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The following symbols are used in tables in the *Review*:

... Three dots indicate that data are not available or are not separately reported.

(–) A dash indicates that the amount is nil or negligible.

A blank space in a table means that the item in question is not applicable.

(-) A minus sign indicates a deficit or decrease, unless otherwise specified.

(.) A point is used to indicate decimals.

(/) A slash indicates a crop year or fiscal year; e.g., 2004/2005.

(-) Use of a hyphen between years (e.g., 2004-2005) indicates reference to the complete period considered, including the beginning and end years.

The word "tons" means metric tons and the word "dollars" means United States dollars, unless otherwise stated. References to annual rates of growth or variation signify compound annual rates. Individual figures and percentages in tables do not necessarily add up to the corresponding totals because of rounding.

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The “new regionalism” and the Free Trade Area of the Americas: a less benevolent view

Roberto Bouzas

This paper examines the pros and cons of the “new regionalism”, taking as a landmark the negotiations for a Free Trade Area of the Americas (FTAA). It summarizes the main features of the “new regionalism” and reviews some of the challenges and opportunities opened up by North-South preferential trade agreements (a category that includes many of the new vintage of such agreements). It underlines the role of domestic policies as a complement to trade liberalization, an aspect generally overlooked in the debate about trade negotiations and preferential trade agreements. It reviews the record of the FTAA negotiations, emphasizing recent trends and prospects. Lastly, it summarizes the main points raised and emphasizes the problematic features of the FTAA that is starting to emerge after a decade of negotiations.

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I

Introduction

Preferential trade agreements (PTAs) have mushroomed in the Western Hemisphere since the mid-1980s. After two decades of active negotiations, the final architecture of this network of preferential trade pacts is still in the making. The proliferation of PTAs in the region is not entirely new, but the latest vintage of trade discrimination differs in several ways from that of the past and this has caused it to be labelled the “new regionalism”.¹

Whether convinced of its beneficial effects or of its inevitability, many analysts have evaluated the “new regionalism” benevolently, emphasizing the potential advantages and minimizing the costs. Only a handful of “free-traders” —usually accused of lacking “practical sense”— have consistently raised a critical voice.

The objective of this paper is to examine the pros and cons of the “new regionalism”, taking as a landmark one of its most significant and complex manifestations, the negotiations to establish a Free Trade Area of the Americas (FTAA). The problems that have emerged in relation to the architecture and regulatory content of the FTAA are indicative of the challenges and opportunities offered by the new vintage of trade discrimination. A hemisphere-wide preferential agreement may create trade opportunities for the Latin American countries and foster economic

development throughout the continent, but this will not come about automatically. The opportunities that may be opened by the FTAA —like those stemming from any process of economic liberalization— are conditional. If they are to materialize, the agreement must meet certain conditions and be accompanied by policies that make it possible to reap the benefits of increased competition, larger markets and deeper specialization. Seen in this framework, the FTAA negotiations display worrying trends.

This paper has five sections. Following the present introductory section, section II summarizes the main features of the “new regionalism” and reviews some of the challenges and opportunities opened up by North-South PTAs (a category that includes many of the new vintage of such agreements). Section III underlines the importance of domestic policies to complement trade liberalization and the vital role these play when it comes to actually reaping the opportunities offered by the “new regionalism”, an aspect generally overlooked in the debate about trade negotiations and preferential trade agreements.

Section IV reviews the FTAA negotiations to date, emphasizing recent trends and future prospects. Section V, lastly, summarizes the main points raised in the paper, with comprehension rather than prescription as its aim.

II

The “new regionalism” and North-South preferential trade agreements in the Western Hemisphere

The wave of preferential trade negotiations that has swept over the Western Hemisphere in the last two

decades has been a key ingredient of the so-called “new regionalism”.² This process has resulted in a complex

□ I am grateful for the valuable comments made by an anonymous reviewer.

¹ At the southern end of the Western Hemisphere the “new regionalism” was inaugurated by the Argentine-Brazilian Trade and Cooperation Programme signed in 1986 (a precursor to Mercosur). At the northern end the first agreement was the United States-Canada Free Trade Agreement (FTA).

² The “new regionalism” is now worldwide. Even the Asia-Pacific region, which had traditionally stood aside from discriminatory practices, has joined the global trend, as suggested by the preferential pacts signed by Japan, the Republic of Korea and Singapore. For an early analysis of the characteristics of the “new regionalism”, see Bouzas and Ros (1994); see also IDB (2002) and Torrent (2002).

web of PTAs that Baghwati (1993) has likened to a “spaghetti bowl”. Although at first sight, at least in Latin America, it does not look very different from the “old regionalism”, the “new regionalism” has been accompanied by changes in both context and content. The contextual changes include a more outward-oriented policy environment (as a result of unilateral and multilateral liberalization) and a renewed emphasis on promoting closer integration into the world economy (in contrast to the “autarchic” policies prevalent in the past). The most significant changes in content include broader coverage of issues and disciplines (a “deeper” agenda) and the emergence of North-South agreements binding together national economies with large disparities in per capita income. These new features may increase liberalization commitments, but also friction between divergent regimes and standards of treatment. In the “new regionalism” the developed countries have also become active contributors to the “spaghetti bowl”. The most prominent case, because of its systemic role and its decisive contribution to the creation of the post-war multilateral trading regime, is that of the United States, which after decades of championing multilateralism has embraced discrimination as a complementary policy.³

The “new regionalism” has certain advantages over the PTAs of the past. Some of these have to do with the new trade policy environment, such as the fact that more outward-oriented trade policies have lowered the welfare costs of trade diversion for members and of negative discrimination for non-members. Others, however, relate to the specific content of the “new regionalism”. A number of analysts have pointed out that North-South PTAs give smaller and less developed economies preferential access to large high-income markets. This benefit cannot be obtained through unilateral liberalization and is shared with others when liberalization is the result of multilateral bargaining. Under some circumstances, preferential access to large markets can be a powerful driving force for developing-country exports. Similarly, the broader coverage of disciplines typical of the “new regionalism” may provide the developing-country partner with more stable market access conditions. This is particularly important because of the type of

protectionist instruments typically used in industrial countries, such as “administrative protection”, sanitary standards, etc. North-South agreements can also be a vehicle for improving expectations, conferring greater certainty upon the policy regime and attracting larger flows of foreign investment into countries that usually face severe balance-of-payments constraints (Ethier, 1998; World Bank, 2000). Moreover, some authors point out that they can encourage (or even “force”) developing countries to adopt institutions prevalent in the developed partner, thus helping them to improve economic performance.⁴

To deliver these results, which are not automatic, North-South arrangements must respond adequately to at least four challenges: ensuring effective reciprocity;⁵ helping to cope with adjustment and transition costs; preventing the consolidation of polarization dynamics; and ensuring that institutional spillovers have a positive effect and can be effectively appropriated by the developing partner. None of these can be taken for granted, and they should thus be explicitly addressed in any North-South agreement.

Although the issue of reciprocity is critical, the historical evidence shows that it has not been easy to enforce in the multilateral trading system, including the Uruguay Round that ended in 1994. In fact, although agriculture was included within the general disciplines of the General Agreement on Tariffs and Trade (GATT) and the parties agreed to phase out quantitative restrictions on trade in textiles and garments, the Marrakesh Agreement establishing the World Trade Organization (WTO) and the implementation process that followed have generated widespread dissatisfaction in the developing world. There is now a growing consensus that in some fields, such as the protection of intellectual property rights and the enforcement of trade-related investment disciplines, the developing countries accepted commitments without being fully aware of their impact and implications, making reciprocity virtually impossible.

Taking into account the precedents at the multilateral level, it may be worth asking what factors may increase the likelihood of North-South preferential pacts being negotiated in a more balanced way. As a matter of fact, several structural features of the North-

³ The European Community has had a tradition of activist preferential trade policies towards developing countries, largely as a result of the European colonial past.

⁴ See Schiff and Winters (2003).

⁵ Reciprocity is the policy whereby governments grant one another concessions deemed equivalent in some way (for example, one of them reduces tariff or other barriers to imports in exchange for the trading partner making equivalent concessions in its export barriers).

South variety of regional integration may work the other way and hinder reciprocity. First, industrial countries typically have well-established democratic institutions that give citizens' votes greater weight in the domestic political process than is usually the case in the developing world. Partly as a result, legislatures in industrial democracies tend to play a more substantive role in policy design and to be more effective at transmitting private-sector interests (collective or otherwise). This feature of the policy process is reinforced by the fact that in the industrial countries the private sector tends to be better organized and to identify and promote its strategic interests more effectively than in developing countries. In the latter the private sector tends to organize more around "defensive" issues that provide only a fragile basis for the construction of an "offensive" bargaining agenda. Non-business actors in industrial countries also tend to have a more active and informed role in the policy-making process, raising the likelihood that their views and interests will be reflected in the final deal.

The chances of North-South preferential negotiations leading to more reciprocal outcomes are also negatively affected by the fact that some issues which are very sensitive for a number of developing countries are the outcome of the interplay of forces in the global political economy. This being so, it is unclear how preferential negotiations can make substantial progress towards more balanced trade agreements.⁶ Examples of these sensitive issues are domestic subsidies for temperate agricultural products and the implementation of "trade relief", especially antidumping duties. In effect, a cursory examination of existing North-South preferential arrangements confirms that these issues were left untouched by the negotiators.

The likelihood that North-South preferential arrangements will be based on reciprocity is also shaped by the dynamics of the bargaining process (outcomes are "path dependent"). Political economy considerations suggest that one factor influencing industrial countries' choice of partners for negotiating preferential trade arrangements is the minimization of

transition and adjustment costs (and hence of domestic political opposition). In an asymmetrical context this will increase the probability that the agreement will reflect the priorities and sensitivities of the more powerful partner. If an industrial country signs successive agreements with one developing country at a time, these are very unlikely to be based on reciprocity. In addition to the effects of this bargaining path on the regulatory content of successive agreements, the "exclusion costs" for outsiders will increase *pari passu* with the expansion of the preferential network (either through a "minilateral" arrangement or a "hub-and-spokes" system). In the present context of uncertainty as to the evolution of the multilateral trading regime, the resulting "defensive incentives" may make the costs of non-participation (even in a non-reciprocal deal) economically and politically unbearable. The increase in perceived "exclusion costs" may raise the price of the "entry ticket", reducing further the likelihood of reciprocal and balanced agreements.⁷

North-South preferential trade agreements can be a vehicle for improving expectations, providing policy regimes with greater stability and attracting larger inflows of foreign investment to developing countries. They may also encourage a developing country to upgrade its existing institutions and adopt some of those commonly found in developed countries, thus improving economic performance. But these benefits are less automatic than is presumed by the more enthusiastic proponents of North-South regionalism. More stable policy regimes will be good only if the underlying policies are sound and sustainable. Moreover, although economic integration with a developed country can trigger institutional modernization, the "importation" of institutions is rarely the best way to proceed, not least because the efficacy of alternative institutional arrangements is contingent on the environment in which they operate (Lawrence, 1999). This is not to deny that institutional effects may be positive, but to underline that much will depend on the particular circumstances and on the domestic environment and policies. Moreover, some foreign institutions (or regimes) may simply run

⁶ North-South PTAs (such as the North American Free Trade Agreement or the free trade agreements between the European Union and Mexico and Chile) have been carefully drafted to avoid touching on issues that are very sensitive for the developed-country partner (such as temperate agriculture in the case of the European Union). Although this may be an acceptable bargain for some developing countries, it may be extremely inefficient for others.

⁷ These perverse dynamics are not taken into account by the tautological argument often used to explain away the behaviour of developing-country governments in respect of North-South agreements, namely that "if they participate voluntarily, it must be because they benefit".

counter to the economic or policy interests of the developing-country partner.⁸

Transition and adjustment costs in the developing country are a third key issue for North-South regionalism. Like any liberalization process, preferential liberalization will require the parties to cope with these costs. When factor endowments differ greatly between the partners, as is usually the case in North-South agreements, the resulting specialization pattern will be largely inter-industry. Consequently, relative prices and factor payments will experience comparatively large changes.⁹ These changes, furthermore, will be bigger in the smaller partner. Conventional trade theory treats this outcome as evidence that most of the gains from trade liberalization will accrue to the smaller economy. However, although inter-industry specialization offers the potential for large efficiency gains, these gains are conditional and if they materialize they will do so only in the long term. During the transition, national economies will need to cope with the costs of adjustment.

This time-consistency challenge is a major political economy problem, but one that receives relatively little attention in conventional international trade theory. It is also a major issue for policy makers in the real world. The intense debates that took place in the United States Congress when it was considering NAFTA (a treaty that involved Canada, Mexico and the United States) and, more recently, when it passed the Trade Promotion Authority (TPA) Act are illustrative of the attention that the treatment of transition and adjustment costs mobilizes in the case of industrial countries.¹⁰ These issues are even more important for developing countries, where adjustment costs are typically larger and where less financial, political and institutional resources are available to cope with their consequences. If this issue is not addressed cooperatively, it may deepen existing

asymmetries by enabling the developed-country partner to deal more effectively with its own adjustment costs or even transfer some of the burden to the developing-country partner.

Finally, market and policy failures can help transmute adjustment and transition costs into polarization dynamics and path divergence. North-South preferential arrangements offer opportunities for convergence in per capita income levels between rich and poor countries, but they may also consolidate vicious circles of stagnation and decay. As a matter of fact, there is no theoretical reason why one trajectory should predominate over the other. While some authors emphasize the forces for convergence (World Bank, 2000), others underline the persistence of divergent economic performances over time (this is the case with cumulative causation models and endogenous growth theories).¹¹ In the latter case, “polarization effects” could heighten existing inequalities and make preferential trade agreements economically and/or politically unsustainable, unless active public policies are adopted.

In developing countries, failures in financial, information and technology markets are frequent. In addition, there are widespread policy failures due to the relative fragility and newness of democratic institutions and the weakness of their administrative capabilities. In this context, the forces for convergence may be too weak. With per capita income disparities much smaller than those prevailing in the Western Hemisphere, the European Union has made intensive use of structural and regional funds to promote cohesion and counteract the forces of polarization. The available evidence suggests that apart from the contribution made by financial transfers (which is debatable), the upgrading of local institutions has played a key role.

In summary, the “new regionalism” has advantages as compared to the typical PTAs of the past (many of them related to the broader trade policy environment), but it also faces new challenges that make clear-cut conclusions about its superiority hard to sustain. Many of the challenges and opportunities typical of trade discrimination are magnified in North-South agreements. This ambiguity lurks in the background of most analyses, but its implications are rarely developed in full. Under some circumstances the “new regionalism” can bring tangible benefits for a

⁸ Protection for intellectual property rights as originally established by the Trade-Related Aspects of Intellectual Property Rights (TRIPS) Agreement was problematic for many developing countries, something that was officially acknowledged after much diplomatic activism in the area of public health.

⁹ Intra-industry or intrasectoral specialization is less resisted than inter-industry specialization because it is usually accompanied by less significant relative price changes. This, in turn, means more modest changes in production factor payments and income distribution.

¹⁰ As well as defining precisely what trade negotiating objectives should be pursued by the United States Administration, the TPA was passed simultaneously with a package of financial resources to provide social security benefits to workers left unemployed by higher imports.

¹¹ See Bouzas (2003) for a discussion of the effects of structural and policy asymmetries on economic integration.

developing country (such as rapid manufacturing export growth in the case of Mexico). However, the nature and extent of these benefits will be contingent on the content of the agreement, the bilateral agenda, the structural characteristics of the partners and domestic policies. These qualifications sound quite obvious, but they have been downplayed in the past and it is only recently, as evidence of the difficulties has emerged, that they have begun to occupy a more visible place in the public policy debate.

Going beyond the national focus, one should emphasize that for outsiders the impact of the “new

regionalism” (especially North-South agreements) is likely to be negative. The resulting “defensive incentives” may distort policy decisions and make the playing field even less level than it was before. Evaluating the consequences of this process from a “cosmopolitan” perspective —rather than a purely national one— is a difficult task, but one that must be attempted if the impact of the “new regionalism” is to be properly assessed. Much of the inconclusive debate about whether regionalism is a stepping-stone or a stumbling-block for multilateralism bears on this issue, which is not theoretical but empirical.

III

The role of domestic policies

Preferential trade agreements, particularly North-South ones, provoke strong reactions for and against. The resulting debate generally assigns only secondary importance to what is after all the key to reaping the potential benefits of economic integration: domestic policies. Trade liberalization (be it preferential, multilateral or unilateral) may increase efficiency, foster productivity growth and contribute to economic development, but it is not a sufficient condition for growth and development, as the simplistic policy recommendations prevailing in the 1990s suggested. Similarly, economic integration and North-South preferential agreements may encourage growth and development, but that will depend on the content of the agreement and the accompanying domestic policies.

