altering income concentration indices by means of tax policies and transfers (public spending).

Finally, in addition to the regressive structure of the tax burden, the region has serious tax evasion problems. According to various ECLAC studies,[7] income tax evasion is very common and ranges from 40% to 65% approximately, representing a shortfall of 4.6% of GDP on average. These high levels of evasion undermine the redistributive effect of income tax. On the one hand, as noted by Jorratt (2009), evasion affects horizontal equity, since evaders end up paying less than tax-payers with the same capacity to pay who choose to fulfill their tax obligations. On the other hand, it may also reduce vertical equity, especially in progressive income taxes: the higher the taxes, the greater the incentive to evade them. In addition, people with more resources have easier access to professional advisers, who often promote tax avoidance strategies or reduce the risks of non-compliance. Monitoring of evasion and avoidance is therefore essential in order to improve the distributive effects of tax systems in the region.

[6] In Jamaica, which is perhaps typical of many Caribbean counttries, the forgone revenue represented by tax holidays, tax incentives and other exemptions was as much as 60% of total tax revenue in the fiscal year 2002-2003. Tax incentives represented 24% of revenue from corporate income tax and 56% of the taxes on international trade. In the OECS countries which depend on import duties, the fiscal revenue lost because of tax holidays was estimated at 4.3% of GDP in Dominica and 12% in Saint Kitts and Nevis. It is calculated that the annual loss of revenue for the whole subregion is between 9.5% and 16% of GDP.

[7] See Álvarez Estrada (2009), Arias Minaya (2009), Cabrera (2009), Cabrera and Guzmán (2009), Cetrángolo and Gómez Sabaini (2009), Jorratt De Luis (2009) and Roca (2009).

Table VII.3
LATIN AMERICA AND EUROPE (SELECTED COUNTRIES): INCOME INEQUALITY BEFORE AND AFTER TAXES AND TRANSFERS, 2008
(Percentage variation of Gini coefficient)

Latin America	
Argentina	-2.0
Brazil	-3.6
Chile	-4.2
Colombia	-7.0
Mexico	-3.8
Peru	-2.0
Latin America and the Caribbean (6 countries)	-3.8
Europe	
Austria	-34.2
Belgium	-36.2
Denmark	-40.8
Finland	-34.7
France	-24.4
Germany	-34.9
Greece	-25.0
Ireland	-35.8
Italy	-22.9
Luxembourg	-41.5
Netherlands	-33.3
Portugal	-24.0
Spain	-25.5
Sweden	-35.6
United Kingdom	-34.6
Europe (15 countries)	-32.6

Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of E. Goñi, J.H. López and L. Servén, "Fiscal redistribution and income inequality in Latin America", *Policy Research Working Paper*, No. 4487, Washington, D.C., World Bank, January 2008.

To sum up, the region's existing fiscal systems have three common features: (i) low tax ratios, (ii) regressive taxation, and (iii) poorly allocated public spending. Although some progress has been made with respect to these limitations, the tax structure remains highly concentrated in consumption taxes and revenues suffer as a result of high levels of evasion and avoidance, poor collection of direct taxes such as income tax (especially personal income tax) compared with the developed countries, and little or no taxation of capital assets. Instead of being a mechanism promoting more equitable income distribution, the region's taxation and public spending systems are thus producing greater inequality.

4. The fiscal covenant for distributive equity

The evidence given above confirms the need for a fiscal covenant that affords the State greater power to redistribute resources and to play a more active role in the promotion of equality. As regards both social spending and the collection of resources to finance it (especially the tax structure), there is significant scope for progress and enhancement of the redistributive role of the State.

This is the framework in which, for over a decade, ECLAC has been emphasizing the importance of the fiscal covenant (ECLAC, 1998b). Five main tasks or principles have been

identified, which today are still fully relevant: continue or complete the task of consolidation of public accounts, improve the productivity (quality) of public expenditure, create increasingly transparent public management machineries, and promote more distributive equity, all within a democratic and participatory environment.

Since a fiscal covenant of this nature has political implications far beyond those which would result from conventional fiscal or budgetary reform, the concept of the role of the State and the strategies which the authorities are trying to promote must be made explicit. For example, the idea of a fiscal covenant is something akin to vindicating the notion of development planning, which in turn reflects the desire for a comprehensive design of public policies. These policies may be conceived as mechanisms intended to promote “continents” rather than “islands” of equity. The general goal of equality presupposes substantial improvements in many sectors. The quality and universalization of education, the amount and coverage of social benefits and the capacity of measures to help the poorest will be crucial issues for the achievement of lasting progress in income distribution.

Today the idea of a fiscal covenant is finding favour in the region. The concept has been gaining support in international organizations and in national political dialogue, at the sectoral level or overall. There are at least two reasons for this greater willingness to embrace fiscal covenants. First, the evidence that public spending is a powerful instrument for containing the most corrosive effects of external volatility (decline in employment, income and consumption). Second, the recognition that good fiscal policy, backed by sound institutions and adequate public management capacity, makes an additional contribution to social equity and cohesion and to productive development.

Insofar as it requires agreements between the various public and private agents, the fiscal covenant must include at least the following components:

- A commitment to gradually increase the tax burden, so as to balance improved fiscal policy with adequate incentives for productive investment.
- A clear determination on the part of the State to improve revenue collection, including gradual reduction and control of evasion and progressive abolition of exemptions from direct taxes, for the sake of greater equity and efficiency.
- A reform of the tax structure in agreed phases, especially increasing income tax.
- A shared platform on which variations in the tax burden and structure are consistent with the larger role of fiscal policy within overall public policies.
- A clear and agreed public agenda for improving the transparency of public expenditure, the public institutions responsible for it and spending efficiency and effectiveness.
- A programme of gradual reprogramming of social spending in which the reallocation within and between sectors will, according to available evidence, show a greater redistributive impact and greater externalities in terms of equity and productivity.
- A tax structure and expenditure policy that take into account territorial inequalities and actively attempt to eliminate them. For example, territorial cohesion funds or mechanisms designed to introduce a progressive tax burden following a territorial approach.