During the 1990s many Latin American and Caribbean countries implemented ambitious trade liberalization programmes, but most of them did not experience any significant improvement in economic performance, as measured either by real output or by export growth.¹² The potential benefits of trade liberalization can be reaped only if this is accompanied by the right domestic policies in the realm of the macroeconomy, competitiveness and the compensation of critical market failures. This equally holds true for preferential liberalization.

The macroeconomic environment in which trade liberalization takes place is critical to its sustainability

and final impact. In Latin America there is a long tradition of trade liberalization programmes being implemented *pari passu* with macroeconomic stabilization processes built around the nominal exchange rate as an anti-inflationary anchor. All of them have led to appreciation of the domestic currency in real terms and, eventually, to external crises and policy reversals. These failures, occurring more than once in some countries, have weakened the productive fabric and reduced their ability to benefit from future episodes of trade liberalization. It is unlikely, furthermore, that economies subject to recurrent external shocks and volatile capital flows will be able to sustain successful trade liberalization policies over time while simultaneously achieving an acceptable growth performance.

In fact, countries will only manage an acceptable economic performance if they pursue export-oriented exchange-rate policies (preventing real appreciation of the domestic currency for long periods of time), implement prudent fiscal policies that avoid the build-up of excessive public-sector debt, and adopt mechanisms to offset unexpected shocks and turbulence. This being so, a preferential trade agreement which limits the scope for using policy instruments that can lessen a country’s vulnerability to external shocks (originating, for example, in the financial markets) is unlikely to be the right recipe for responsible macroeconomic management. Conversely, one that includes compensatory mechanisms to deal with unexpected external shocks may increase the likelihood of more satisfactory macroeconomic

¹² See Bouzas and Keifman (2003) for a more detailed discussion.

outcomes. For example, there is a broad consensus that the rapid and massive financial help provided by the United States government to Mexico in 1994-1995 helped that country to leave the “peso crisis” behind it faster than it would otherwise have done. NAFTA probably had a favourable impact on investors’ expectations, helping Mexico to overcome the crisis faster, but the financial package engineered by the United States Administration was at least as important at this time.

To bring about domestic conditions that will enable them to benefit from economic integration and trade liberalization, countries also need to implement policies that foster competitiveness and compensate for market failures. A more open trade regime is a necessary condition for greater economic efficiency, but other complementary policies that enable countries to reap the gains of international specialization are equally important. A competitiveness strategy of this kind should be based on at least three pillars: i) construction of adequate infrastructure; ii) diversification of the production structure, and iii) the development and strengthening of national innovation systems.

The lack of adequate infrastructure is one of the key factors holding back international trade. Many goods are not traded simply because high transport costs represent a major trade barrier. The relatively high prices of services also diminish the incentive to fragment the production process across countries, limiting the scope for intrasectoral specialization. Foreign aid could make a significant contribution to the upgrading of trade-related infrastructure by focusing on regional projects, or national projects with regional externalities. In North-South agreements, the issue of infrastructure development should be more easily and effectively addressed than in South-South agreements or unilateral or multilateral liberalization because one of the parties is usually well equipped with financial resources and administrative expertise that can be used for this purpose. The example of infrastructure spending in the European Union, where per capita income disparities are much smaller than in the Western Hemisphere, should encourage a more effective focus on this issue.

Export promotion policies can help to diversify production. Active trade diplomacy that opens up foreign markets, identifies new opportunities and disseminates information may help to increase exports. But to be effective these policies need a well trained bureaucracy and public-sector officials capable of

developing a cooperative —but independent— relationship with the private sector. This suggests that there is a very significant role for export promotion policies focused on the provision of information, foreign trade support, financial assistance and insurance guarantees. Many of these instruments and institutions are already in place in a number of Latin American countries, but their efficacy is low. However, there are exceptions which confirm that their contribution really can be significant. Rather than conventional export subsidies (for the most part limited by multilateral commitments), a modern view of export promotion demands an emphasis on the efficient provision of information, coordination and other public goods.

Considering the failures that prevail in technology, credit and human capital markets, policies to increase productivity are the best recipe for better export performance in the long run. Although the Uruguay Round agreements prohibited non-agricultural export subsidies, they gave the green light to other domestic aids widely used by the industrial countries (such as subsidies for research and development). There are three aspects that are critical if the gap between industrial and developing countries as regards the type and extent of public-sector aids is to be closed (ECLAC, 2002). In the first place, policies should foster forward and backward linkages as a mechanism for rectifying a dualistic economic structure in which modern activities that are closely integrated into the world economy operate side by side with backward and low-productivity sectors. In this area, domestic public policies can help by providing infrastructure and coordination geared towards the strengthening of production clusters. Secondly, there must be official agencies in a position to help local firms (especially small and medium-sized ones) with technology diffusion, innovation and human resource development. Public policies should focus on providing a solid scientific and technological infrastructure, stimulating research and development and coordinating innovation activities undertaken by universities, research institutions and firms. Lastly, since research and development spending is about five times higher as a proportion of real output in the industrial countries than in developing ones, governments in the latter should consider granting research and development subsidies to the private sector.

None of these policies is guaranteed to succeed, particularly given the institutional fragility and weakness that prevail in Latin America. Even so, it is

essential to undertake appropriate initiatives in each of these fields, if the objective is to reap the potential benefits of trade liberalization and economic integration. As the experience of Mexico after a decade in NAFTA demonstrates, despite rapid export growth to

the United States market and the change in export composition, the lack of effective domestic policies in these critical areas has perpetuated a dual economy in which personal and regional income disparities have widened instead of contracting.

IV

Ten years after Miami, where are FTAA negotiations heading?

When the FTAA process was launched in 1994 it was received with a mixture of enthusiasm and scepticism. Both reactions were justified. Some governments regarded it as a way of restoring trade and investment incentives eroded by the preferences granted to Mexico, while others which did not see such obvious trade and investment incentives regarded it as an insurance policy that would guarantee stable access to a large market and as a mechanism to lock in economic reforms and improve expectations. Some governments saw the FTAA as an opportunity to strengthen hemispheric relations and make United States engagement in the region more explicit. These enthusiastic views account for the support that gathered around the initiative in many Latin American governments and the intense diplomatic efforts that many of them made to include trade issues on the agenda of the First Summit of the Americas, the presidential meeting held in Miami in December 1994.¹³

But the sceptics also had a point. Divergent agendas, interests and perceptions, asymmetries of development and size and the credibility problem faced by United States negotiators (lacking a Congressional mandate to negotiate trade agreements on a fast track basis) offered good reasons for pessimism. Despite these reservations, the more reluctant governments had little option but to follow the predominant trend. Consequently, they focused their efforts on strategies

to block or delay the negotiations. This was made easier for some time by the credibility deficit of the United States negotiators, but as time passed even the most reluctant parties started to prepare for substantive negotiations by organizing their public sectors and promoting closer cooperation between private and public actors.¹⁴

During the first three years of negotiations the participant governments gathered information, got to know each other and laid down the strategic principles that would guide the negotiations. Only at the Fourth Ministerial Meeting held in San Jose, Costa Rica in 1998 did the trade ministers announce the key principles and define the structure within which the negotiations would be carried on.¹⁵ However, the set of principles agreed at that time left several issues unresolved, enabling the parties to interpret commitments in different ways.¹⁶ The presidential meeting (Second Summit of the Americas) held in

¹³ A few weeks prior to this meeting, the United States Administration was inclined to exclude any specific trade commitments from the final declaration. Several governments in the region mobilized to change this decision, arguing that the failure to make an explicit commitment on trade would reduce the relevance of the Summit. For an analysis of the early years of negotiations, see Bouzas and Svarzman (2001); see also Feinberg (1997).

¹⁴ The Brazilian Government, one of the most reluctant participants in the FTAA process, was at the same time one of the most active in creating the domestic conditions it needed to negotiate effectively. See Da Motta Veiga (2002) for an analysis.

¹⁵ The main principles agreed were: i) consensus decision-making; ii) the agreement of a single package of rights and obligations valid equally for all signatories ("single undertaking"); iii) individual or group participation in the negotiations; iv) WTO-consistency; v) no *a priori* exclusions in market access negotiations; vi) the coexistence of the FTAA process with subregional integration processes; vii) equal rights and obligations, taking into consideration differences in size and development levels, and viii) the launching of effective negotiations in 1998 and conclusion by 2004 at the latest. At the San Jose meeting the parties agreed on the structure of the negotiations: there would be nine Negotiating Groups overseen by a Trade Negotiations Committee formed of deputy trade ministers. The Committee would meet at least once every 18 months.

¹⁶ One example of the ambiguity of some of the principles agreed on at San Jose was the coexistence of the "single undertaking" and "early harvest" principles.

Santiago, Chile in 1998 ratified the agreements reached in San Jose and formally launched the negotiations.

After Santiago the FTAA negotiations moved on to the next phase, with a more specific agenda that included mandates for each Negotiating Group and the specific procedures and modalities to be adopted in each forum. The parties agreed to write a unified draft text and submit it to the Sixth Meeting of Ministers of Trade scheduled to take place in Buenos Aires in April 2001. At that meeting the trade ministers examined a long “bracketed” text that consolidated the results achieved—or lack of them—in each of the nine Negotiating Groups. Much of the text simply reported divergent national positions.

The Seventh Meeting of Ministers of Trade took place in Quito in November 2002 and made modest progress with respect to the Buenos Aires meeting. In Quito a second draft text was submitted to the ministers, the Committee on Institutional Affairs began to operate and negotiating methods and procedures for the next phase were agreed upon (including the procedures for notifying base tariffs), as was a timetable for exchanging market access offers (starting on 15 December 2002). For all the apparent progress, in many chapters of the draft text only a few brackets, relating to formal aspects, were removed. Wherever text had been bracketed because of substantive differences of opinion, it remained so now.

The Quito Meeting of Ministers of Trade also raised doubts about the feasibility of the timetable, particularly when it came to the submission of market access offers. In fact, in five of the groups (agriculture, market access, government procurement, services and investment) market access negotiations were launched and a timetable for exchanging offers was set before critical differences over the methods and procedures to be adopted by each negotiating group had been bridged. The architecture of the services chapter and its relationship with the investment chapter, for example, were left unresolved.¹⁷ There was also disagreement over how tariff concessions should be submitted in the goods chapter.¹⁸ The operational

content of the special and differential treatment principle was also a matter of controversy.¹⁹

The offers submitted since December 2002 reflect these ambiguities. In the goods and services chapters practically all countries had submitted offers by the target date (15 February 2003), but this was not the case with the investment and government procurement chapters. The groups of countries that submitted joint offers (Mercosur, the Andean Community and the Central American Common Market) did so with different formats, coverage and architectures, illustrating the difficulty of finding a common approach. The United States, meanwhile, submitted four different market access offers depending on the group of countries concerned. All other participants made a single offer, indicating the possibility of some type of special treatment for small economies. Services and investment offers were also made, following different architectural approaches.

In summary, just prior to the Eighth Meeting of Ministers of Trade, held in Miami in November 2003, the FTAA negotiations faced a large number of unresolved issues. The lack of offers from Argentina and Brazil in certain areas such as government procurement, services and investment reflected a growing preoccupation with the overall balance of the negotiations. In effect, the United States refusal to deal with certain issues at the hemispheric level (such as antidumping and agricultural subsidies), either because they were regarded as inappropriate for preferential treatment or systemic in nature, encouraged a response that consisted in the withdrawal from the FTAA agenda of issues considered to be of “offensive” interest to that country (precisely investment, services and government procurement).²⁰ Consequently, in mid-2003 Mercosur formally submitted a proposal to continue negotiations along three parallel tracks: a bilateral track in the “4+1

most-favoured nation principle or would include differing treatment by country or group of countries. See: <http://www.ub.es/obsglob/Semercosur-.html>.

¹⁹ The Quito ministerial declaration reaffirmed some conditions for progress in the negotiations which made explicit the concerns prevalent among the participants. Major concerns were the need to make “continuous, balanced and substantial progress on all negotiating issues”, to take into consideration differences in development level and size, and to link the FTAA negotiations to the progress made in the Doha round.

²⁰ Concerning the potential of the FTAA as a trigger for policy change in areas considered sensitive by the United States, it is telling that the Western Hemisphere countries which have not yet started bilateral preferential negotiations with the United States accounted in 2001 for slightly more than 6% of United States exports, as compared to 44.3% for the hemisphere as a whole.

¹⁷ It was left undecided, for example, whether offers in the services sector would be made following the criteria of negative or positive lists or whether offers on services-related foreign direct investment would be included in the investment or services chapter (the “commercial presence” modality, in the jargon of the General Agreement on Trade in Services). For a detailed discussion, see: <http://www.ub.es/obsglob/Seriemercosur-.html>.

¹⁸ It was left undecided whether the presentation of market access offers in goods sectors would be made on the basis of the regional

format” (Mercosur member States and the United States), an FTAA track and a multilateral track. Each track would cover a different range of issues and the FTAA agenda would be considerably less ambitious than initially conceived.²¹

The reduction in the breadth and scope of the FTAA was complementary to another trend firmly established in recent years, namely the creeping “bilateralization” of the negotiating process. Since 1994 a multi-layered process of bilateral and “minilateral” negotiations, with access to the United States market a key consideration, has developed simultaneously with and in parallel to the FTAA process. As part of this process, and after a long delay, the United States Administration signed a free trade agreement with Chile and concluded negotiations with the members of the Central American Common Market. Negotiations were also launched with the Dominican Republic, Peru, Colombia, Ecuador and Bolivia. From the standpoint of United States interests, these sequential negotiations have aimed at gradually consolidating an agenda and an architecture consistent with broader United States negotiating objectives. The strategy has not been limited to the United States, though. Mercosur attempted with much less success to establish a free trade area in South America, while Mexico and Chile have succeeded in consolidating their role as hubs in the “hub and spokes” system under construction.

The Miami Meeting of Ministers of Trade did not clear up existing doubts about the prospects of the FTAA process, and indeed raised new ones. The summit was not an open failure, but it replicated a standard feature of FTAA negotiations: postponement of the most sensitive issues, even though the date set for concluding the negotiations was only 12 months ahead.

In practice, the Miami meeting formalized what was already a fact, namely that the FTAA, if eventually agreed, will be considerably less ambitious than originally envisioned. This “light” version of the FTAA may serve the needs of several of the key parties, even if some of them formally oppose that architecture.

The Miami compromise²²—drafted by United States and Brazilian negotiators—gave rise to a two-layered agreement. The first layer includes “a common and balanced set of rights and obligations applicable to all signatories”, while the second layer includes “additional benefits and obligations” for those countries or groups of countries willing to negotiate deeper market access commitments or stricter disciplines. The first and common layer would include rights and obligations in the nine areas under negotiation, with no exclusions. However, in the absence of an agreement to develop specific (and deeper) rules on all these issues, the resulting agreements may simply replicate the commitments already made at WTO. In that event, the WTO-plus nature of the FTAA process would be seriously open to question. The Ministerial Declaration also failed to go into any detail about the content of the general agreement, since the parties failed to reach consensus (a situation which remains unchanged as of late 2004).

The Ministerial Declaration did not clarify the relationship between the hemispheric agreement and the bilateral or plurilateral agreements either. One alternative could be to adopt an architecture similar to that of the pre-Uruguay Round GATT, whereby a multilateral agreement with rights and obligations for all signatories coexisted with voluntary codes of conduct. Another alternative could be a multilateral umbrella giving coverage to the existing network of bilateral and minilateral agreements. In this latter case the FTAA would resemble the architecture of the Latin American Integration Association (LAIA), with the major novelty of having the United States and Canada inside.

²¹ See: <http://www.ub.es/obsglob/Semercosur-.html>. On that same occasion 13 countries (12 from Latin America plus Canada) submitted a document urging that an ambitious agenda be retained. Uruguay also presented a text that sought to reconcile the “original approach” with some degree of flexibility to accommodate national specificities.

²² Ministerial Declaration of 20 November 2003 (Free Trade Area of the Americas, Eighth Meeting of Ministers of Trade, Miami).

V

Conclusions

Although the negotiations have not concluded yet, the FTAA process demonstrates how difficult it is to negotiate reciprocal North-South preferential trade agreements. Indeed, the FTAA that is starting to emerge after a decade of negotiations is very problematic. The best guarantee of a more balanced and reciprocal agreement would have been to stick to negotiations undertaken within a “plurilateral” framework (the original spirit of the “single undertaking” concept). The asymmetries of the negotiating process, however, pushed it irreversibly in another direction.

After a decade of negotiations, the scenario of a balanced and comprehensive FTAA that offers an acceptable bargain to all the parties involved seems to be out of reach. This has been due to the nature of the agenda and the differences over how to deal with it (a number of parties have shown a limited interest in a comprehensive agreement). The interdependence between some of the issues under negotiation and the multilateral situation has made it unlikely that the former can move faster than the latter, unless a biased agenda prevails. In this context, as the United States Trade Representative stated after the failure of the WTO 2003 Ministerial Conference in Cancun, the United States is ready to move forward with its strategy of “competitive liberalization”, reaching deals with partners that are ready for this. This scenario deepens the asymmetrical nature of hemispheric trade negotiations and reduces the likelihood of truly reciprocal trade agreements.

The most likely scenario for the FTAA is an agreement of limited coverage, along the lines of the “two-layered” architecture agreed in Miami. Given the difficulty of coming to terms on what should be included in the “umbrella” agreement, however, there

is a very high chance that this will end up as an “ultra-light” set of general principles. Such an agreement, however, may suit the interests of a larger number of partners than initially imagined.

Indeed, an “ultra-light” agreement would not run counter to the United States trade policy strategy of pursuing its trade agenda by the bilateral route. United States negotiators can continue to pick up those partners that offer the least resistance to their demands and whose own demands conflict least with the United States domestic political economy. This would enable them to continue promoting their trade objectives at a relatively low domestic political cost. For countries that have become hemispheric hubs, an “ultra-light” agreement may be a reasonable compromise to prolong the benefits of positive discrimination. In turn, the most reluctant partners (such as Brazil) may find that this scenario offers a way of putting off the tough choices implicit in a North-South agreement. This, however, must be weighed against the consequences of negative discrimination in Western Hemisphere markets and the resulting increase in the costs of exclusion. Over the medium term, this can hardly be regarded as an acceptable alternative unless the Doha Development Round makes unexpectedly substantial progress.

The complex trade architecture that will emerge in the Western Hemisphere is likely to exacerbate the mercantilist bias implicit in trade negotiations, making what is already a structurally asymmetrical playing field even less level. Considering the fragility of the disciplines governing preferential trade agreements at WTO, the prospects for North-South regionalism and its complementarity with the multilateral trading regime cannot but raise serious concerns.

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The State, the markets and development financing

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This article examines the role of the State, institutions and financial markets in the financing of economic development, and in particular the role of development banks. It touches on the limitations of today's conventional approach to development financing problems. It stresses information asymmetries as a cause of credit rationing and the poor distribution of savings. It also offers an analysis of the role of the State and markets in development financing, together with a policy agenda suggested by the different approach set forth here. It concludes with some considerations concerning problems and challenges now facing development financing in Latin America.

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I

Introduction

In recent years, economists have been taking a renewed interest in the role played by the State in development financing. This interest almost disappeared from the theoretical debate after 1973, when Shaw and McKinnon put forward the thesis that financial liberalization would solve the problem on its own by enabling long-term financing mechanisms to be created in the private sector.

In contrast to the liberal outlook inherent in Shaw and McKinnon's models, neo-Keynesian writers have set out to study the distribution problems caused in credit and capital markets by information asymmetries. Our view is that, while this approach has yielded sound arguments for public policy involvement in development financing, it is still analytically and politically ambiguous and excessively vague as a guide to government policy.

From the analytical point of view, this ambiguity stems from at least two elements: i) the conceptualization of financing in capitalist economies, according to which financial institutions (including banks) are regarded simply as intermediaries between savers and investors, with a merely passive role in determining the volume of funds for investment financing, and ii) the definition of information problems (asymmetry) in the financial intermediation process, which leaves out the concept of uncertainty in the Keynesian/Knightian sense.¹

From the political point of view, the ambiguity (as many conservative writers have explicitly stated) concerns the scope and the ultimate outcome of State intervention, in the light of what is now a long-standing debate about market failures versus State failures. This is because it is usually not made clear whether the State should confine itself to improving information distribution and regulatory mechanisms, or whether it should finance sectors directly, in which case it is also necessary to determine which sectors should be so benefited.

This article offers a constructive critique of these models, based on a different approach that stresses the role of institutions and uncertainty in the problematic of development financing. Consequently, the analysis offers a more positive view of the role of the State in this field and puts forward a policy agenda that, in theory, could guide financing and institutional development policies in the financial market.

The article is divided into five sections. Following this introduction, section II undertakes a critical examination of the conventional approach to the problems entailed in development financing; section III presents an alternative approach based on a Keynesian outlook; section IV considers what policy agenda arises from the approach presented in the previous section, and section V brings a summary and conclusions.

II

The conventional approach

All theories need a stylization of the ideal operating conditions for the object of analysis. In physics

models, for example, results are always calculated for "normal conditions of temperature and pressure". By

□ This article was written when the author was an economist at the Economic Development Division of ECLAC, but the ideas it contains do not necessarily represent the viewpoint of that organization. The author is grateful for the comments of Antônio José Alves Jr. and Jaques Kerstenetzky on a preliminary version of this text and for the excellent comments of an anonymous reviewer for this Review. Responsibility for any remaining errors is the author's own.

¹ This omission is particularly serious given that one of the fundamental characteristics of developing economies is the continuous emergence of new sectors, the introduction of new technologies and the creation of new markets. These are, by definition, situations of uncertainty, since there are no past data that can easily be drawn upon to guide credit analysis or to determine companies' long-term asset prices.

positing this “ideal environment” we can characterize the process in its unadulterated state and evaluate results that appear to differ from those predicted by the theory.

The same procedure is used in economic theory: a model is created for the operation of markets and their agents in what is considered to be an ideal environment. As we are dealing with social systems, and thus with human institutions, this task is obviously far more complex, not only because the object of analysis (economic organization) may be interpreted differently depending on the theoretical and ideological position of the analyst, but also because it alters over time.

Despite this complexity, in financial intermediation and development financing theory, as in other areas of economics, stylization of the object is vital for establishing whether particular markets and agents are working efficiently (by comparison with our ideal model), detecting the failures and “noise” that could be preventing markets from operating properly, and working out policies to remedy possible failures in the intermediation process.

One of the most conventional stylizations of financial intermediation and development financing issues is taken from the neoclassical capital market model and termed the efficient markets hypothesis (Lewis, 1992). In the first case, the market is composed of two optimizing agents: savers and investors. Savers (suppliers of savings) have defined intertemporal preferences and investors (users of capital) carry out production functions, and therefore have specific marginal capital productivity curves. The capital market and financial institutions are defined as the *locus* and as the agents through which the intermediation of savings takes place, respectively.

According to this model, savers and financial intermediaries have, under ideal conditions, all the information and instruments they need to determine their portfolio composition, and there is no lack of investment financing sources. Some investments go unfinanced because their returns are lower than savers ask, given their intertemporal preferences.

According to the efficient markets hypothesis, capital markets are efficient if they fully and accurately reflect all information in setting the prices of financial securities (Malkiel, 1994, p. 739). In its most categorical form, this theory suggests that, notwithstanding the possible (short-term) volatility of financial asset prices, these change over the long term in accordance with the underlying economic variables of the agents who issue

them (Wicksell’s natural rate of interest).² This hypothesis, then, simply complements or reinforces the idea that savings are allocated efficiently to the most profitable investments, in accordance with the intertemporal preferences of savers.

In the conventional model, then, the financial system is defined as a *locus* or passive intermediary that does not influence the volume and quality of investment financing funds. Its efficiency is gauged simply by its ability to distribute information among productive investors and savers, the “real actors” in the financial market. Vittas and Cho summarize this point of view as follows:

“In an ideal world in which economic information is complete and readily available, the financial system is passive. Investors fund the projects that yield the highest returns, and neither governments nor financial institutions need to improve the allocation of credit. In the real world, however, information is highly imperfect and costly to acquire, and the allocation of credit suffers from the unequal distribution of information, the costs of monitoring and verification, and the cost of default or contract enforcement. Under these conditions, credit is not necessarily allocated to its best use” (Vittas and Cho, 1997, p. 278).

When the conventional approach is applied to the analysis of development financing problems, the outcome is that only two reasons (“failures” or “impurities”) can be found to justify active government policy intervention in the financing process:

- i) markets are incomplete (underdeveloped) and thus cannot act as efficient intermediaries between savers and investors, and
- ii) there are significant information failures that prevent markets from distributing savings efficiently.

For at least the last three decades, as we shall now see, these have been the two main focuses of most of the conventional development financing analyses that, emphasizing one aspect or the other, have provided the basis for policy-making.

² See Andersen (1983-1984) for an analysis of the efficient markets hypothesis.

1. Incomplete markets and financial repression

Half a century ago, Gurley and Shaw (1955) recognized that the capacity to finance growth might be constrained when there were no markets capable of matching the maturities of surplus spending units (savers) and deficit units (investors). If the market were incomplete the supply of credit would be below potential and the level of accumulation thus lower than it would otherwise have been.

In our view, this would be an interesting way of analysing the problem of development financing had it not come to be generally understood as a by-product of the conventional approach described. This by-product, which has been of the greatest importance because of its influence on the financial policies of developing countries (and even some developed ones), is the range of so-called financial liberalization models that have come out of Shaw and McKinnon's seminal studies of 1973. Those authors share Gurley and Shaw's (1955) opinion that financial underdevelopment is a serious obstacle to development. The difference between the two types of analysis is that financial liberalization models link financial underdevelopment (incomplete financial markets) with prolonged "financial repression" in such economies.³ In other words, "financial underdevelopment" (defined here as lack of financial depth) is put down exclusively to misguided interest-rate repression and selective lending policies.

To Shaw and McKinnon's way of thinking, State intervention in capital markets is not justified by failures of intermediation due to incomplete markets. Rather, it is because of the intervention itself that markets remain incomplete. Using these authors' work as a starting point, economic development theory came to regard the issues raised by Gurley and Shaw in the 1950s—the problems of financial underdevelopment and its negative effects on development, and the role of the State in mitigating these effects—as secondary matters that could be resolved fairly easily by financial liberalization.⁴

Models like the one suggested by Shaw and McKinnon provided a theoretical justification for some failed attempts at financial liberalization, whose disastrous outcome was that instead of the supply of lending and investment resources expanding as

expected, financial instability increased and was often followed by the failure of banks and enterprises, in addition to economic recession.⁵

Perhaps the clearest lesson from these experiences is that the problem of incomplete markets in development financing is not resolved simply by reducing the role of the State in capital markets, deregulating, and freeing up interest rates. In fact, the institutions and markets which we term the financial system are usually the outcome of decades of trial and error by private-sector agents, working under the stimulus of policy and regulation. In the case of development financing (and financial market institutions) it can be seen that institutional experiences and configurations differ widely, in both developed and developing economies.⁶ This subject, which is perhaps the most important in this article, will be returned to later.

2. Information asymmetries and distribution problems

By moderating the typical Walrasian model hypothesis concerning the perfect distribution of information, authors such as Stiglitz have been able to show that there are problems with the distribution of long-term funding (such as credit or even equity rationing) caused by failures of information distribution.

According to this view, then, information asymmetries can introduce financial market inefficiencies that may have considerable real *quantitative* effects (Gertler, 1988, p. 560). In other words, lenders (direct or intermediary) have difficulty in distinguishing between good projects (for instance, profitable investment projects with a low risk of default) and bad ones. To avoid adverse selection risk and moral hazard, the rational solution for the lender is to set interest rates lower than the capital market equilibrium rate and ration credit. Besides distorting the distribution of funds,⁷ this leads, as Stiglitz and

³ See Studart (1999) for a critical analysis of these models.

⁴ See, for example, Gertler (1988) and Gersovitz (1988).

⁵ Studart (1999) presents a bibliography of papers that describe the failure of attempts at financial liberalization as a way of expanding sources of development financing. Of these papers, perhaps the most striking is that by Díaz-Alejandro (1985).

⁶ Howells and Bain (1997, chapters 16-19) give a description of the fundamental differences between the financial market institutions of the United Kingdom, the United States, Germany, France and Italy. See Zysman (1983) for a more detailed analysis of the effects of these institutional systems on investment financing mechanisms.

⁷ A typical instance of the "lemon" problem as proposed by Akerlof (1970).

Weiss (1981) have shown, to a reduction in the credit supply.⁸ Faced with these failures, the State would seem to have an important enabling role to play, supplying credit to rationed sectors and bringing sectors with good prospects to the attention of intermediaries and savers.⁹

This approach has been criticized on two counts: i) if the problem is due to failures of information distribution, then more careful regulation, with internationally accepted rules of disclosure, and recent advances in the production and distribution of information (such as the emergence of private-sector risk-rating agencies) should make State intervention unnecessary, and ii) if there are market failures, what guarantee is there that they will be worse than government failures?¹⁰

III

Investment financing and market structures: beyond the conventional approach

In several passages of the General Theory (Keynes, 1936), and in later articles, Keynes insisted that investment was the determining factor in income and saving. This reversed the direction of causality identified by the conventional approach, as was logically required by his principle of effective demand.¹¹ The switch points, in turn, to a hierarchy of agents in the financing mechanisms of capital formation in capitalist economies:

i) as Wicksell also concluded, it is banks, and not savers, that play a fundamental role in determining the aggregate supply of investment financing sources, and thus “in the transition from a lower

By contrast with analyses based on Gurley and Shaw’s models, those that follow Stiglitz’s (1993) thinking play down the problem of financial underdevelopment (the fact that financial markets are incomplete) when examining the difficulties of development financing. This is because for Stiglitz the problem is purely macroeconomic (information asymmetry) and independent of the institutional structure (size and organization of financial markets) in which financial intermediation occurs. Again, because the problem is one of poor information distribution, it makes no difference whether economies are slow- or fast-growing, or whether they have undergone deep structural changes or not. In our view, these two aspects are major gaps in any attempt to understand the problems of development financing.

to a higher scale of activity” (Keynes, 1937, p. 668);

- ii) saving is a result of the investment process, and not a prerequisite for investment;
- iii) the allocation of savings that are generated by the income multiplication process is important for dealing with problems resulting from the growing mismatch between maturities during economic growth, and
- iv) the preference of banks and securities holders for liquidity, and not the intertemporal preference of consumers, is what determines the volume and maturities of investment financing.

⁸ This analysis runs directly counter to the theory of financial repression: “This is important because the original critique of interest-rate ceilings was that they created a credit rationing problem. The ceiling prevented the price of credit from rising until demand for credit equalled supply. It is now believed that credit will be rationed even without the ceilings set by policy” (United Nations, 1999, p. 138).

⁹ See Stiglitz and Uy (1996) for an application of this approach to the analysis of the South-East Asian experience.

¹⁰ This is the tenor of the following comments by Jamarillo-Vallejo (1994, p. 53) on Stiglitz (1993) at the Annual Meeting of the World Bank, which echo many current criticisms of development financing institutions: “In his paper Stiglitz is asking us to assume that governments all over the world —especially developing countries—

are wise, fair and efficient enough to carry out the kind of ‘perfect’ intrusive intervention suggested by him. It is as if the world of the second best had just been discovered and we had not learned from the experience with the different forms of government intervention that we have seen in this century.” Vittas and Cho also raise this dilemma in the same terms: “Ultimately, however, the advantages depend on the *motivation and efficiency of the government involved*. Governments do not always ‘do the right thing’. Government involvement in credit allocation can, and often does, result in rent seeking by borrowers, corruption by bankers and government officials, and crowding out of other worthwhile projects” (Vittas and Cho, 1997, p. 280; my italics).

¹¹ See Carvalho (1992, part I) for a post-Keynesian analysis of the foundations of Keynes’s theory.

The differences between Keynes's approach and the conventional model are not merely semantic: the Keynesian model has a "stylization" of its own, embracing the microeconomic, macroeconomic and institutional dimensions of the investment financing process. This stylization can be used as an alternative to the conventional approach when examining the role of the State, markets and institutions in development financing. This is what will be explained now.

1. Mismatched maturities and credit rationing in a development context

A large proportion of development financing needs are for long-term funding. Productive investment usually goes to fixed assets, which take a long time to generate returns. In financing the acquisition of a long-term asset, both commercial banks and productive investors will be exposed to the risks entailed by mismatched maturities. If banks grant long-term loans (and accept savings at shorter maturities, as usually happens), they are not only exposed to an obvious risk of default, but also run liquidity and interest-rate risks. If their financing is short-term, the productive investors will have to be continually rolling over their short-term credits, and will thus be exposed to the risk of higher interest rates (which in turn increases the risk of default on their bank loans).

Like any other agent, bankers have a preference for liquidity, although this is defined differently in their case than in that of financial investors. The preference of banks for liquidity can be expressed by the following argument. Given the stock of reserves held by commercial banks, the creation of deposits represents a reduction, albeit temporary, in the ratio between reserves and high-liquidity assets on the one hand, and sight deposits on the other. This ratio (hereafter α) is a proxy for the increase in the maturities gap between bank assets and liabilities. A lower α means greater financial vulnerability for banks.