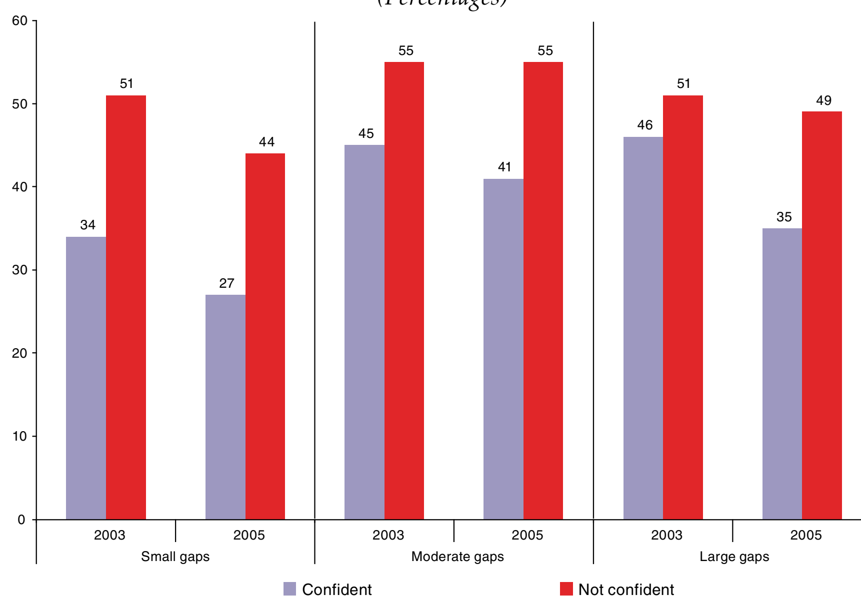
The social consensus and the legitimacy of the Government are based on the beliefs of individuals and their perceptions of State action. Citizens understand that they must pay taxes, provided that these ensure the provision of public goods and services by the State. Consequently, the way in which the Government spends public resources will largely determine its degree of legitimacy and its right to demand more revenue from tax-payers.

Lastly, if the fiscal covenant is based on the need to finance public policies by increasing the tax burden, it will be important to increase public confidence that these resources are being well used. In this connection, the most recent data from the Latinobarómetro survey show that the mix of confidence in spending and willingness to pay more taxes is not particularly widespread in society (see figure VII.7). This "tax hostility" is a problem that must be tackled precisely by greater transparency in the use of tax resources, as well as tangible impacts on well-being as a result of their use. The vicious cycle of low tax collection and limited tax legitimacy must be broken and replaced with a virtuous cycle of higher tax collection and greater consensus regarding tax reforms.

Figure VII.7

LATIN AMERICA (18 COUNTRIES): PEOPLE WHO BELIEVE THAT THE TAX BURDEN IS VERY HEAVY, BY DEGREE OF CONFIDENCE IN TAX SPENDING AND SOCIAL GAPS IN COUNTRIES, 2003 AND 2005 [a]

(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), *Latin America in the Mirror: Objective and Subjective Dimensions of Social Inequity and Well Being in the Region* (LC/G.2419-P), Santiago, Chile, 2009, forthcoming.

[a] The questions used in the Latinobarómetro survey were: All things considered, do you think that taxation levels in [country] are very high, high, low, very low or just right? Are you confident that tax money will be well spent by the State? Countries are divided into three groups according to size of the social gap.

The regional agenda should be subjected to the scrutiny of the majority of citizens. Decision-making processes must be based on an agenda of probity, in which the various interests are transparently identified and dialogue, negotiation and consensus are basic decision-making tools. A public agenda must be constructed which includes a strong private sector and a solid citizenry with rights and real opportunities to exercise them.

E. The importance of social covenants for equality and strategic development

The fiscal covenant mentioned harks back to the importance of building social covenants in order to promote the new State/society/market equation proposed in this document. Without the legitimacy and political solidity of agreements between the various stakeholders, the proposed reforms could well remain in the realm of wishful thinking and good intentions.

Social covenants are explicit agreements between social and political stakeholders on a certain general or specific social order. Being explicit, they are different from the various types of mutual accommodation that occurs between the various sectors over time without the involvement of any stakeholder-defined institutional structure or forum. They are also different from what in Latin America was called a “compromise state”, consisting of a series of unstable arrangements between the various sectors concerned: middle class, organized working class and upper class (bourgeoisie and oligarchy).

With covenants, the three basic issues are content (what they are about), stakeholders (between whom they are concluded) and methodology (how they are reached).

The content of covenants depends on their historical context. They may be creative (establishing a new social order of a general nature or within a specific sector), operational or instrumental or simply institutional civic agreements renewed or amended in the electoral context. Their coverage also varies. They may be pacts of national unity and forward-lookingness, as in the case of South Africa at the end of apartheid or accords concluded at the end of civil wars; they may be political, relating to the type of State organization (federalism, centralism and other forms) or to the political regime, such as the Punto Fijo Pact in Venezuela or the Naval Club Pact in Uruguay; they may refer to the socio-economic model, including fiscal, productive and labour covenants; they have to do with the model of international integration, forms of participation of civil society or a specific sector such as education, health or communications. In general, covenants tend to combine various aspects. The best known examples of social covenants are those forged between workers, management and the State (with a strong role for the State) that gave rise to the European welfare State, the New Deal in the United States and the Moncloa Pacts during the Spanish transition.