The smaller and shallower interbank and securities markets are, the greater this vulnerability. For example, in the absence of a large interbank market or a market for securities bundled into securitized loans (secondary securitization), the liquidity of loans in bank portfolios will be zero. This means that Central Bank rediscounts are essential to prevent bank liquidity problems. Because such rediscounts are punitive in character, however (either because their discount rate is higher than the market rate, or because they entail a loss of public confidence in the solidity of the bank applying

for them), banking institutions only use them as a last resort.

Thus, given the structure of financial markets and the access of banks to liquidity sources, the preference of these institutions for liquidity can be traced directly to the perception that default, liquidity and interest-rate risks increase as deposits rise.

Interestingly, in periods of investment-based growth, perceived default and liquidity risks tend to rise simultaneously: while the portfolio of applicants for bank funding tends to expand (implying the acceptance of new customers with higher perceived risk), the ratio between total liquid assets and loans falls.¹² Since such lending is financed by expanding short-term deposits, the mismatches between liability and asset maturities increase.

As perceived total risk rises, banks tend to become more conservative for any given level of expectations and begin to be more selective in their lending, seeking more collateral and better returns on their operations. Thus, over the course of the development process, rising demand for credit (usually stronger than aggregate demand growth, at times of economic expansion) tends to be rationed for a given level of expectations.¹³

In growing economies where financing comes from bank lending, therefore, credit rationing is due not only to information asymmetries, but potentially to three other causes:¹⁴

- i) bank financing levels come up against ceilings set by banks (given their level of expectations) as they respond to ever-increasing demand for credit;
- ii) banks do not have the data they need for credit analysis, for example in the case of new clients;
- iii) data for accurately assessing the creditworthiness of potential clients do not exist or are of no use. In the latter case, for example, there tends to be discrimination against innovative companies (those that introduce new products or forms of

¹² It could be assumed that banks expanded their lending only to existing clients, of course, but this would be an extreme case.

¹³ See Sobreira and Studart (1997) for a formalization of this hypothesis. It should be noted that in general, as Minsky (1982) shows, bank expectations tend to rise at times of growth, which creates the potential for lending booms.

¹⁴ Credit rationing caused by information distribution problems (information asymmetry) affects the financing (whether of production or accumulation) of any kind of productive activity. This is because a microeconomic problem comes into play: the market may be very good at allocating resources, but to do this it must have access to the information it needs to evaluate risk and, thence, expected returns.

production or operate in new domestic and external markets) and against small and medium-sized enterprises (Dosi, 1990).

Thus, at times of growth, credit is rationed mainly by applying greater selectiveness to the growing perceived risks. This rationing tends to favour established enterprises that can offer higher-value collateral, which may result in the exclusion of new or small businesses and of investment projects whose returns are uncertain or very long-term.

2. The role of capital markets, speculators and individual and institutional investors

We have seen that, in the absence of long-term securities (issued by companies in specialized markets or sold by “universal banks”), investment financing involves an increase in the financial vulnerability of investors or financial intermediaries, defined for the purposes of this study as the difference between the average term of their assets and that of their liabilities. The less developed the markets or the demand for longer-term assets are, the greater the problem of asset mismatch will be and the harder it will prove for private-sector agents to undertake investment financing.

Long-term securities markets provide individual investors with the liquidity they require (through trading in secondary markets), increasing the attractiveness to them of securities which for the

community as a whole are, by definition, illiquid.¹⁵ Such securities markets are, therefore, the main market mechanisms allowing productive investors and “universal banks” to extend the maturity of their liabilities and therefore reduce asset mismatch. This process of liability restructuring, whether by extending maturities or converting debt, is what Keynes called “funding”.

The extent to which capital markets accelerate economic growth largely depends on the size and development level of the primary markets where assets are issued and where, consequently, capitalists can obtain financing. The size of primary markets depends, in turn, on how well organized secondary markets are and how much business is transacted there, since these markets give issuers the opportunity to place securities more cheaply and give financial investors the liquidity needed to offset the risk of capital losses. A large volume of daily transactions is essential to the liquidity of secondary markets, and this requires dynamic participation by short-term investors (speculators).

Although speculators are essential to the market, long-term individual and institutional investors are the “anchor” that prevents volatility from becoming excessive. A market dominated by short-term speculative activity tends to inhibit the operations of institutional investors, particularly those that are more averse to capital risk, such as pension funds and insurance companies.¹⁶

IV

The problems of development financing

In the context of development, the existence of appropriate institutions, markets and market regulation and supervision mechanisms makes possible, but does not guarantee, investor access to long-term financing.¹⁷ Such access is essential for financially sound growth.

Besides considering the need for a suitable regulatory and legal framework, any analysis of

development financing problems needs to take at least two aspects into account: institutional underdevelopment (including financial markets, institutional investors¹⁸ and the auxiliary institutions of financial intermediation) and information problems (asymmetrical information and uncertainty). These aspects are analysed below, and will provide the basis for the policy agenda presented in the following section.

¹⁵ In other words, if all the holders of a given financial security decided to sell it simultaneously, its price would tend quickly to zero.

¹⁶ It is no coincidence, therefore, that growth in the United States capital market involved the simultaneous expansion of company listings and institutional investors. This subject will be returned to later.

¹⁷ This section draws on Acevedo (2000).

¹⁸ See Studart (1999) for an analysis of the role of institutional investors in the provision of long-term funding.

1. The weight of institutions and history

The system of liability restructuring (funding) through capital markets requires a complex institutional system. Alongside a legal and regulatory structure that guarantees rights and reduces the likelihood of fraud, these markets are constituted by agents with different investment preferences and by providers (businesses and government): institutional investors (including pension funds) usually have a preference for longer-term securities, while speculators buy and sell over shorter terms.

Institutions of this kind do not develop as a straightforward result of market forces. One of the great problems connected with the development of capital markets is the cost of maintaining them, which largely depends on their original scale. For this scale to be significant, the number and size of issuers, the volume of funding that needs to be raised and the number of long-term security purchasers are all of vital importance. The development of the United States capital market in the late nineteenth century was basically underpinned by gigantic railway projects required for the expansion into the interior of the country. Not only were the original issuers large companies, but income distribution in the United States economy was better in the nineteenth century than it is in most developing economies today. Combined with relatively rapid economic growth, this led to a considerable and steady increase in demand for assets issued on the capital market. It also provided the basis for an increase in the number of institutional investors, as these tend to concentrate savings and invest them in assets that are compatible with their contingent liabilities, i.e., over longer terms.¹⁹

Where long-term assets are concerned, the scale of both supply and demand appears to be crucial. This is why highly developed securities trading markets are not the historical norm, but the exception. Most developed economies—the exceptions are the United States and the United Kingdom—and developing economies have different funding mechanisms.²⁰ The

German system, in which funding is dominated by private-sector “universal banks”, is an interesting and much cited example.

The German model is characterized by concentration in two respects: i) the type of financial institutions, since universal banks predominate and the role of specialist institutions (banks and non-banks) is not significant, and ii) the large size of banking institutions. Another structural characteristic of the private-sector credit system is the weakness of the capital markets as sources of corporate financing, even in the case of large enterprises, which should in theory have easy access to direct funding. The concentration of financial saving in banking institutions makes them the main potential purchasers of securities and shares. This tends to depress the demand for those securities that compete directly with the other core business of banks: lending. Thus, in the German model it is indirect financing that predominates, the intermediaries being banks that capture savings in the form of deposits and apply them as loans.

Regulation also played an important role in shaping this type of financial system, although it worked in a direction quite contrary to that seen in the United States or the United Kingdom. In Germany, for cultural and historical reasons, financial regulation always sought to create the right financing conditions for rapid economic growth and, indeed, reconstruction in the post-war periods (Zysman, 1983, pp. 251-265). Accordingly, no restrictions of any kind were placed on the areas in which banks could operate; on the contrary, they were—and still are—explicitly allowed by local authorities to operate even in the non-financial sector. This regulatory background largely explains the tendency towards concentration in the German financial system (in the two senses mentioned earlier) as well as the tendency towards conglomeration or the formation of large corporations led by universal banks, which operate in various sectors of the economy.

Looking at specific financial structures helps to reinforce the idea that there are different institutional models for accumulation financing and there is no reason to think that one is more efficient than another.

¹⁹ This is not the place to go further into the role of railway development in the growth of the United States capital market. The reader is referred to Schumpeter (1939), particularly chapter VII, for further information on the subject. See also Pollard (1964) for an analysis of developments in the United Kingdom.

²⁰ In the United States model before deregulation in the 1990s, commercial banks were usually the main providers of the finance needed to begin investment projects. Investment banks played an auxiliary role, providing loan guarantees for investing companies,

underwriting the flotation of the securities concerned when conditions in the organized markets were favourable, and holding in their portfolios securities (shares and bonds) issued by the companies financed. It should be noted that, from a macroeconomic point of view, the additional saving generated by the multiplier process increases the liquidity of organized markets, and this in turn determines the market conditions for such issues.

Zysman (1983), for example, argues that systems as different as those of the United States (based on capital markets) and Germany (based on credit) were equally effective for the development of their economies after the War.

We can conclude that, regardless of the institutional organization of the financing process, the existence of such funding mechanisms may be essential for maintaining the borrowing conditions of investor companies and reducing their financial vulnerability to potential changes in short-term interest rates. Otherwise, growth may be restricted by the absence of appropriate financing mechanisms or by a considerable increase in the financial fragility of productive investors and the banks that finance them.

2. Institutional underdevelopment: markets, universal banks and institutional investors

For finance mechanisms to exist, all that is necessary is the existence of banking institutions with the ability to issue means of payment. Nonetheless, we have already seen that development financing based on bank credit tends to lead to financial fragility and credit rationing, factors that jeopardize the continuity of growth. This is because, firstly, financial instability tends to depress the economy²¹ and, secondly, because growth can be constrained by the lack of investment financing mechanisms. An economy that lacks suitable funding systems is an economy with little financial slack for economic development.

Capital market systems are perhaps the most complex problem of development financing since, for institutional progress to be made with them, not only does there need to be a suitable system of regulation and supervision, but at least four interrelated factors come into play.

In the case of capital market-based systems, these factors are:²²

- i) the size and depth of markets for long-term corporate securities, and
- ii) the size and investment profile of institutional investors.

In the case of universal bank systems, the factors are:

- iii) the investment profile of financial investors (families and institutional investors) in these banks' assets, and
- iv) the profile and potential role of banks in long-term financing.

Institutional investors not only help bring robust capital markets into being, but stimulate them to attain greater efficiency and depth, as Vittas argues:

“Experience from Anglo-American countries suggests large potential benefits from the interactive process between institutional investors and securities markets. Institutional investors can act as a countervailing force to the dominant position of commercial banks and thus promote competition and efficiency in the financial systems. They can stimulate financial innovation, modernize capital markets, enhance transparency and information disclosure, and strengthen corporate governance” (Vittas, 1998, p. 6).

Nonetheless, the increase in the number and size of institutional investors in the financial system should not be regarded as a cure-all for the development of long-term private-sector financing mechanisms. The expansion of institutional investors (pension funds, for instance) does not in itself lead to an increase in the supply of credits for investment financing. Such an increase continues to depend largely on the earning and saving capacity of families and businesses.

At the same time, the growth and development of institutional investors make it easier to match financial instruments to the maturities usually required in the productive investment process, because such institutions (which include pension funds, mutual funds and insurers) have long-term contingent liabilities, and this enables them to invest in long-term instruments such as shares and bonds.

Thus, the existence of organized markets for long-term securities (such as capital markets) and of institutional investors with a preference for long-term investments could ease the problem of mismatched asset maturities. After carrying out an investment, the investing companies could have access to securities with maturities that were more compatible with those of their investments, and thus pay off short-term credits obtained from commercial banks.

This is why investment financing in most economies with small capital markets is carried out

²¹ See, for example, Minsky (1982).

²² In the current debate, excessive importance is attached to the regulation and supervision of financial markets as a way of fostering development financing mechanisms. Appropriate regulation and careful supervision are obviously indispensable to the operation of any market but, for the reasons already given, they will not in themselves resolve the problems of development financing.

through universal banking institutions capable of drawing in long-term funds (such as the German universal banks), or through public-sector banks that carry out funding using fiscal or para-fiscal resources (as in most developing economies). These are alternative ways of avoiding the problem of mismatched maturities, which can constrain the expansion of long-term financing for economic growth.

The development of a long-term bank securities market is attended by some of the same problems as are faced by corporate securities markets, including those of scale. After the War, for instance, Germany experienced a large rise in the demand for long-term bank assets, as a result of:

- i) the concentration of investment in reconstruction and the equipping of industry;
- ii) the particular role of the universal banks in the direct financing of the accumulation process;
- iii) economic growth associated with a fairly equitable income distribution;
- iv) the preference of German savers for assets issued by universal banks, as capital markets were tiny to begin with.

Thanks to the increase in demand for bank securities, insurance and long-term saving instruments, universal banks were in a position to capture resources with different maturities, from sight deposits to longer-term ones. Consequently, the management of mismatched maturities is carried out within the asset structure of these institutions themselves.

Having the right institutions to finance and fund accumulation seems to be a basic prerequisite for financially sound development. Even if we assumed the existence of fully developed markets or banking institutions with the characteristics of the German universal banks, however, there would still be problems caused by information failures and uncertainty in the funding process. Once we have analysed the aspects related to information we can conclude our analysis of the problems of development financing.

3. Information failures and uncertainty

Development is usually characterized by a combination of growth and structural change, with innovative companies often introducing new technologies or new ways of organizing production, or entering a sector where learning costs and economies of scale may constitute barriers to entry (Dosi, 1990). In these situations, uncertainty about the future and thus

investment risk are high, but decrease as infant industries mature.²³

The logical consequence of what has just been said is that information problems increase considerably in economies that are going through a stage of growth and structural change. If our hypothesis holds true, the financing problem in developing economies is not confined to information distribution or failures in relation to various projects with known returns, but extends to uncertainty about the outcome of efforts to introduce a new production pattern or to find new markets, as well as the consequences of these factors for the sector and the macroeconomy.

Table 1, which distinguishes two types of uncertainty, illustrates this: type I uncertainty can be reduced to risk, while type II cannot. Established firms and sectors with a performance track record, generally in the form of periodic balance sheets, and with relatively high collateral and marginal investments, are type I risks. Type II risks are new firms with no track record and little collateral to set against the risks incurred.

Whether or not there is a private-sector finance and funding structure, type II information problems impede risk analysis and thus the private-sector intermediation of resources for particular firms. This cannot be regarded as a market failure: the efficient markets hypothesis itself is based on the idea that private-sector institutions and financial markets are efficient at collecting, processing and distributing information. Obviously these markets and institutions, even in a fully competitive environment, do not act as providers of finance in conditions of uncertainty that cannot be reduced to risk.

According to the definition of economic development given previously (as a process of growth associated with structural change), and assuming we are correct in our conclusions about the effects of uncertainty that cannot be reduced to risk on the financing process, the role of the State in development financing is far more significant than the conventional model would suggest. It is no coincidence that public-sector development institutions in developing countries arise primarily as instruments for applying development strategies and only secondarily as a response to information failures in markets. The role of these

²³ See Moreira (1995, chapters 1-4) for a modern analysis of the infant industry concept and its use to justify the application of industrial promotion policies in the development process.

TABLE I

Information problems when growth is accompanied by structural change

	Type I	Type II
Type of financing demand	Established companies and sectors with relatively high collateral and marginal investment.	Creation of new companies or sectors; entry into sectors with entry barriers due to learning costs and economies of scale, or into new markets; relatively little collateral.
Information problems	Information distribution problems (information asymmetry, etc.).	Information from past offers no reliable guide to the future performance of investing companies.
Possible intermediation failures	Monitoring, selection and lending problems; incomplete or non-existent markets; imperfect competition. Credit rationing caused by a rapid increase in the financial vulnerability of commercial banks.	Risk cannot be evaluated, so that private-sector financing sources are not available.

Source: Prepared by the author.

institutions is not confined to intermediation between savers, other financial intermediaries and investors. This is what will be analysed below.

4. Policy and the role of development banks

What do the conventional models have in common as regards the role of the State in development financing? In our view, it is the idea that the State is external to the financing of the capitalist accumulation process. Whereas in some models State intervention is seen as distorting relative prices, reducing the efficiency with which resources are used, in others this intervention is seen as a last resort for dealing with intractable market failures.

The approach taken by the present study implies that the State can play a role of great importance in fostering more solid sources of development financing, given that:

- i) institution-building policies can (and should) mitigate the problems of incomplete markets, facilitating the creation of finance or funding mechanisms that use private-sector resources. These policies range from the development of appropriate regulations and oversight mechanisms to the provision of incentives for the creation of long-term securities markets.²⁴ Since institutional

- investors are vital for the consolidation of such markets, these policies also have to offer incentives (regulatory and otherwise) that increase the attractiveness of the securities concerned;
- ii) direct financing policies can help construct a path towards development and the establishment of what Stiglitz and Uy (1996) call a “vision” by creating new information and making it possible for agents to organize themselves and plan for the future on the basis of optimizing behaviour. This is what Aoki, Murdock and Okuno-Fujiwara (1997) consider “market enhancement”.

These two lines of policy are complementary. A developmentalist State needs to orient its policies essentially towards the implementation of a development project and the consolidation of particular sectors as part of that.²⁵ Public-sector development financing policies (and their instruments, the development banks) emerge, therefore, as tools for implementing development strategies, channelling

possible the creation of a liquid secondary market in mortgages... The modern home mortgage in the United States and the securitized mortgage market itself are initially the result of the 1934 National Housing Act. This Act created the Federal Housing Administration (FHA) as a mechanism for attracting private capital into the housing market.” The chapter in Feeney referred to presents an interesting analysis of the role of public-sector institutions in the development of this market, now the world’s largest domestic market in private-sector securities.

²⁵ This seems increasingly to be the conclusion arrived at by authors as varied as Amsden and Euh (1990), World Bank (1994) and Stiglitz and Uy (1996) in relation to the success of the South-East Asian model.

²⁴ An example of this was the development of the mortgage asset markets that now form the basis of the United States property financing system. As Feeney (1995, chapter 5) puts it: “The US securitized market has been greatly influenced by a number of government and quasi government institutions, which have made

TABLE 2

A classification of development financing-oriented public policies

Information Markets	Complete information	Asymmetrical information	No information
<i>Intervention required</i>			
Complete markets	No intervention necessary	Better information distribution (BI) policies	BI + market enhancement (ME) policies
Incomplete markets	Institutional market development (MD) policies, including incentives for institutional investors to invest in long-term private-sector assets	MD + BI	MD + ME
No markets	MD	MD + BI Selective lending (SL) policies	SL

Source: Prepared by the author.

long-term funding into strategic sectors and creating investment opportunities, not only within the sectors chosen but also in those with which the sectors concerned have forward and backward linkages.

Consequently, development banks are not just intermediaries between savers, other financial intermediaries and investors, but enablers of market creation and producers of the information required. Once standardized, with known quality and returns, their instruments can be traded in private-sector securities and credit markets.²⁶ In other words, once these markets have been created and returns on the instruments generated have been assured, the attractiveness of their securities for the private-sector capital market opens up debt rescheduling or conversion opportunities that do not require recourse to public funds. Public money should be treated as a scarce resource, given the demand for social spending that development entails.

Again, the rules for State intervention in the development financing process should be classified by how complete the markets and information for the sectors to be financed are. Table 2 gives the results of a simple policy classification exercise.

The table is an attempt to classify decisions on State intervention and the type of policy required to deal with problems of incomplete information and markets. In the case of sectors and businesses that have access to financial markets and to all the information they need, no State intervention is required. This is the position of large enterprises listed in organized securities markets, which not only have access to these markets but publish regular audited balance sheets.

Moving towards the right of the table from this category, i.e., to the “Asymmetrical information” and “No information” columns, the need for government intervention increases. In the case of established firms that are in a position to publish balance sheets and whose future prospects can easily be assessed by the market, what is needed to deal with information asymmetries is a policy that encourages the spread of information, rather than a standing policy of selective lending. Firstly, credit risk databases (available to private-sector financial institutions) could reduce the problems of asymmetry here. Secondly, public-sector financing institutions could make credit lines conditional on these companies raising funds in share or long-term securities markets, which would help make the issuer more transparent to the financial market. This is what we have called better information distribution policies (BI).

When information needed by the market to analyse risk is not available (uncertainty), a distinction has to be drawn between two possible categories of firm. The first includes established small companies that, because of their size, do not normally have

²⁶ The Republic of Korea offers a useful example for analysis of the role of financial development institutions, not because the State is given a major role in financing, but because of the characteristics of the country's remarkable economic development, entailing as it has considerable long-term financing risks and uncertainties. See UNCTAD (1996, part 2, chapters 1 and 2) for a brief and accurate analysis of the recent development strategy of that country (and other fast-growing Asian economies).

accurate accounting records or much in the way of collateral. In this case, expanding access to private-sector financing is necessary to encourage the use of normal business accounting (a BI policy) and to create collateral funds that can be administered by development banks.

In the second category are businesses whose track record cannot be taken as a guide to future performance (because of their investment profile) and which have relatively little collateral. This category includes companies using advanced technology, or those entering markets that have not been much developed in the country (for example, a new product which has no substitutes in the market). In this case, however developed the financial markets are they will be unable to evaluate the risks and thus will not be in a position

to channel resources (whether through lending or through security and share issues) to these investments. Direct financing may be a viable alternative, at least until the company is established and the information needed for risk analysis is available. Use could also be made of some measures to raise private money, such as the creation of guarantee funds and risk sharing systems. These are what may be considered market enhancement policies.

The less organized markets are, and the less complete the information available, the greater will be the need for State involvement in development financing. In theory, as table 2 shows, microenterprises and small and medium-sized firms should be given high priority when any selective lending policy is applied.

V

Conclusion

If we apply a Keynesian approach, there are two problems with development finance:

- i) In the absence of appropriate finance and funding institutions, such as the universal banks in Germany or long-term asset markets, rising credit risk and the exposure of private-sector agents when outgoings exceed expectations can lead to bank credit rationing and dangerously increase the financial vulnerability of the agents involved in long-term financing (banks and productive investors). Institutional underdevelopment may, therefore, result in financially unsound development and, ultimately, in financial crises.
- ii) Information problems in development financing go beyond the conventional difficulties of poor information distribution (asymmetry). “Emerging” and innovative sectors, as well as small and medium-sized enterprises in general, find it hard to obtain credit because the information made available is unreliable for risk analysis purposes. They have little or no collateral and their client relationships with private-sector financial institutions, if they have any, are underdeveloped. Public-sector financing policies can consolidate production sectors, making their future issues of assets in private-sector markets more attractive. In other words: as these sectors consolidate, information problems in financial intermediation tend to diminish

in many cases, expanding the scope for private-sector intermediation of resources to finance accumulation.

The opportunity arising from this process can only be taken up on a large scale if the necessary funding institutions exist. This, in turn, requires policies to bring into being a regulatory and institutional system appropriate for the development of long-term bank and corporate securities markets in the private sector—including larger purchases of long-term private-sector assets by institutional investors. It is in this way that institution-building policies can generate development financing mechanisms that are more financially robust.

The early twenty-first century offers significant opportunities and encouragement for policy action to create sound development financing mechanisms. Firstly, the financial markets (particularly international ones) changed considerably in the 1980s and 1990s, bringing in new methods of raising capital (securitization) and segmenting risk (derivatives, for example). Secondly, recent events in the financial markets have opened up the possibility of applying longer-term institutional development policies aimed at strengthening the role of institutional investors and long-term securities markets in the financing of larger firms that can more easily access these markets.

Nonetheless, the difficulties have not diminished. At a time when the possible routes towards development are changing and external financing is

becoming ever scarcer and more volatile, the availability of sufficient domestic financing with the required maturities is becoming a prerequisite for financially sustainable development. As Stiglitz (1993)

states, the dilemma now is not whether the State should intervene, but how best it can do it.

(Original: Portuguese)

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Systemic governance and development in Latin America

Christian von Haldenwang

The capacity of political regimes to formulate and implement policies in the common interest appears to be a crucial factor of development. Public institutions in Latin America are often characterized by a lack of common interest orientation. As a result, most countries of the region are ill-prepared to meet the challenges of global market integration and knowledge-based development. Two approaches have been particularly influential in linking institutions to economic development: the good governance approach, originally put forward by the World Bank, and the systemic competitiveness approach introduced by the German Development Institute. Drawing on insights from both concepts, this paper presents a framework for the assessment of reform blockades and propensities in given political systems. This is the “systemic governance” approach, and it focuses on the capacity to generate and implement decisions in the common interest at all levels of the political system. In order to promote second-generation adjustment reforms, the systemic character of governance has to be grasped.

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I

Introduction

From a political scientist's point of view, the most important obstacle to development lies in the fact that political institutions in developing countries are often unable to formulate and implement decisions that serve the common interest.¹ Because of this, public goods such as security and the rule of law, as well as basic goods and services such as education, health care or access to water, are not provided in a sufficient quantity and quality, and they often do not benefit those who need them most. The lack of security, legal protection and other public goods translates into high transaction costs and a low propensity to innovate—typical features of developing economies. In such an environment, positive externalities that arise from economic interaction are not used for the benefit of all, but rather internalized by a small group of actors, thus deepening the polarization of wealth and income. Also, the generation, provision and application of knowledge, an increasingly important feature of economic development, is hindered by weak public institutions.

This assessment applies to a majority of Latin American countries. With few, albeit important exceptions, the countries of the region seem to be ill-prepared to face the structural transformation from a resource-based to a knowledge-based economy. Speaking in general terms, so far there has been no “development premium” arising from democratization *cum* market liberalization. On the contrary, the opening of markets to global competition in the 1980s and 1990s has led to an increased dependency on natural resources or manufactured goods with low technological content, low input of qualified labour and short national value chains.

Although some regional economies have succeeded in conquering new markets or deepening value chains, the general picture is one of a persistent, not diminishing, competitiveness divide between Latin America and the industrialized world (including a number of East Asian countries), as illustrated by the region's steadily diminishing role in international trade.²

At the same time, economic growth has done little to ease income polarization. It appears that the social and economic costs of market opening in Latin America have been higher than necessary and the benefits lower than expected.

Recent political crises in Argentina and Bolivia underline what has become a *leitmotiv* of the development debate in Latin America: there is a pressing need for additional reform. It would be unreasonable to maintain, however, that the region had not experienced profound change, both economically and politically. Development is taking place, although development paths differ considerably from those mapped out by international experts. Facing major obstacles to change, reform-oriented governments tend to focus on lighthouse projects, hoping that the introduction of good governance in a small number of cases may have positive side-effects on many others. Some of these “islands of modernity” have even become international benchmarks for innovation.

However, it has proved extremely difficult to make reforms sustainable in the long term, and to promote change on a broader scale. Accordingly, the question is how such sustainability and scale can be achieved. In answering this, the role that existing political and administrative institutions play in the definition and implementation of development strategies has to be taken into account.

□ A first draft of this paper was written while the author was working as a research fellow at the German Development Institute (GDI) in Bonn, Germany. The views expressed herein are the author's and do not necessarily reflect those of any of the institutions he has worked in. The author would like to thank Tilman Altenburg of the GDI and Koldo Echebarria of the Inter-American Development Bank for their helpful comments on an earlier version of the paper.

¹ In the words of Kofi Annan, “without the rule of law, predictable administration, legitimate power and responsive regulation, no amount of funding, no short-term economic miracle will set the developing world on the path to prosperity” (cited in Santiso, 2001, p. 388).

² At the outset of structural adjustment, in 1980, the Latin American share of international merchandise exports was 5.4%, of which 0.9% was accounted for by Mexico. In 1990, the figure was 4.3% (Mexico, 1.2%). In 2001, the region accounted for 5.5% of global merchandise exports, of which 2.5% came from Mexico. This means that the region's recovery in world markets in the 1990s was entirely due to Mexico's strong performance within the North American Free Trade Agreement (NAFTA) (see: www.wto.org/english/res_e/statis_e/statis_e.htm#worldtrade, of 30 September 2003). Only recently has this trend been reversed, mainly because of rising global commodity prices.

This paper proposes a conceptual framework for assessing the institutional reform path available to political authorities in less than perfect settings. It does so by taking a closer look at two well-known approaches which have tried to tackle the complex relationship between institutions and development: good governance and systemic competitiveness. Analysing the actual performance of existing institutions at the meta, macro, meso, and micro levels makes it possible to describe the threats and opportunities they present for structural

change. By looking at the *systemic governance* of political regimes, this paper seeks to contribute to a more realistic approach to State modernization and development cooperation. Both policy makers and international donors have to realize that exclusion, marginalization and poverty, rather than the failings of specific development patterns, are systemic features in many developing countries. Consequently, this paper calls for a revision of the Washington consensus in the light of the findings presented below.

II

Institutions and development: good governance and systemic competitiveness

1. Good governance

The World Bank introduced the notion of good governance in the late 1980s in order to describe the requirements, mostly at the national level, of transparent and efficient public regulation and service delivery for market-oriented growth.³ The concept served as a guide to State reforms and development cooperation in the structural adjustment process, and has been a crucial reference point for institutional reform ever since. Although other international actors have different project portfolios and diverging views on some key aspects of State-society relations, it can be argued that the World Bank concept of good governance constitutes a “bottom line” vision shared by most international organizations. This vision embraces democratic and legitimate political institutions, an efficient and accountable public administration, the rule of law, human rights guarantees and effective public regulation of markets.

In promoting good governance, the World Bank has limited itself to issues covered by its mandate, thus leaving out, for instance, reforms to core political institutions such as parliaments or electoral regimes.

Today, World Bank activities focus mainly on judicial and administrative reform, the regulation and promotion of market competition, decentralization, anti-corruption measures, and fiscal reform. However, the Bank has made it increasingly clear that without common interest orientation of core political institutions and actors good governance cannot be achieved. This is one of the main messages of the *2004 World Development Report* (World Bank, 2003).

Since the mid-1990s the United Nations Development Programme (UNDP) has taken a somewhat different approach to good governance, stressing the importance of participatory political processes and articulate civil society organizations, and emphasizing the role of the State in the promotion of human rather than merely economic development (UNDP, 1995; UNDP, 1997, pp. 10-41). UNDP has identified four different dimensions of governance:

- Economic governance: a competitive and non-discriminatory market order conducive to economic growth.
- Political governance: participatory, democratic, legitimate, pluralist and accessible political institutions.
- Administrative governance: an efficient, transparent, independent and accountable public administration.
- Systemic governance: societal institutions that protect cultural and religious values, help to provide for freedom and security, and promote equal opportunities for the exercise of personal capabilities.

³ See World Bank (1992). Recently, Thandika Mkandawire, Director of the United Nations Research Institute for Social Development (UNRISD), has called attention to the fact that the term “good governance” as originally devised by African scholars had a much broader meaning than later suggested by the World Bank. See Mkandawire (2004, p. 380).

While the first three dimensions constitute “the formal institutional and organizational structure of authoritative decision-making in the modern state” (UNDP, 1997, p. 10), the fourth dimension highlights the embeddedness of the State in a wider context of social order. As can be seen, we borrow the term “systemic governance” from UNDP, although we use it as a truly comprehensive concept and not as a residual category for institutions which do not fall into one of the other categories.

However, putting the approach into practice has been difficult. International donors and civil society organizations in Third World countries have had trouble in promoting good governance in the face of governments which, while usually agreeing that particular institutions needed modernizing, have been less enthusiastic about calling into question the traditional, elitist functioning of the political process itself. The prevailing implementation pattern has thus relied on one-off reforms, all too often with only limited impact on the general governance of the partner State. This has led some authors to announce, maybe a little prematurely, the “demise” of the good governance concept.⁴ Critics claim that the approach:

- i) overemphasizes government downsizing and austerity while failing to address crucial issues of underregulation and public-sector weakness;
- ii) focuses almost exclusively on the failings of institutions with respect to good governance, neglecting the functions public institutions (even “bad” institutions) effectively fulfil;
- iii) concentrates on the internal functioning of individual public institutions, ignoring others and disregarding the embeddedness of institutions;
- iv) therefore, does not account for the propensity and capacity of existing political systems to adapt to changing framework conditions on the basis of a common interest perspective;
- v) accordingly, lacks a deeper understanding as to which societal actors may influence the promotion (or blocking) of governance reform, and does not have a vision of the strategic management of development;
- vi) lastly, inflates expectations by emphasizing the gains from reforms and suggesting linear progress, while omitting the costs of adjustment and the inherent risks of institutional change.

⁴ See Doornbos (2001). For the following criticisms, see also Moore (1993), Weiss (2000) and Mkandawire (2004).