The stakeholders (who participates and how) depend on content and bargaining power. In covenants on the economic and social order, the main stakeholders have traditionally been the social classes represented by their organizations, mediated by the State. The best example is that of tripartite agreements between the State, trade unions and employers’ associations, which may be conducted through consensus or by means of institutionalized arrangements such as economic and social councils. If the covenant concerns the political order, the main stakeholders are political parties and usually also the parliament. In the aftermath of civil war or the establishment of a new regime, peace commissions are sometimes placed over the stakeholders in a mediatory function, or may be composed wholly or partially of the stakeholders. In societies in which class distinctions are tending to become blurred, where there are numerous stakeholders whose social class is not clear, and in which political parties have lost legitimacy, national councils or commissions emerge such as the Equity Council in Chile, consisting of representatives of civil society and of the State, experts, mediation bodies and political parties. Agreements of this type are generally difficult to implement because they are not institutionalized, but they play an important role by defining expectations and historical perspectives on the sort of covenant that may later emerge in other specific spheres.

As regards methodology, bodies such as constituent assemblies are the most common type of mechanism when a new national system is put in place. In other cases, however, there may be an institution such as an economic and social council, laws and formal written or oral agreements or simply mere understandings which take shape in practice. This raises the problem of how to deal with free riders or of who is the guarantor of the covenant.

The content, stakeholders and methodology can be determined only with respect to specific situations. Here, a society's history and political culture are decisive, since their spaces, stakeholders and legitimacies are different from those of other societies. The political regime is also important; in a democracy, it is assumed that there will be some type of bargaining process that is compatible with the rights of the citizens and stakeholders involved, and that the covenant will have a general soundness conferred by the inclusion of all citizens in the legitimate interplay between majorities and minorities.

1. Social covenants and equality

Equality of rights provides the normative framework and the basis for social covenants creating more opportunities for those who have less. The equality agenda requires that covenants should be rethought in order to create institutional policy consolidating a democratic and participatory order with a development approach that expresses the will of the majority and allows all stakeholders to participate. This agenda includes the construction of a far-reaching economic and social agreement whose ultimate expression is the fiscal covenant. As stated in the previous section, this requires a tax structure and a tax burden that strengthen the redistributive role of the State and of public policy in order to guarantee thresholds of well-being. Labour institutions that protect employment security are also part of the equality agenda. Another pillar of that agenda will be an array of production, labour, territorial and social policies that seek not only equality of opportunity but also to narrow gaps in outcomes.

(a) Content

In this connection, ECLAC has stressed the importance of covenants for social cohesion (ECLAC, 2008b). Such covenants seek to consolidate social protection systems on the basis of the principles of universality, solidarity and efficiency, with clear and sustainable rules, effective management, linkage of different institutions, participation and enjoyment of rights by the population, decentralized operations and public-private engagement. Substantively, social cohesion covenants have broad coverage and include generation of public revenue, more productive fiscal expenditure, transparency of public spending, protection of equity, strengthening of democratic institutions, creation of employment, social protection and education and training.

A covenant for equality is basically a covenant designed to redistribute income and other assets,[8] and to correct tremendous structural heterogeneity. While greater production convergence is the foundation for achieving greater social equality in a sustainable manner, the most

[8] In addition to the usual assets of physical, human and social capital, ECLAC advocates inclusion of the time variable. For example, the considerable gender-based differences between available time and time devoted to unpaid work. Another aspect is the importance of understanding time as a generation sequence. In this sense, the distributive mechanisms of the State affect the way in which generations will pay for and benefit from growth. This is connected with the demographic window which is currently positive in the region. Environmental sustainability is also part of this equation.

immediate and available redistributive mechanisms of the State are still tax reform, the taxation system and the allocation of social spending. The State is a key player, not only because it must equalize opportunities but also because it must reduce inequality of outcomes over the life cycle, within and between generations. In other words, the participation of the State means the difference between the "equity effect" and the "equality effect".

Redistribution faces two challenges. First, nowadays it is inconceivable outside of democratic mechanisms: it cannot be achieved by physical coercion and must be based on consensus-building around the agenda of the covenant in question. Second, there is no democratic political force without the creation of large majorities to achieve national political agreements that are in the nature of State policy rather than government policy. Agreements of this type are reached in the midst of conflicts of interest, so that the role of the political system is precisely to mediate between various interests in order to build consensus.

(b) Stakeholders

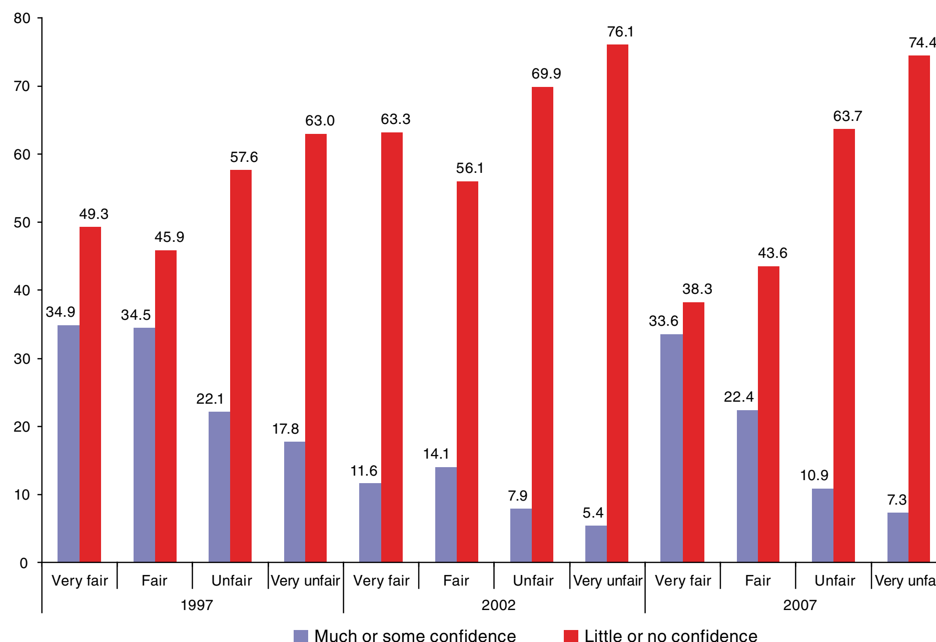
An initial important factor –albeit one with uncertain implications– is public opinion regarding the fairness of existing distribution. On the one hand, the greater the perception of unfairness, the greater may be the willingness to conclude social and fiscal covenants with a redistributive agenda. On the other hand, the opposite may be true: a society perceiving fairer distribution is also a society that is more demanding about the role to be played by the State in guaranteeing equality. According to figure VII.8, there tends to be less confidence in political institutions when there is a greater perception of distributive unfairness. The State and the political system will have to deal with this vicious cycle in order to enhance public confidence in the redistributive capacity of the State (ECLAC, 2009j).