Criticisms have been directed above all against the World Bank, which has reacted partly by broadening its focus and assuming a more political position, partly by sharpening its profile and bringing in other organizations as complementary actors.⁵ Through its Comprehensive Development Frameworks (CDF) and Poverty Reduction Strategy Papers (PRSP) in particular, the Bank has sought to put reforms in a broader context of pro-poor economic growth and improved governance. Whether these instruments will effectively bring about a change of view concerning key governance issues remains to be seen.⁶

2. Systemic competitiveness

Systemic competitiveness is a concept introduced by the German Development Institute in the 1990s with a view to achieving a better understanding of the challenges of economic development, competition and enterprise organization arising from globalization.⁷ Drawing on insights from ECLAC and the Organisation for Economic Co-operation and Development (OECD), it synthesizes debates on clusters and industrial districts, innovation economics, networks, neostructuralist approaches to the State, New Institutional Economics, etc.⁸ The fundamental question, as brought out by the concept, is not whether the State *or* the market should be strengthened, but rather how both types of institutions can interact in order to combine strengths and overcome specific weaknesses.

The concept of systemic competitiveness distinguishes four levels of interaction:

- i) the *meta-level* encompasses development-oriented values, a social consensus on the necessity and conditions of market-oriented development, and the capacity of a political order to formulate visions and guidelines for development;
- ii) the *macro-level* refers to a stable macroeconomic and macropolitical framework and general patterns of regulation that enable factor, commodity and capital markets to work properly (sound fiscal

⁵ See World Bank (2000, pp. 55-58 and 2001, p. 96).

⁶ Recent PRSP evaluations by both the World Bank and the International Monetary Fund (IMF) show that so far expectations have not been met. See: www.imf.org/External/NP/ieo/2004/prspgrf/eng/index.htm and www.worldbank.org/oed/prsp/index.html, of 20 October 2004.

⁷ This chapter draws mainly on Esser and others (1996) and Altenburg, Hillebrand and Meyer-Stamer (1998). See also Altenburg and Meyer-Stamer (1999).

⁸ See Fajnzylber (1988) on “international competitiveness” and OECD (1992) on “structural competitiveness”.

- policies, a market-friendly exchange-rate policy, open investment regimes);
- iii) the *meso-level* consists of task- or sector-specific institutions which provide specific public goods and services necessary for economic activity and promote development on sectoral or territorial terms;
 - iv) the *micro-level* focuses on intra-firm management to promote efficiency gains and innovation, and inter-firm networking that allows for the creation of positive externalities and spillovers between enterprises.

By integrating these four levels of interaction, the approach points to a new balance of power between State and market, whereby the former has to acquire new regulatory competencies in some fields and deregulate other areas, in order for the latter to work properly. The basic idea behind the concept is that it is not the individual firm that carries broad-based development and sustainable growth, but rather networks of enterprises and their interactions with other social actors in the context of integrated production systems. For these networks to build up and these interactions to occur, transaction costs are a crucial factor. They are especially high if markets are volatile, institutions weak and the macroeconomic setting unstable. The systemic competitiveness concept presents a number of ideas on how to lower transaction costs at different levels of State intervention.⁹

Unfortunately, the concept has less to say about the State's *capacity* to bring about the proposed changes, i.e., its ability to define and implement policies that serve the common interest. With regard to this, Altenburg and Meyer-Stamer recommend the strengthening of heterarchical, network-shaped forms of decision-making that integrate public and private actors: "We take it for granted that autocratic, hierarchical modes of governance are becoming obsolete. New forms of governance are emerging that are based on a new kind of interaction between State and social actors, typically in horizontal networks."¹⁰

This assessment does not relate well to today's reality in the Latin America region, nor does it take account of the prerequisites of effective public policy in general: the State's capacity for authoritative

decision-making and policy implementation is a key—and often absent—feature of governance for development. To be sure, networks and public-private cooperation are becoming increasingly important in the formulation and implementation of policies, since they allow for the inclusion of relevant actors at an early stage of decision-making, thus improving the quality of decisions and facilitating the implementation of policies. But if these "new forms of governance" are not embedded in a clear definition of the respective roles of public and private actors, along with a certain degree of State autonomy *vis-à-vis* powerful societal interests, they are very likely to impose additional stress on the governance of a political regime in terms of legitimacy, effectiveness and efficiency.¹¹

To sum up the argument, the concept of systemic competitiveness encompasses the functions States should assume in order to promote broad-based development. Also, in connecting to a number of related debates and approaches, it provides valuable insights into the logic and sequencing of institutional reform at different levels of the political system. On the other hand, its promoters do not examine how hierarchical forms of public decision-making operate in developing countries, and how they relate to network-like patterns of political interaction. As a result, the concept is quite demanding where State capabilities are concerned. Although a group of advanced developing countries may be able to meet the exigencies of systemic competitiveness, those situated towards the lower end of the scale will most certainly have a hard time doing so.

For this second group, which includes a majority of Latin American countries, the question is whether (and how) institutions with limited regulatory capacity and little autonomy *vis-à-vis* powerful societal interests can produce policies that serve the common interest. So far, this issue has hardly been touched upon by the international debate on development, although many agencies have acknowledged the need for further strengthening of the institutional structure.¹² Rather, a common approach is to assume implicitly that the State which is supposed to improve its governance by means of institutional change already has the capability to carry through these reforms in a sustainable way.

⁹ Altenburg and Meyer-Stamer (1999, pp. 7-16).

¹⁰ Altenburg and Meyer-Stamer (1999, p. 3). To be fair, one should mention that Meyer-Stamer (2001, p. 27) recognizes the need for heterarchical patterns of organization to be controlled by hierarchical forms of governance.

¹¹ Referring to this problem, Evans (1992, p. 139) calls for the State to have "embedded autonomy".

¹² One of the most interesting approaches to this topic is that of ECLAC (2000). As a matter of fact, civic rights cannot be exercised effectively without a minimum common interest orientation on the part of the State.

An alternative approach would be to explore the conditions under which States with a low level of autonomy and capacity do act in the common interest. As Olson (2000) has shown, common interest orientation *is* possible even in such a setting: political leaders do not have to be altruistic in order to pursue common interest policies, even without a sophisticated system of checks and balances.¹³ However, their rational self-interest is broader than Olson suggests in that it includes the interest of legitimizing and thus preserving a given order, along with that of serving their own interests through redistribution. Any government aiming to survive tries to legitimize its rule by invoking some kind of common interest. Normally, this implies a degree of public goods provision.

As a consequence, political regimes do not need to be perfectly representative in order to limit redistribution and provide public goods. Conversely,

even under representative rule political leaders will have an interest in advancing their own privileges. This means that the problem of common interest policies cannot be resolved merely by the establishment of a democratic order, as suggested by some contributions to the good governance approach: even though the vast majority of Latin American countries are governed by democratically elected authorities, it would be naïve to assume that leaders always pursued policies in the common interest. Rather, the pursuit of their own privileges (or redistribution, in Olson's terms) and public goods provision (or common interest policies) are two divergent options which have to be continuously rebalanced, taking into account the available resources and the institutional setting. In the following chapter we will see how these divergent interests translate into governance patterns at different levels of interaction.

III

Systemic governance

At the outset of the new millennium, most Latin American economies have switched from State-led to market-led development, but the concomitant adjustment of political and societal institutions has been slow, uneven and conflictive. The reform programme sketched out in the Washington consensus focused on macroeconomic opening and called for the liberalization of foreign commerce, the deregulation of markets and investment regimes, and the privatization of public-sector enterprises. Although reference was also made to modernizing public administration, strengthening the State's regulatory capacities, improving the rule of law and consolidating democratic regimes, these aspects only received due attention later in the 1990s, when it became increasingly clear that structural adjustment was coming up against problems rooted in the system of governance itself.¹⁴

Today, Latin America faces a twofold challenge: governments have to see through "second-stage"

adjustment reforms while at the same time laying the groundwork for knowledge-based development in the wake of economic opening and globalization.¹⁵ It is a key question for the next decade or so of Latin American development whether the second- (or third-) generation reforms required today will be implemented swiftly and thoroughly. Will the eventual shift from resource-based to knowledge-based development be more inclusive and at the same time less disruptive and less conflictive than the shift from State-led to market-led development has been? This question can be answered if we know what the basic lock-ins of the current institutional setting look like.

In this section we maintain that political systems in Latin America are characterized by a mix of "modern" and "traditional" institutions. We present an approach that helps us to better understand the resources these peculiar political orders generate for their respective societies. We call this approach "systemic governance" and define it as the capacity to generate and implement decisions in the common interest at all levels of the political system. In the following sections we take a

¹³ See Olson (2000, pp. 1-109). In Olson's terms, the common interest is an interest which aims at a Pareto-efficient distribution of welfare gains.

¹⁴ See, for instance, Haggard (1995); Edwards (1995); Haggard and Kaufman (1995, pp. 151-379).

¹⁵ See Naím (1994); Pastor and Wise (1999); Kuczynski and Williamson (2003).

closer look at the meta-, macro-, meso- and micro-levels of governance.

1. The meta-level

If development is a process that involves goal-oriented behaviour, then a society's development potential depends to a considerable degree on its capacity to set itself goals and pursue them. This applies to nations as well as to local communities. Social identities and goals are important prerequisites for mobilizing and focusing public and private resources in order to overcome development blockades. This is especially important at times of structural change and adjustment, when societies are obliged to leave traditional development paths and create new structures and routines. Strategic planning and goal setting can be described in terms of the political meta-projects societies propose for themselves. In this context, Stepan's distinction between offensive and defensive projects is useful.¹⁶

- *Offensive projects* have a foundational character. They aim at overcoming lock-ins resulting from path dependency. For example, European Union membership has been a broadly accepted offensive project for Eastern European candidate countries, allowing for sweeping changes in the regulation of economic and social affairs.
- *Defensive projects*, in turn, are formulated in reaction to a perceived threat to society. They aim at preserving (or reconsolidating) a given order. In Latin America, incoming authoritarian regimes formulated defensive projects against communist subversion in the 1970s and 1980s, mostly with quite negative consequences for economic and social development.

The basic function of political meta-projects is to legitimize public policies. If they attract public support they endow the State with autonomy *vis-à-vis* societal actors and with additional capacity to generate revenues (taxes, fees). In contrast, a government that is unable to formulate and "sell" a project will face difficulties in mustering the necessary political and material support to carry through structural reforms. At present, Germany seems to be a good example of this kind of problem.

It should be kept in mind, however, that political meta-projects are not a stable, long-term source of

legitimacy. Usually, they have a short or medium time horizon, which means that sooner or later those targeted by the project will ask for tangible results. If a project is successful, State interventions may be transferred into more institutionalized patterns, eventually forming a new regime with a proper basis of legitimacy. If a project fails, though, the regime will most certainly have to cope with legitimacy problems.

In Latin America, the main offensive project that came with State-led development from the 1950s to the 1970s was populism.¹⁷ Its argument was that taking control of the State from the vested interests of landed and financial capital was the key to a more equitable and "modern" distribution of resources, largely in favour of urban workers and the emerging middle class. The underlying motive of this project was rent seeking through the control of an active and interventionist State. Populism fitted well into pre-existing patterns of political integration and decision-making in Latin America. For instance, as benefits were distributed by the incumbents of political or administrative posts, the traditional personalist focus of Latin American politics was reinforced. However, as an approach to welfare policy it has been rather inefficient. Even before the rapid increase of poverty during the "lost decade" of the 1980s, Latin America had the least equitable distribution of wealth and income of any region in the world. Things have become worse, not better, since then.

Today, the unfulfilled promise of broad-based development through public intervention and distribution has been replaced by the equally unfulfilled promise of development through market activity. Triggered by the debt crisis of the 1980s, Latin America has experienced a truly dramatic shift in the way development and State-society relations are perceived. In countries with authoritarian regimes, the change to democracy constituted an important foundational project. In contrast to a number of East Asian and Central European countries, though, the market-led pattern of development has not been introduced successfully as an *offensive* project in Latin America. It is revealing that even the most prominent

¹⁶ See Stepan (1985, pp. 320-340).

¹⁷ Populism is defined for our purposes as a set of policies geared towards the integration of hitherto marginalized sectors of the population and based on an i) anti-class, ii) anti-status quo and iii) personalist-charismatic leadership approach (see Laclau, 1986, pp. 165-233, for an in-depth discussion of populism). To be sure, it is not suggested here that three decades of Latin American economic and political development can be summarized under the notion of populism.

“neoliberal” leaders in the region, Argentina’s Carlos Menem and Peru’s Alberto Fujimori, had previously been elected on the basis of a markedly “anti-neoliberal” discourse.¹⁸ There are two basic reasons why political leaders in Latin America have pursued market opening in practice without using it as an offensive meta-project:

- In countries like Argentina, Chile, and Brazil market-oriented reforms had already been initiated under authoritarian rule, with extremely high social and political costs. Accordingly, market liberalization was linked to authoritarianism and thus politically discredited.
- The results of structural adjustment with respect to growth, income distribution and social development have been poor.¹⁹ In the eyes of much of the Latin American public, market-led development is not a project in the common interest, but rather a straitjacket imposed by external forces.

At the same time, after an initial legitimacy boost derived from regime change, many Latin American democracies have had serious difficulties in improving their governance. Corruption, self-serving policies, lack of legal guarantees and of access to political decision-making, and bad administration have been obstinate features of political regimes, leading to widespread disillusionment with the democracy-cum-market model. As a reaction, in some countries (e.g., Venezuela, Ecuador, Peru, Bolivia) neopopulist positions have gained acceptance, with leaders promising to act upon both equity and governance deficits from outside the “political class”, and claiming a renewed role for the State in the development process.

In some countries, recent elections have brought to power leaders who have denounced the equity and governance deficit of structural adjustment without denying the necessity of market integration and economic opening. In conceptual terms, the emphasis on social, economic and cultural rights seems to be a key element of the new political discourse. Modern political constitutions, such as those of Colombia and Brazil, could very well serve as normative platforms for a rights approach to development. In practical terms, however, the elitist, personalist political style prevalent in Latin America has not yet been called into

question. Even under conditions of party-based political competition, as for instance in parts of Brazil, the focus is on persons and electoral cycles rather than on political meta-projects. Most Brazilian citizens expect Lula to change things for the better, not the *Partido dos Trabalhadores* that is in government.

Summing up the argument, it remains to be seen if a new meta-project is emerging in Latin America. Given the current record of lagging growth, growing polarization of wealth and income, a structural undersupply of public goods and services and, above all, a considerable deficit of institution-based legitimacy and confidence, rallying heterogeneous societies behind an overarching development project within the disciplines of market orientation and democracy is a truly challenging task. Without a feasible vision of development, though, Latin American political leaders will have a hard time mustering the resources needed for a radical change of rules. This calls for a piecemeal, incremental, negotiated and broadly communicated approach to structural reform, and not for sweeping changes decided upon by small elite groups.

2. The macro-level

Macropolitical institutions create the overall setting for the production of public goods and services. They stabilize expectations and contribute to economic development by lowering transaction costs. Basic rules for the functioning of markets and political decision-making are set at this level. Many Latin American regimes, however, appear to be unable to provide an effective macropolitical framework. State-led development resulted in a specific set of institutions, and this has not been dismantled completely in the process of market opening. As a result, governments face difficulties in formulating and implementing common interest policies. Strengthening political representation and competition through formal democratic channels seems to be a key to the effective promotion of common interest policies and further institutional reform.

How come democratization has not brought macropolitical stability and effectiveness? One explanation lies in the fact that political systems are characterized by “hybrid regimes”.²⁰ The term refers

¹⁸ In fact, the only neoliberal politician to be elected on an openly liberal ticket was Brazil’s Collor de Mello, who was able to take advantage of a highly polarized political landscape.

¹⁹ See Ocampo (2003) for the relevant ECLAC data.

²⁰ The concept of hybrid regimes was introduced by Karl (1995). Other authors have come to speak, for instance, of “delegative democracies”, “exclusionary democracies” or “defective democracies”. See O’Donnell (1996) and Merkel (1999) for a discussion of democratic subtypes.

to the coexistence of democratic institutions endowed with formally well-defined systems of checks and balances alongside a set of (often informal) institutions, such as clientelism and corruption, which largely determine the social distribution of resources. These informal institutions have flourished at times of State-led development, although they were mostly established a long time ago in the context of colonial feudalism. As a result, rent seeking constitutes a “layer of continuity” in the often rapidly changing institutional settings of Latin American political systems.

The debt crisis and the opening of markets have diminished opportunities for rent seeking in most countries of the region, although substantial transfers may have taken place during the transformation period, for instance in the context of privatizations. At the same time, the structures and agents of the old model have only reluctantly adjusted to the new distributional conditions of market-led development. Even today electoral posts tend to be regarded as vehicles for the pursuit of particular interests. Parliaments are often controlled by forces favourable to the status quo, which try to block or water down reforms. In quite a few countries (e.g., Argentina, Brazil, Colombia), backward regions, which are often strongholds of clientelism, are overrepresented in Congress.

Presidentialism, the prevalent political order in Latin America, has contributed to the consolidation of hybrid regimes:²¹ the contest for legitimacy between the executive and the legislative branches of government has generally resulted in a failure to achieve stable parliamentary majorities. The usual “game” has thus been for parliaments to pass laws piecemeal in exchange for negotiated material benefits each time. In a number of cases, those benefits have been distributed outside of formal budget procedures. Also, it is a well-known fact that Latin American parliaments lack the infrastructure and means to discharge their legislative and oversight functions effectively. Parliamentary deadlocks have triggered recurrent initiatives to side-step parliament, either through outright authoritarianism or by granting exceptional powers to the president.

Political competition focusing on access to rents instead of the provision of public goods has given rise to political parties with weak ideological ties, typically

formed around charismatic leaders. In many countries, furthermore, electoral regimes have been tailored to political personalism. For example, the Colombian electoral regime gives political parties a strong incentive to multiply the number of electoral lists (the so-called “*operación avispa*”), in order to gain additional seats in Congress. This means that local or regional political bosses (*caciques*) rarely negotiate common political positions, but instead start lists of their own. Unsurprisingly, efforts to change this regime under the successive presidencies of Samper, Pastrana and Uribe have failed to prosper due to lack of political support in Congress.

At the same time, new actors have emerged as rent seekers in the face of weak State regulation. Given the dependency on capital inflows of most Latin American countries, transnational corporations or local economic groups are in a strong position to negotiate their participation in privatizations and large investment projects. Using this leverage, companies have been able to reduce their risk and raise their benefits considerably. Generally speaking, Latin American governments still have a long way to go in creating a truly transparent and fair business environment.

Informal institutions are not unique to the Latin America region. They exist in every political system, including those of the industrialized countries. Informal institutions serve as the “grease” of political systems and public administration: they improve the informational basis for policy-making and implementation and provide the shortcuts needed to speed up the political process. They facilitate adaptation to changing environments, preventing excessively violent ruptures in political and societal regimes.

Under conditions of good governance, there is a clear hierarchy between formal and informal institutions: the latter complement the former. In cases of open conflict, formal institutions prevail, or else the formalization of informal institutions takes place.

In hybrid regimes, however, informal institutions do not complement, but at times rather contradict formal institutions: instead of helping to smooth institutional change they serve to postpone reforms, to impose additional adjustment costs on society in general and to prevent innovation in both the public and private sectors. This is so mainly for two reasons.

First, hybrid regimes operate on a two-tier basis of representation and distribution that limits their capacity to formulate and implement common interest

²¹ Presidentialism endows the executive with a legitimacy of its own, independent of parliamentary majorities. On this issue, see Mainwaring and Shugart (1998); Nohlen and Fernández (1998); Krumwiede and Nolte (2000).

policies. On the one hand, political leaders represent and are accountable to citizens who have voted for them; as incumbents of political or administrative authority they have an agenda of public goods provision. On the other hand, political leaders represent and are accountable to clients who support them with needed resources (capital to finance political campaigns, votes, access to elites or specific groups). At this level, holders of public posts have an agenda of rent seeking and distribution. If they fail to deliver, they lose political support and may eventually end up in jail or exile. Obviously, the common interest is not an important factor here, although some degree of redistribution to the poorer sectors of society takes place.

Second, the basic legitimation patterns of hybrid regimes work against market-oriented change. Since political support hinges upon clientelist relationships, the provision of jobs in public institutions is crucial and political leaders will be less interested in raising administrative efficiency by cutting employment. Also, investments will tend to have a time horizon that reflects the political cycle, and they will be geared towards specific groups rather than the provision of public goods to the general public. Finally, elitist and non-transparent patterns of decision-making are crucial features of hybrid regimes. Accordingly, there will be resistance to opening up the political process to citizen participation and public debate.

In the context of market-oriented reform, hybrid regimes have been most successful when they have been able to bring in shock reforms to implement measures that have proved to be inevitable, such as the liberalization of capital markets or currency regimes. Seeing through gradual, more comprehensive reform has turned out to be much more difficult. It appears that the elitist, authoritarian and status quo-oriented part of hybrid regimes may allow for changes if certain prerequisites are met: i) there is a hegemonic reform path with no “soft” exit option (e.g., access to additional funds) on hand; ii) changes are radical instead of incremental, meaning that they cannot be reversed easily (e.g., the opening up of financial markets or privatization), and iii) *statu-quo* groups can be compensated or repressed.

These prerequisites apply to first-generation reforms much more than to the current agenda of institutional modernization and capacity-building:

- i) The core reform path of the Washington consensus, consisting of liberalization, deregulation,

privatization and fiscal adjustment, was “the only game in town” at the time. There were no other adjustment strategies to hand that could claim to be equally all-encompassing and theoretically well-grounded. Today, different options exist with respect to institutional fine-tuning, decentralization and the degree of sectoral regulation and intervention.

- ii) Also, important measures could be implemented through shock policies, changing the rules of the game from one moment to the next without giving vested interests the time to mobilize. By contrast, there is no way of using shock methods to build up regulatory capacities, improve the quality of public goods and services or raise the efficiency of public administration.
- iii) Lastly, in some Latin American countries additional capital inflows derived from capital market liberalization and the privatization of public enterprises were used to alleviate the burden of adjustment for those groups aligned with the traditional model of State-led growth. To the extent that alternative sources of capital dry up, however, pressure for structural reform increases while at the same time the capacity for compensatory measures diminishes.

In general terms, the present situation of a majority of Latin American countries can be described as one of increasing pressure for structural reforms, combined with a decreasing capacity to side-step them. At the same time, democratization and decentralization have contributed to the gradual opening up of political regimes, leading to the emergence of new political forces and the disintegration or rearrangement of traditional organizations. This combination of fiscal pressure and political opening calls for changes in the way political regimes are legitimized. Political authorities all over the region are beginning to realize that political competition has to be organized differently under conditions of market-led growth than under conditions of State-led growth. Compared to access to rents, the provision of public goods by an efficient administration is gaining importance as a source of legitimacy.

3. The meso-level

Common interest policies such as the production of public goods and the promotion of development do not only depend on macropolitical institutions. In most

cases, sectoral institutions at the meso-level are required, too, in order to target policies properly. Recent development thinking grants the State a much more active, and interactive, role in the development process than was originally envisaged by the promoters of the Washington consensus. It is widely agreed today that first-generation reforms aimed at market-led development in Latin America concentrated excessively on macroeconomic adjustment, leading policy makers all over the region to underestimate the importance of meso-level reform.

Latin American governments have become increasingly concerned with filling the institutional gap inherited from the past.²² Institution-building can be observed in a large number of policy fields, each of which presents specific challenges and dynamics. This paper limits itself to discussing two cross-cutting issues that appear to be of particular importance. First, widespread progress with decentralization highlights the need for policy coordination between different levels of government (vertical coordination). Second, promotion of knowledge-based development calls for linkages between sectoral policies and cooperation between public and private actors (horizontal coordination).

State-led development resulted in a specific set of meso-level institutions. Although there is a considerable variety of institutional landscapes in the region, they appear to share some common features:

- State-led development enhanced the centralist logic of public policy already prevalent in many countries of the region, since it presumed that only the national State was able to orchestrate the necessary efforts in the fields of infrastructure, social policy, education and industrial promotion.
- Development was perceived as planned action. Countries in the region built up large planning agencies. More often than not, though, the implementation process suffered from a lack of monitoring and evaluation, from weak links to budgeting, and from overly rigid planning procedures, which did not take sufficient account of the interests and capacities of social actors.

²² See, for instance, case studies on Argentina, Chile, Venezuela, Mexico and Colombia in Naím and Tulchin (1999), especially the overview given by Naím on pages 15 to 32.

- Direct public-sector engagement in production was regarded as a means of overcoming market failure. Sectors such as energy, mining, steel, finance, machinery and shipyards were regarded as crucial. In countries such as Argentina, political ruptures and military intervention led to the formation of large military-industrial corporations.
- Economic development promotion consisted in a two-tier approach. One set of instruments were geared towards big and modern enterprises, normally managed by the economic affairs ministry and its field agencies or by national development banks. Another set of promotion tools were geared towards small enterprises and were often managed with a social instead of a productive focus. Taken as a whole, development promotion had a strong bias against small and medium enterprises (SMEs).
- With respect to research and development (R&D), the constraints of import substitution encouraged public funding in some strategic sectors of industry. Consequently, there was a certain degree of technological capacity-building, although the productivity gap with world markets continued to widen, due to the rent seeking that resulted from protectionism.
- Policy formulation and implementation suffered from sectoral segmentation, despite the rhetoric of integrated planning. The political logic of hybrid regimes gave those operating them strong incentives to avoid cooperation, in order to maintain (or expand, if possible) their own individual spheres of influence. As a result, even in cases where public institutions shared the same macropolitical orientations, there was little institutional fine-tuning and integration of sectoral policies.

This specific pattern of centralized meso-level regulation ceased to serve economic development with the opening up of markets, but it continued to fulfil functions of political reproduction. At the same time, governments at the national and, increasingly, the subnational level have had to assume new roles as regulators, promoters and coordinators of market-led development. Two important reference points for meso-level institution-building today are the decentralization of competencies and resources and the promotion of knowledge-based development.

a) *Decentralization*

With few exceptions, Latin American countries have made major progress with the decentralization of

competencies and resources. In fact, decentralization has been a key policy for reconciling the exigencies of market liberalization with those of State modernization in hybrid regimes. However, there is still a remarkable lack of policy coordination between government levels.

Market liberalization has had major repercussions for the competitiveness of enterprises and locations. Both firms and locations are much more exposed to competition today than they were before. To the degree that the central State has ceased to intervene, produce, subsidize and regulate, it has opened up space for public action at the subnational level. Consequently, international institutions emphasize decentralized institution-building, e.g., with respect to service provision and economic development promotion.²³

State modernization has endowed local and intermediate-level governments with new functions. In the last two decades, governments have increasingly transferred competencies and resources to municipalities and intermediate (department, province, state) levels, above all in areas such as education, health, local infrastructure and public services. Lower levels of government have become more important as partners for the private sector.

However, municipal and regional authorities have sometimes been hesitant to assume the challenges of development promotion. This is because there are still significant disincentives to a more active policy at the local and regional level. To begin with, lower levels of government often depend to a large degree on fiscal transfers from the State, in spite of fiscal decentralization efforts.²⁴ Also, central government agencies tend to maintain their sectoral grip on enterprise promotion and infrastructure provision, with negative consequences for the territorial integration of policies. Without the competencies and capacities to fulfil the tasks imposed on them, local and regional governments find it difficult to assume an active role in the vertical coordination of policies.

Obviously, decentralization does not always stimulate common interest orientation. Institutional patterns of State-led development, such as clientelism and corruption, may be reproduced at the local and intermediate level. However, certain aspects of decentralization, especially the growing intensity of political competition and the greater proximity of political authorities and public administration to their clientele, operate in favour of institutional modernization. Also, a spatial perspective on development facilitates the provision of relevant information to enterprises, the coordination of sectoral policies, the promotion of enterprise cooperation and the deepening of existing value chains locally.²⁵

b) *Knowledge-based development*

Market opening, often in combination with severe fiscal crises, has deeply affected existing innovation systems. On the one hand, the opening up of these systems to global competition has revealed a profound lack of competitiveness and productivity. On the other hand, public investment in these areas has suffered deep cutbacks, making it even more difficult for the respective institutions to cope with the new competition. This latter trend was reversed in the 1990s, with governments spending larger shares of their budgets on education.²⁶ Although this does not say much about the quality of education with respect to the requirements of knowledge-based development, it indicates that governments acknowledge the importance of investing in this area. At the same time, other than in Brazil and Mexico, no upward trend was observed in research and development (R&D) spending in the 1990s.²⁷

Under conditions of global market competition, however, even a knowledge-extensive development path calls for additional efforts to generate, provide and incorporate knowledge, in order to be sustainable. Broadening the growth base through rural development,

²³ The *World Development Report 1997* and *World Development Report 2002* (World Bank, 1997 and 2001) were particularly outspoken with respect to decentralization. The Inter-American Development Bank (IDB, 2001) and ECLAC (see Aghón, Albuquerque and Cortés, 2001) have also stressed the issue of decentralization.

²⁴ Excessive fiscal centralization, a typical feature of the State-led development pattern, lends itself to moral hazard: confronted with budget constraints, it may be more beneficial for a local government to renegotiate its participation in central government transfers than to step up its own revenue-raising or implement austerity measures.

²⁵ See Campbell and Fuhr (2004, pp. 11-52) for a discussion of decentralization in a context of innovation, State reform and market-led development.

²⁶ Average education spending in the region rose from 2.9% of GDP in 1990-1991 to 4.2% in 2000-2001. See ECLAC (2003, p. 27).

²⁷ The enormous R&D spending gap between Latin America and the industrialized countries becomes evident when we compare spending per capita. In 2000 Mexico spent US\$ 23.46 per capita on R&D, Chile US\$ 26.88 and Brazil US\$ 37.71. Spain, on the other hand, spent US\$ 188.42, Canada US\$ 514.76 and the United States US\$ 937.96. See <http://www.ricyt.org/indicadores/comparativos/06.xls>, 17 October 2003.

integrating SMEs into formal markets and global value chains, strengthening agro-industrial know-how (including specific exporting know-how) and promoting the sustainable use of natural resources are just a few of the challenges governments have to deal with today.²⁸

Innovation leading to the development of new products and the extension of local value chains is usually taking place as a systemic interaction of different knowledge fields and actors along the value chain, including providers and customers. In order to reap innovation rents, time-to-market is a crucial factor. Therefore, spatial proximity (allowing for localization economies), a modern communications infrastructure and low transaction costs in general are all crucial elements of innovation systems. These features favour locations that already possess comparative advantages in knowledge-intensive activities.

Yet gradual upgrading of locations is possible. In a number of meso-level areas Latin American governments have already initiated reforms, but work remains to be done. To give some examples, ties between universities, research centres, etc., and the private sector have to be strengthened in order to focus knowledge generation on the needs of enterprises and to stimulate technology transfer. Public monitoring and control of education and R&D has to be improved, so as to enhance the quantity and quality of the knowledge supply. Also, Latin America is lagging behind when it comes to funding for precompetitive research and tax incentives for R&D at the enterprise level. Many countries in the region still have to improve property right protection as a basic condition for the generation of innovation rents. Lastly, since knowledge incorporation is not the isolated work of individual firms, the promotion of inter-firm linkages (provider networks, producer associations, etc.) should receive more attention.

4. The micro-level

In the context of systemic governance, the micro-level refers to the organizational structure and the management of public administration and political institutions. If citizens or businesses throughout the region were asked to describe the public sector they have to deal with, the following features would

certainly come up again and again:

- public administrations regard citizens and enterprises not as customers but as petitioners;
- procedures are complicated and slow;
- the provision of fundamental public goods such as security and legal protection is inadequate;
- excessive hierarchization and centralization undermine efficiency and effectiveness;
- local administrations or governmental agencies do not have the authority or competencies to deal with important issues;
- governments do not have a common set of rules and procedures, making inter-institutional cooperation slow and fitful;
- budgeting is not transparent, so that citizens do not know what their taxes and fees are being spent on;
- careers in public administration depend on political backing, not on personal capacity;
- bribes and other kinds of extralegal favours are needed to get things done.

Again, this picture is not exclusive to Latin America, nor does it reflect ongoing changes in the region. In fact, some Latin American administrations are considered world pioneers of administrative reform. Brazil and Chile, for instance, offer examples of best practice in a number of fields such as participatory budgeting, customer orientation and the use of information and communication technologies in government. In the majority of cases, however, public administrations still constitute a negative factor in terms of competitiveness and governance. Why is this so?

Public institutions need an internal organizational structure in order to function properly. The organizational structure which emanated from State-led development is quite different from the one envisaged by the good governance and systemic competitiveness approaches. Rent seeking as a fundamental economic behaviour and clientelism as a basic political pattern engendered major lock-ins with respect to administrative reform: since control of State institutions meant access to rents, and political loyalty (even legitimacy) accrued from material benefits distributed through clientelist networks, public-sector staffing became a crucial element of both welfare policy and regime stabilization.

As a result, a typical feature of public administration in Latin America is overstaffing combined with a critical lack of human resources (since, sooner rather than later, the most competent employees migrate to the private sector) and an utterly inadequate

²⁸ This paragraph draws on Altenburg (2003). See also Von Haldenwang (2000, pp. 9-15).

infrastructure. This is especially true at the regional and local level, where career opportunities are even scarcer and equipment even more obsolete. Also, institutional memory is weak due to high turnover rates in the wake of political changes. This leads to the seemingly paradoxical situation of excessively rigid formal routines combined with a high dependency on case-by-case negotiations in everyday operations.²⁹

Reforms at the micro-level should aim above all at transforming the self-perception of public administration, in favour of a stronger orientation towards citizens and clients. So far, the opening of markets and the changing role of the State *vis-à-vis* society have modified the picture described only at a snail's pace. Indeed, the continuing provision of jobs in the public sector has been used as a device to soften the social impact of market liberalization and privatization. Regional and local institutions have been particularly keen to preserve this welfare function, since reproduction of clientelist relations starts at the local, eye-to-eye level and most of the costs of unemployment have to be shouldered locally.