In order to reverse this vicious cycle, the support of the political and social stakeholders must be enlisted. This requires the creation –albeit in virtual or symbolic terms– of a cultural climate favourable to a redistributive coalition, so as to weaken the force of stakeholders opposed to any redistributive covenant adversely affecting their interests. In this connection, what is important is not only the legitimacy of the State but also the inclusion in this coalition of stakeholders that have great symbolic prestige in society and are supportive of equality, such as grassroots religious associations, philanthropic organizations, social communicators, solidary foundations, and trade unions.[9]

Unlike national foundational covenants, in which all sectors participate equally and equally willingly, an equality covenant involves all affected sectors, even if they are relatively disfavoured. This is possible only when they feel that they have more to lose if they do not participate in the covenant than if they do, when the legitimacy of the redistributive coalition is such that they have no alternative but to join it, or when they perceive that the "systemic effect" of the covenant will give them more benefits in the long term than the lack of one.

[9] A very interesting example is found in Chile, where the Equity Commission was created at the initiative of the Catholic Church and some of its spokespersons advocated a maximum ethical wage to balance the minimum legal wage.

Figure VII.8
LATIN AMERICA (18 COUNTRIES)[a]: CONFIDENCE IN POLITICAL INSTITUTIONS[b] BY PERCEPTION OF FAIRNESS AS REGARDS INCOME DISTRIBUTION, 1997-2007
(Percentages)



Source: Economic Commission for Latin America and the Caribbean (ECLAC), on the basis of special tabulations of data from the Latinobarómetro database, 1997, 2000 and 2007.

[a] The data available for the Dominican Republic are only for 2007.

[b] The index of confidence in political institutions was constructed on the basis of the following questions: Please look at this card and tell me, for each of the groups, institutions or persons listed, how much confidence you have in them: much, some, little or none? Political parties and Parliament or Congress. The replies were divided into three groups: (i) much or some confidence in Congress or Parliament and the political parties; (ii) little or no confidence in both institutions; and (iii) a group in between, with much or some confidence in one of them.

Among social and political stakeholders, special consideration must be given to the State, which as a stakeholder is both a space for others and an agent organizing and intervening in society. In order to design and implement an equality agenda, the institutional structure of the State must therefore be capable of bringing into play two aspects of its personality: the State as a space in which the various stakeholders meet and negotiate and the State in its capacity to intervene, set goals and evaluate outcomes in the area of equality. This means that the equality covenant must be considered to be a policy of State, not only of government.

The State must be rethought and reconnected with the ability to steer development and real capacity to assign resources and perform regulatory functions, in the context of new relations with society, the system of representation and the basis for the creation of social stakeholders – in other words, civil society.

In this context, three models pose different types of problem for the construction of social covenants. In more societal models, stakeholders and grassroots social movements have a major presence, but the State and the political parties do not. In this case, however powerful it may be, in the absence of an authority to which demands can be addressed and of parties representing it,

civil society is still on its own and at the mercy of self-appointed powers which are precisely the ones that tend to oppose redistribution and equality. In party-based models, on the other hand, the parties can build redistributive coalition agreements and proposals on the subject. However, the weakness of the social stakeholders detracts from the legitimacy of the agreements and means that they have little real basis beyond political calculation. In the more autocratic models, the leader has greater capacity to spearhead a redistributive proposal but less possibility of concluding agreements involving productive and political sectors which are not part of the governing group. Lastly, technocratic models tend to give priority to equilibrium and economic growth and are less supportive of redistributive policies.

It is difficult to imagine an equality covenant under democratic regimes that does not include mediation by the parties and parliament. The parties can represent the various sectors not convened by civil society organizations and, in addition, are ideal forums for the formulation and negotiation of proposals both with the electorate and with specialized bodies such as parliament. There are three problems here, which affect countries in different ways. The first is the absence, in some cases, of a full range of parties. The second is the difficulty currently experienced by parties in transcending opportunistic proposals made during election campaigns and projecting themselves into an ideal of social organization such as equality, with its correlatives – production models and development. This involves reaching basic consensuses on production and social issues, independently of the political situation. Consequently, the third issue that the parties must be the political expression of the redistributive coalition between different interest groups that will make this development ideal a reality. Since these are policies of the State, this may require consensus-building and partnership efforts that may conflict with electoral requirements and with a fragmented political map preventing the achievement of agreements or covenants with greater social import and political continuity. There does not have to be unanimity, but there is a need to construct stable projects with the support of the majority and egalitarian goals. This requires party review and reform, which in turn necessarily implies political reform.

(c) Modalities

This brings us to the third aspect of the social covenant: the methodology for reaching it. The goal here is not to propose institutional engineering, since this necessarily varies from case to case depending on the national context. But it is important to consider the social and political mix on the various stages where a social equality covenant plays a role: Parliament, local and regional stages and new negotiating scenarios.

The first task will probably be to carry forward a national debate on the subject. Its forms may vary. It must include a forum for drafting content, which may be similar to the methodology of the constituent assembly or national council or commission, in which State agencies, experts, social stakeholders and religious institutions participate in formulating agendas and overarching goals overall and for each sector. In addition, equality agreements should be endowed with a certain degree of solemnity, with the creation of technical commissions to draft legislation for discussion in parliament.

A social equality covenant should engage civil society and the parties (in the style of a national equality council), at least in an advisory capacity, across all the areas of competence of traditional institutions (ministries and the Executive Branch, evaluation and advisory bodies). The local and regional levels are extremely important for the administration, coordination and participation of grassroots stakeholders.

2. Labour covenants

Separate mention must be made of labour covenants, for at least three reasons. The first is that labour negotiations have a long history and there are international standards on tripartite negotiations that clearly identify the participants: workers, management and the State. Second, labour agreements are vital for reconciling the goals of labour protection and decent employment with the productivity agenda of firms. Third, they are a component of social equality –given the influence of employment earnings– and of social cohesion.

The goal of a labour agreement is to improve labour institutions so that they are better able to perform their dual function of imparting economic dynamism and protecting labour. In view of the goal of greater equality, special efforts must be made to expand the coverage of labour institutions to an increasing proportion of the working age population, a large percentage of which is still excluded.

Social dialogue is the mechanism by which the content of labour covenants must be defined, and it must examine the specific bottlenecks that prevent labour institutions from performing better in a particular country. There are forums for developing solutions that promote both economic growth and worker protection in the existing context. However, this combination is not always possible, so that it is essential to identify the forums for and the validity of mutual concessions between governments, employers' organizations and trade unions.

International labour standards can be a valuable reference for the social dialogue. In view of their tripartite origin in the deliberations of the International Labour Organization (ILO), these standards already represent the outcome of social dialogue and they generally offer enough scope to be converted, through national debate, into relevant and legitimate rules in each country. The same is true of the focus on "decent work", which has become widely accepted internationally and among social stakeholders.

There is also a need for more resources to redesign labour institutions. In order to avoid substantially increasing labour costs, which could hurt demand for labour, these resources should be provided from fiscal revenue. Thus the debate on labour covenants cannot be dissociated from the context of the general fiscal covenant.

A gradual approach is also important. Although it may seem tempting to negotiate a unified package of reforms in all relevant areas, which could facilitate the practice of mutual concessions, in many countries this is not feasible because there is no climate of confidence between the parties. A confidence-building process is therefore required, which could consist of gradual steps in the right direction to enlarge the openings for embarking on new agreements.

It is also recommended that labour agreements should be part of a long-term development strategy. The strategy and its relevant goals will define some of the key requirements for labour institutions and link them to non-labour aspects, such as education and technological progress. The next section describes some successful cases of agreements between various participants in the framework of long-term development strategies.

In view of the weakness of protection systems, it is essential to concentrate on the design or improvement of a system to provide protection against unemployment and act as a disincentive to excessive staff turnover. The features of the scheme will depend on the specific situation of each country and on the way in which the social covenant can bring about consensus in the light of the complex variables of financing, coverage, entitlements, obligations and complementary services, among others.

As noted in chapter V, active labour market policies play a central role in improving equality in the labour market, for example by enhancing training with a view to greater production convergence in the economies. In addition, these policies facilitate confidence-building and learning processes. Although there are of course differences of opinion regarding programme financing, management and oversight, concurrence on the basic interests of the main stakeholders facilitates the conclusion of agreements on specific instruments. In view of the great unmet challenges –for example, as regards training– a broad dialogue on the enhancement of active labour market policies could have a favourable outcome, opening up space for debate in other areas.

3. Covenants and learning: a look at the positive experience of alliance-building between agents

Some countries quickly adopted a development strategy and agenda following a common practice: adoption of a medium- and long-term strategic vision, an action plan for achieving goals and objectives and a public-private alliance supporting institutional policy for the definition and implementation of strategies, programmes and policies. According to some ECLAC studies on which this section is based (ECLAC, 2008b; Devlin and Moguillansky, 2009), concerning the experience of 10 countries,[10] the combination of strategic approaches and construction of alliances between agents is crucial to understanding these countries' recent development successes. This success is exemplified in productive transformation, export expansion and diversification, addition of value and know-how in exports, reduction of the income gap with rich countries and enhancement of equality.

The strategies include goals such as more and better employment, better education and reduction of inequity, which are closely linked to the strategy of productive transformation, enhancement of international integration and innovation. This approach adopted in covenants forged in countries with successful development experiences coincides with the recommendation in this document that advances in the area of social equality should be dynamically linked to advances in productive capacity, employment and economic growth, in a strategic approach to development.

One example is Ireland, which during the 1970s and 1980s pursued a policy of indiscriminately seeking direct foreign investment and in the 1990s specialized in four areas, pharmaceuticals, chemicals, ICT and medical equipment. The goal of this reorientation was to preserve the policy of high wages, which rose rapidly in line with productivity, and to reduce the income gap within the country in order to remain competitive. In addition, today Ireland has a National Economic and Social Council (NESC), which is one of the most inclusive institutions as regards the variety of stakeholders and consensual dialogue. In fact, over time NESC developed a discussion methodology designed to facilitate consensus. NESC prepares a triennial report that provides strategic input in the negotiation of the national social agreement between Government, business and the trade unions and has for some time been very influential in the formulation of the Government's national plan.

Another example is the Operational Programme Enterprise and Innovation (OPEI) of the Czech Republic, which is part of that country's Economic Growth Strategy[11] In addition, it benefits from the Structural Funds and the Cohesion Fund of the European Union, designed to achieve convergence with the richest countries in the Union. OPEI was planned as a renewable

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[10] The countries covered in the study by Devlin and Moguillansky (2009) on which this section is based were: Australia, Czech Republic, Finland, Ireland, Malaysia, New Zealand, Republic of Korea, Singapore, Spain and Sweden.

[11] See [on line] http://home.cerge-ei.cz/munich/TEXTY/2005_09_06_SHR_final_eng.pdf.

programme, from 2004 to 2006 and from 2007 to 2013 (Ministry of Industry and Trade of the Czech Republic, 2007), so that it has long-term financing and can achieve successes over a period of time. It focuses on SMEs and mixes public and private resources to stimulate entrepreneurship, innovation, internationalization of firms, business support services, and improvements in institutional quality and the business environment.

Reference should also be made to the experience of the Moncloa Pacts, in Spain. In 1977, the country was experiencing severe economic and social difficulties under the Suárez presidency. There was a call for a major national agreement with the support of all political parties, as well as of general and business unions and a series of economic, social and political agreements were signed allowing planning for the future and gigantic development strides. This strategic agreement also allowed Spain to increase the tax rate by one percentage point each year over ten years to provide responsible financing for development efforts.

Following the global financial crisis, the new Government of Australia quickly devised a plan to combine short-term policies with long-term strategy in order to meet future challenges. It implemented the Nation Building – Economic Stimulus Plan, designed to create and support employment and to attract long-term investment. This initiative was, in turn, part of a proposal for meeting the strategic challenges created by the international crisis, climate change, population ageing and long-term food and water supply issues. To this end, the Government is spearheading a revolution in the areas of education, investment in infrastructure and innovation, health and environmental reforms, and a new and more participatory form of government inaugurated during what was known as the Australia 2020 Summit.

In addition to the formal and structured alliances in countries such as Ireland and Finland, there are other forms of association: informal and tacit (not institutionalized) as in Spain and Sweden; formal but ad hoc as in Australia, in which Governments convene them for a specified period of time, engaging special stakeholders; or hybrid as in the Czech Republic, New Zealand and the Republic of Korea, where various types of alliance coexist. However, the coalitions that in practice prove most effective, facilitate transparency and prevent State capture by economic stakeholders are the ones that are formal and structured.

The formation of this type of alliance is a gradual social process with much institutional learning, in which each country has to find the solutions best suited to its cultural, historical, political and economic reality. However, there are certain requirements. First, the State must have the necessary qualities to be a credible partner of the private sector: professionalism, honesty and technical know-how, combined with fiscal soundness to finance programmes and incentives. The purpose of these schemes is, on the one hand, to help firms seeking to enter new markets and upgrade their products, processes and technologies and, on the other, to give workers better-quality employment and higher wages. Second, the State has to find ways of interacting strategically with the private sector (in the broad sense of business, academia, workers and NGOs) to ensure that it is not captured by special interests and that the alliance preserves its character of public good. Third, the State must improve its ability to manage and coordinate incentive and cooperation programmes with the private sector, implementing them transparently and with permanent performance-based accountability.

The private sector also has new responsibilities. In order to take advantage of the opportunities of the post-crisis era, it must adopt a medium- and long-term vision, aiming to steadily scale up its activities by means of investment and innovation. It must also be prepared to

proactively support formation of an alliance with the public sector which would be in the nature of a public good. This will enable the State to expand its resources and capacity in order, among other things, to: (i) become a credible partner, mobilizing the country's best talents; (ii) pursue policies that help to reduce poverty and inequity; (iii) provide infrastructure, logistics and connectivity; (iv) support learning through more and better education in key areas for competitiveness, training and investment in additional incentives to encourage innovation; and (v) promote the internationalization of SMEs.

Latin America also has experience with alliances.[12] Among the formal and structured ones, with stakeholder participation similar to that of Ireland's NESC, mention may be made of Brazil's Council for Economic and Social Development (CDES), which was created in 2003 as an advisory body to the Office of the President and has influenced policies and parliamentary reforms. Peru also has a body providing broad-ranging advice to the Government on medium-term and long-term topics: the National Agreement, created in 2002. However, the power and capacity of this forum to influence policy have been declining because it did not succeed in gaining the full attention of the leaders of the existing Government and did not have sufficient interaction with the public.

In Chile, on the other hand, alliances have mainly been ad hoc, convened by the Government to work on specific topics such as education reform, inequality, financial reform, negotiation of free trade agreements and the Pro-Growth Agenda formulated by the Confederation of Production and Commerce (CPC). One of the main differences from alliances in countries outside the region is that the dialogues are topic-based and do not take place in the framework of an agreed vision of the future, so that it is difficult to achieve cohesive agreements under a common umbrella. In addition, there have been forums for dialogue and commissions whose agreements were not binding or which did not link up with defined government responsibilities.

Colombia is one of the countries in which the public-private alliance is most deeply rooted in the State, having been developed in the early 1990s. Currently the most broadly accepted alliance is the National Competitiveness Commission, a public-private body linking relevant stakeholders and institutions at the national and regional levels. As established by law, this Commission represents a meeting-place for the various economic representatives, where productivity and competitiveness policy is outlined, in accordance with the country's development plans and programmes. However, as noted by Gómez Restrepo, Botiva and Guerra (2007), the persistent lack of institutional linkage results in duplication between and within the various bodies and confusion about the role played by the various agents in the development of the national competitiveness policy.

In general, a review of the experiences of nine countries in the region studied by Devlin and Moguillansky (2009) and their comparison with successful cases outside the region lead to the following conclusions: (i) Even if alliances have formal support at the highest level of government, their legitimacy and future relevance are affected by changes of government; (ii) There are rarely any legal or informal ties by which these alliances can influence the decisions of the public authorities, so agreements are often not forwarded to executing agencies and are not allowed for in the budget, which discourages the economic and social stakeholders involved; (iii) In some countries, the councils have an unmanageable number of participants, making them unwieldy;

[12] For a detailed analysis of the features of public-private alliances, their composition and their linkage to various levels of public administration, see Devlin and Moguillansky (2009).

(iv) These bodies have no budget to employ a technical secretariat and conduct the necessary studies to enable them to base their discussions on solid arguments, especially for the long term; (v) There are no proper procedures for preventing State capture. In view of these problems, in Latin America and the Caribbean public-private alliances rarely influence strategies or, more importantly, political decisions.

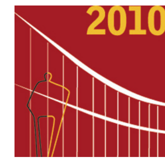
If the agreements constructed are to prosper, they must be truly long-term, have precise and agreed goals and be based on efficient, effective, transparent and properly financed public policies. It is not enough to conclude agreements relating solely to the objective sought; it is also necessary to define methods and time frames for implementing them, institutional arrangements to make them sustainable over time and, of course, the resources to finance them.

4. By way of conclusion

A social covenant requires and promotes changes in political action. It results in a more proactive State, stronger mechanisms of legitimacy and representativeness, stronger engagement on the part of economic agents, and the participation of various social stakeholders, together with the creation of appropriate forums. The covenant is a process rather than a result. It involves discussions and agreements on long-term coexistence projects, sacrifice of immediate interests for the sake of the common good and the development dynamic, and a general commitment to a better society and better-quality political action. It is an attempt to relegitimize politics on the basis of both inward democracy and outward integration into an increasingly globalized order.

This is clearly a far-reaching and long-range task, requiring the strategic vision advocated here. But a start must be made at once. It is important to have social covenants so that policies are not dependent on election timing and changes of government. It is important to adopt an approach to fiscal viability that is centred on civic rights, particularly social rights. It is important to direct growth towards more and better employment. It is important to reflect gender and generation changes in a new architecture that makes the care economy compatible with labour market participation, takes advantage of the windows of opportunity presented by the demographic transition and averts the risks arising from this transition.

Development, as we experience it, envisage it or have suffered it, has reached a turning in the road today. The financial crisis and its social impacts, as well as the threat of climate change, have placed a large question mark over the scope of the production and economic paradigms prevailing in earlier decades. In this situation, citizens are now seeking refuge and guidance from their Governments and their States and a fairer international order with a greater variety of voices. Without a new State architecture reflecting the new context, the new realities emerging from the crisis, the requirements of the equal rights agenda and the challenges of climate change, there will be no future.



Epilogue

Era of change, change of era

The foregoing chapters have proposed possible routes for development in Latin America and the Caribbean. There are no one-size-fits-all formulas for the countries of the region. The challenge for each Government, State and nation is how to order priorities and objectives, as well as the instruments they will use to pursue them. What this document presents is a vision of development and an array of policies and policy criteria, which are offered as points of reference for the countries as they weigh the options for moving forward.

This document is clear in its proposals. It emphasizes the need for the State to play a strong role and stresses the importance of sound policymaking as countries revitalize and recreate democracies against a backdrop of globalization. In this vision, the State is the fulcrum for reconciling policies for stability with those for economic growth, production development with convergence, harmonization across territorial areas, the promotion of quality employment and greater social equality. It is also suggested that continuous, better quality and more lasting democracy creates the conditions for a better State because it allows the development of better systems of accountability and transparency that avoid bureaucratism and corruption and enables the State to regulate and support the market. Political action is emphasized as the sphere in which Governments and citizens can forge badly-needed links in order to work towards cohesion and craft the covenants that, in democracy, necessarily underpin the development of a rights-based agenda and the construction of an efficient State with a vocation for equality and a quality democracy with a vocation for inclusion.

The task of development today is pitted against challenges and changes in circumstances born out of the crisis, as discussed at the start of chapter I. The crisis has implications in the long term that require decisions to be made and measures to be taken in the present. Furthermore, the structural trends that are in evidence today add up to a genuine change of era. Four of them are commented on below.

First is climate change, as mentioned in chapter I, which is closely bound up with a long history of industrialization and production patterns that are highly intensive in carbon dioxide emissions and fossil fuel consumption and, moreover, with a specific type of relationship in which humankind depends on nature for its collective reproduction. The effects of climate change are deep, systemic and, in the absence of decisive changes and global accords, catastrophic. Multilateralism is a basic principle for framing those agreements: as well as the will of States, a new "global justice" is necessary if the efforts made and agreements reached are not to condemn the developing world to permanent underdevelopment.

Climate change imposes limits and forces a shift in production paradigms and consumption patterns. It places intergenerational solidarity firmly at the heart of the equality agenda and even calls into question our way of relating to the world. Under the threat of climate change, the future of every individual is inextricably linked with the future of all. Now, facing global warming, the destruction of the environment and the crisis in energy sources, the world is more interdependent than it has ever been before. Against this backdrop, the present document has pointed to the region's alternatives and limitations for moving towards lower-emissions less fossil-fuel-intensive economies.

The second trend is technological change and what is known as the network, information or knowledge society. This is not about technical progress simply as a requirement for global competitiveness. For three decades now, innovations in information and communications technologies (ICT) have been creating a very different society that is bringing about changes in economic and production patterns, modes of work and organization, communications systems, learning and information processes, social linkages, forms of government and ways of exercising democracy and controlling society.

The "techno-social" paradigm also underlies the current crisis, discussed in chapter I, and has led to a review of the State-market equation. The network system leans towards deregulation and self-regulation, but this creates a problem when projected onto areas of global life in which deregulation, as the world has seen, can be harmful and dangerous, such as finance, arms trafficking, labour organization and environmental management. For that reason, the network itself should provide the means to strengthen regulation in areas of global life which, precisely because of their lack of oversight, are liable to unleash global crises, be they economic, production-related, environmental or world security crises. Chapter II sets forth proposals for increasing capacity for regulation in one of these areas, finance, with a view to enabling the network system to grow in a way that is compatible with the principle of development with stability. Chapter V offers proposals for adjusting the regulation of the labour market and labour institutions in order to avoid the heavy costs in terms of employment security and quality that the new production paradigm can impose unless it is applied with a view to equality and social cohesion.

The information society is here to stay. The key socio-economic activities in this society are the capture, storage, transmission and processing of data. Nations may develop at different rates and in different directions depending on how societies and States position themselves within this paradigm and how they disseminate it. There is no intrinsic good in technology itself; only uses of it that are more or less virtuous, more or less synergetic, more or less democratic, more or less egalitarian, more or less productive —in short, more or less successful. For that reason, this document has dwelt on public policies that can combine the production development of our economies with greater social inclusion. Chapter III looks in particular at pathways in which

development is centred on technological changes and human capacity to latch onto and promote them. It looks at ways of locking into the opportunities inherent in the information and knowledge society and the new technologies. The proposal is to move more successfully, in the medium term, towards more productive systems that spread innovation and technical progress more widely and in a more environmentally sustainable manner.

The third structural trend discussed here is demographic change, which has two distinct components. The first is the growth of the human population, which has reached magnitudes in the twenty-first century that were unthought-of in the nineteenth and has shifted the relative weight of the global population towards the undeveloped world. Added to the tremendous global inequality and the occurrence of conflicts and natural disasters, population changes have generated unprecedented flows of migration, with attendant problems whose solution requires international agreements of ever greater scope.

The second component of demographic change is the demographic transition. This involves the region more directly, since the relative weight of the different age groups in the population will change in the coming decades. Albeit with differences from one country to another, Latin America and the Caribbean is now in the midst of a demographic dividend in which the smaller child population and still incipient population ageing process mean that the region today has a larger proportion of working-age people in relation to the dependent population. The countries must take advantage of this dividend in the next few decades, in order to prepare for the time when the greater weight of the older population will shift the balance between the productive and dependent populations, when society will need to be highly productive if it is to generate the resources needed to cover health and social security needs.

Lastly, the demographic transition shifts the equation of State, market and family as regards meeting well-being and capacity-building needs. The way these three agents interact to provide services, monetary outlays and support networks must be reassessed as the proportional structure of the different age groups in society changes. The transfers discussed in chapter VI are of strategic importance in this framework. Supporting the care economy today means promoting greater participation by women in the labour market, thereby broadening the productive population base in preparation for the future challenges of the demographic transition. This support also means ensuring that children progress through the education system from early childhood to at least the end of the secondary cycle and investing in the production capacities of the next working generation, who need to start preparing now to be more productive, given that their burden will grow heavier as the dependent older population increases. Hence the call for progress in developing a solidarity-based pillar within social security: public transfers in the form of non-contributory pensions will become increasingly important in sustaining an older population much of which has not been able to participate continuously in contributory or individual capitalization systems.

The fourth structural trend emphasized in the document is cultural change. Greater global interconnections create greater awareness of the diversity of tastes, values and beliefs, but they also generate instances of deep cultural and religious intolerance, some of which crystallize into virulent forms that threaten global security. After the fall of the Berlin wall, the collective notion of democracy as part of global cultural heritage spread, but ethnic conflicts revived the ghosts of collective violence. The worldwide growth of consumption and financing give the market a pivotal role in defining meanings, identities and symbols. For many, the globalization of communications and information, together with the mass use of ICT, has shifted references in

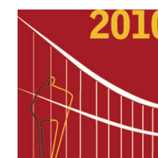
space and time as well as portrayals and visions of the world, at the same time as it raises questions about the pace and depth of changes in preferences, life plans and norms of coexistence. The consolidation of religious identities is progressing side by side with the secularization typical of modernity. The foundations of ethnocentrism and patriarchy are increasingly being shaken by indigenous and women's movements. The threat of climate change is forcing humanity to rethink the way it relates to nature and to the planet on which we all live.

So deep has the cultural change been that it also, undoubtedly, leads to questioning of society's form of organization. The foregoing pages do not attempt to address this topic, but we are very aware that cultural change has a powerful influence on the global order, multilateral agreements, styles of politics and policymaking in the countries, and the demands made by citizens, whether symbolic or material. Policies cannot be made for young people, for example, without taking into account the radical cultural changes that they are experiencing. Gender and cultural components are increasingly part of the mainstream of pro-equality policies, as discussed in chapter I, and call for a difficult balance to be struck between equality of opportunities and respect for differences. Equality of rights —the central value proposed in this document— is the cornerstone of policymaking because it enshrines a universalist vocation capable of absorbing and reconciling these rapid cultural changes.

The world has never been so crisscrossed by acts of communication on a planetary scale as it is today. Never has humanity been so aware of its own diversity, so divergent in lifestyles yet so convergent in global imaginaries (from political democracy to multiculturalism). Never has there been such a global proliferation of options for consumption and knowledge that mark out life directions and individuation choices. At no time before has there been as much reflexivity —awareness of injustice and arbitrariness— or greater possibilities for lobbying and visibility. Never has humanity been so clear about the unsustainability and fragility of a paradigm that is destructive towards nature.

The new development paradigm must be made to do everything possible to build a model of globalization that breeds greater collective awareness of global public goods; awakens democracy across the planet by affording a voice to the most diverse range of actors in the open concert of global governance; and provides excluded sectors with the tools needed to close gaps in capacity, citizens' rights and access to well-being. The new model of globalization must develop policies with a long-term vision —but start work on them as a matter of urgency— in order to remain one step ahead of the climate, technological, demographic and cultural scenarios that current trends are now projecting.

It is as a contribution to this more global and strategic approach that the proposal set out in this document is offered.



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