Modernization efforts in public administration today are based on a set of normative premises that are broadly accepted in both developing and industrialized countries. These premises are often discussed under the general heading of "new public management" (NPM).³⁰ Rather than a detailed model for administrative reform, NPM refers to a set of instruments and normative guidelines extracted from the experience of innovative public administration, mostly in Anglo-Saxon and Scandinavian countries. Key elements are:

- a shift from management by rule to management by result, using the impact (outcome) of public

action on target groups as the main criterion for administrative quality;

- the internal decentralization of competencies and fiscal responsibility, in combination with the introduction of private-sector accounting methods and contract management;
- the mobilization of private capital for investment by means of privatizations, public-private partnerships (PPPs) and subcontracting;
- an emphasis on customer- and citizen-orientation, including new methods of participation, budgeting, demand assessment and personnel management.

If political, economic and fiscal framework conditions are tending in the direction of administrative reform and at the same time the normative guidelines of that reform seem to be widely accepted, why is it that the dynamics of micro-level reform are still rather low in Latin America? A main reason lies in the fact that market-led development does not by itself generate the public institutions needed for competitiveness. In order to introduce and consolidate modern management methods there have to be further changes in the incentive structure.

For example, instead of NPM-oriented reform, political leaders often prefer the "successful failure" of public institutions, namely a situation where the failure to produce public goods and services is accompanied by the successful alimentionation of particular client groups. Also, excessive centralization and overly rigid hierarchies within public-sector bodies discourage innovation from below. In such a setting, public-sector employees will most likely try to prevent changes unless they are invited to participate in the reform process and compensated for the frustrations, setbacks and additional efforts that usually come with administrative change. Lastly, without visible improvements in service delivery, public support for reforms will be low.

As a consequence, reforms are most likely to succeed if they: i) offer a prospect of political benefit to reform leaders; ii) allow for innovations from below, along with political leadership from above; iii) include proper personnel management right from the start of the process, and iv) are designed to produce at least some highly visible short-term results, in order to secure public support.

²⁹ Apart from the organization and working of public administration, there is also a micro-level dimension to political institutions in a narrow sense of the term. For instance, the poor performance of parliaments in Latin America can be traced back in part to the lack of technical support for individual members and to the deficient organization of parliamentary affairs. See Krumwiede and Nolte (2000, pp. 90-109).

³⁰ See Von Haldenwang (2000, pp. 25-30) and McCourt and Minogue (2001) for a review of critical approaches to NPM. Koldo Echebarría has called my attention to the fact that NPM is more than just a micro-level approach. This is certainly true: NPM implies fundamental changes in the relationship of public institutions with citizens and enterprises. In this sense, there is a meta-level dimension to micro-level reform.

IV

Conclusion

This paper has focused on common features of systemic governance in the Latin American region. In order to assess the reform propensity and orientation of individual countries, additional case-by-case analysis is needed. To give an example, the kind of systemic governance and institutional lock-ins generated by a country such as Ecuador with its strong dependency on public rents from oil exports will be different from those of, say, Honduras with its focus on maquila-type assembly for export based on cheap, low-skilled labour. However, to the extent that development is taking place within the parameters of market economies, there is a general need to strengthen the common interest orientation of public institutions.

Systemic governance in this context implies that the proper functioning of a political system, i.e., its ability to formulate and implement policies in the common interest, hinges upon political capacities at different levels. These levels have been examined separately, but in analytical terms they should be regarded as an integrated whole. Hence, the question arises as to which laws determine the interaction between levels. For instance, if meta-level institutions change, will there be predictable change patterns at the meso-level? This paper does not provide a final answer to that problem, but rather draws some tentative conclusions on the basis of the findings presented above.

Neither top-down nor bottom-up explanations of political change are wholly satisfactory. Experts who emphasize planning and vision as normative guidelines for political action would probably incline towards a model of change that started at the meta-level of systemic governance and proceeded downward. There is a point to this reasoning: development as goal-oriented behaviour needs some kind of idea concerning the status quo desired in the future. But then again, there is no clear-cut relationship between visions and reality. Political action often takes place under conditions that do not follow strategic reasoning. Pragmatism may at times be the only guiding principle on hand.

On the other hand, there are experts who favour a reform model that starts from modernization at the meso- or even micro-level. Visible improvements in one place are expected to stimulate reforms elsewhere,

thus generating a bottom-up process of change where “islands of modernity” gradually emerge together. The idea of “best practices” that can be learnt from, the widespread reliance on pilot projects as a means of innovation and the increasing number of international conferences where practitioners and social scientists present their showcases to each other bear witness to this approach, which we might term “inductive”. Yet there are major obstacles to this model of public-sector modernization: unlike enterprises, which *must* learn in order to survive in the market, public institutions may very well prefer to avoid learning, for the reasons outlined in the preceding section.

An alternative to the linear approaches touched upon above would be to think in terms of cross-cutting feedback circles. If societies leave traditional development paths, parts of the pre-existing institutional setting cease to be functional. Openly dysfunctional institutions create legitimacy problems: citizens begin to question the way things work, and political forces begin to look for institutional alternatives. This seems to be the case right now in quite a number of Latin American countries, given the poor record of the market-*cum*-democracy model in terms of economic, social and political integration.

If political systems succeed in enhancing their legitimacy through common interest orientation and improved performance at any of the four levels, they free up resources which can be employed for further system consolidation. In principle, the higher the level at which change takes place, the stronger the effect on the system’s legitimacy. The direction and dynamics of change, though, depend on the resources mobilized by social groups to punish performance deficits or to reward improvements.

This calls for an approach that does not focus exclusively on the final objectives of reforms, but keeps an eye on the processes leading to those objectives. Such an approach would promote public-sector capacity-building to enable States to act swiftly and sustainably on legitimacy problems. Also, it would strengthen representative decision-making and implementation, since representative democracy has proved to be the most suitable order for handling complex public policy issues. Lastly, it would promote interest articulation and mobilization by underprivileged groups

so that the performance deficits affecting the neediest could be put on the political agenda more effectively.

In contrast, an approach that pursues the modernization of individual institutions will most likely fail to produce sustainable improvements in governance. Itemizing particular measures, even creating a truly comprehensive list of necessary reforms, will not obviate the logical fallacies outlined in this paper.³¹ This is a major shortcoming of the good governance concept as discussed so far: fine-tuning and complementing the Washington consensus are a necessary but not sufficient approach to development and development cooperation.

The contours of a new development project are just beginning to emerge. The new emphasis on social, economic and cultural (i.e., collective) rights in development theory, as highlighted by the UNDP approach to good governance, has yet to be translated into political projects. In this context, extending effective citizenship to hitherto excluded social sectors is a key factor for change.³² When development cooperation is called upon to become more political, it is not only the level of intervention that is referred to. What is meant, rather, is that donors and governments alike should focus their programmes in a way that offers the prospect of sustainable legitimacy gains.

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³¹ This additive approach seems to characterize recent efforts to "complete, correct, and complement the reforms of a decade ago". See Williamson (2003, p. 18); Navia and Velasco (2003, pp. 265-303).

³² See ECLAC (2000).

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The monetary pendulum in Mexico

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First World priorities and the need for nations to coexist in harmony have given rise in each period to a set of rules constituting the international economic order. This is a shifting order, in which national goals move alternatively towards and away from those of an international nature. The objective of the gold standard was to uphold monetary convertibility, if necessary at the expense of national objectives. By contrast, the Bretton Woods system inverted the terms of the equation by making governments responsible for employment and growth. The monetary pendulum is now swinging back again, from nationalism to cosmopolitanism. In the case of Mexico, owing to failures of adaptation, this latest shift has translated into an all-out struggle against inflation that has brought the country to a state of chronic near-stagnation, leaving it trailing in the rear of the world development process.

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I

Introduction

National policies have been conditioned to varying degrees by economic paradigms, the dominant outlook of the first World and the unavoidable need to organize the world economy around a set of rules that must be complied with if nations are to coexist in harmony. Of course, any international order will be subject to conflicts and to asymmetries in compliance; nonetheless, the advantages of joining this order or the disadvantages of staying outside it are particularly intense for peripheral countries.

An essential part of the economic arrangements among nations are the monetary and currency regimes that underpin reciprocal transactions. The abolition of frontiers, the emergence of new economies of world importance and the technological revolution have made

change indispensable and agreements much more complicated to reach.

Since the introduction of the gold standard, monetary regimes have been influenced by ideological factors serving to explain, rationalize and implement the distribution of benefits, costs and responsibilities in each world economic order.

This article aims to provide a brief review of the historical swings in the monetary pendulum, emphasizing movements that have opened and narrowed the gap between purely national goals and those of a cosmopolitan nature. The consequences of these movements for development are significant, and they show how completely factors of an ideological nature have become intertwined with the economic life of nations.

II

From the gold standard to Bretton Woods

Although they may be masked, it is possible to recognize the swings of the ideological pendulum governing the long-standing opposition between the demands of the international order and the democratic demands of each country, which are plainly revealed in monetary policies. Until the First World War, the dominant ideologies, together with the weakness of workers' parties and restrictions on the voting franchise, meant that the former demands prevailed over the latter, particularly as trade increased under the influence of the British Empire. The central objective of the gold standard was to underpin monetary convertibility in the most draconian way, with the costs being met by deficit countries.¹ Accordingly, governments and central banks used unpopular measures to combat balance-of-payments deficits, deflating economies by raising interest rates and reducing the money supply; i.e., depressing development, imports and prices.²

Subsequently, the devastating repercussions of the great crisis of the 1930s, universal suffrage and the rise of social democratic parties upset political balances and economic paradigms. Citizens increased their sovereign power over the course of national life, colonialism disappeared, the rising spiral of international trade was broken and economies grew as never before. Keynesian policies and the Second World War brought the world out of depression and guided the logic of national strategies, to the point where the State was held responsible for full employment and growth in each country.

As a result, the currency system of the gold standard collapsed and the regulatory power of central banks was weakened; countries raised barriers to trade and capital flows. In the international order, existing agreements were wound up and the so-called Bretton Woods institutions were created. There arose a new monetary/currency regime that, unlike the previous

¹ See Bloomfield (1959) and Eichengreen (1996a).

² Besides representing a government commitment to the prevention or limitation of currency fluctuations, fixed parities serve as a

nominal anchor for productive agents' operations and expectations about the behaviour of monetary policy.

one, did not stipulate fixed exchange rates. Instead, these could be revised whenever a country could show that it was suffering from a fundamental imbalance and the International Monetary Fund (IMF) accepted this. The IMF itself provided some balance-of-payments financing and permitted national controls on capital movements and, in practice, on trade in goods and services as well.

The system that came out of Bretton Woods reflected political changes that had made it unviable to use deflation in deficit countries as the only way of correcting payment imbalances, and that had opened the way for the most intense period of world economic development in history, particularly in peripheral areas. Parities could be adjusted to eliminate external deficits at lower cost to the country concerned. In turn, controls made it possible to avoid the effects of sudden or speculative capital movements and moderate the build-up of adverse trade balances.

Nonetheless, the agreement only allowed parities to be altered when serious imbalances existed and were recognized by IMF, which reduced exchange-rate flexibility in practice. Before acknowledging an imperative need for devaluation, before admitting that monetary policy had failed, governments and central banks strove to keep the exchange rate unaltered, heightening the opposition between external adjustment and national development goals. For this purpose, they had instruments available to them for increasing protection (tariffs, import permits, etc.) and correcting payment imbalances, at least temporarily.

Meanwhile, under pressure from the United States, the Bretton Woods system sought to re-establish monetary convertibility as a prerequisite for strong growth in international trade. A failed attempt was made to do this with the pound sterling (1947) by means of the Havana Charter, which sought to create an international trade organization; progress with the General Agreement on Tariff and Trade (GATT) was initially modest as well, while the creation of the European Payments Union (1950-1958) was regional rather than multilateral in its approach.

These early efforts foreshadowed, however, the beginning of another swing in the pendulum, away from nationalism and back towards cosmopolitanism. To begin with, attempts to reintroduce universal monetary convertibility came up against conflicts of interest among the developed countries. The European nations, devastated by war, stood out against trade liberalization; to rectify their balance-of-payments situations they would need substantial currency

devaluations which would damage the living standards of their populations without fully alleviating the constraints on their production and export capacities (in 1947 Europe had a combined deficit of US\$ 7.5 billion).³ For its part, the United States believed that convertibility was indispensable to create a climate of fair competition for its exports. To help solve the problem, the United States Government agreed to provide substantially greater financing to Europe under the Marshall Plan and other arrangements.

Between 1959 and 1961 the European countries restored current-account convertibility, but left capital-account controls in place. The monetary policy pendulum continued to swing away from economic nationalism as the interests of countries in the developed world became more and more convergent, although not all the difficulties disappeared and new problems arose.

From then on, as the payment imbalances of Europe and Japan were corrected and trade, investment flows and the operations of international firms all increased, the number and power of private-sector actors on the world stage multiplied, while the influence of national governments waned accordingly. Countries began to restore convertibility for transactions on the balance-of-payments current account, making it harder and harder to apply effective capital-account controls, until these too were dismantled in most countries.

From the 1960s onward, Europe and Japan grew and increased their trade, becoming attractive destinations for foreign investment, while the United States began to display persistent trade imbalances.⁴ Paradoxically, the dollar was consolidating its position as a reserve currency just as the disequilibria in the United States balance of payments were increasing, creating the danger that the country might decide to relinquish gold-dollar convertibility, thus provoking serious liquidity problems in the world (the Triffin dilemma)⁵ and the consequent collapse of the Bretton Woods currency system.

³ In 1949 the European countries devalued their currencies by about 30% yet were still unable to remove import controls. The way was thereby opened, however, to a solution of their balance-of-payments problems (see Eichengreen, 1996a, p. 98).

⁴ As early as 1960 the United States balance of payments was displaying weaknesses that would be considerably accentuated by spending on the Vietnam War and the Great Society projects implemented at the same time.

⁵ See Triffin (1960).

III

After Bretton Woods

The post-war monetary system, which rested on the commitment of the United States to upholding the fixed price of gold, was eroded not only by the risks stemming from cumulative United States deficits, but also by the fact that central banks kept most of their reserves in dollars. In 1971, with its reserves shrinking rapidly and the alternative solution of deflating the economy ruled out, the United States abandoned its commitment to the unlimited sale of gold at a price of 35 dollars an ounce, bringing down the Bretton Woods currency regime. Subsequently a variety of currency regimes were tried, but these gradually moved towards the extremes of more or less free flotation on the one hand and fixed parities on the other,⁶ creating in the process serious currency misalignments between countries, speculative movements, volatility and contagion that are far from having been rectified.

These developments returned the main responsibility for anchoring the world monetary system to national authorities, closely supervised by the multilateral organizations (World Bank, International Monetary Fund, World Trade Organization). For governments to adopt roles analogous to those they had under the gold standard entails costs, since meeting the standards and requirements of the international order means adopting policies and overruling objections in defiance of the popular will. Furthermore, there are asymmetries in the way the international rules are observed: they are inflexible for the developing world, even in the case of emerging countries, and lax for the developed nations, as is shown by the size of United States external payment imbalances and by government deficits that now stand at between 4% and 8% of GDP in Europe, Japan and the United States.⁷

In the last three decades an undeniable paradox has arisen. While in theory countries are free to choose the currency regime they want, even one that gives a maximum of autonomy to their domestic policies, the international order requires each country to have an open economy and stable prices to remove risks to financial and trade flows, the variables with which hegemonic transnational interests are mainly concerned.

In line with these developments, ideological paradigms have shifted so that, rather than development and employment, it is now the control of inflation that is exalted as the leading social objective. This way of thinking has meant that national governments and their institutions are routinely suspected of seeking political advantage at the expense of the fundamental macroeconomic balances. There is ideological mistrust of the behaviour of the State and full confidence in the markets. Consequently, fiscal policy is often criticized for inducing spending that is too high for the natural rate of growth or employment. The criterion of budgetary balance is embraced in all circumstances, i.e., there has been an implicit renunciation of the use of fiscal measures for developmental or counter-cyclical purposes.

In the sphere of monetary policy, the new approach extends not only to policy design, but to the design of institutions as well. The postmodern view of central banking emphasizes the need to solve what are known as “time-inconsistency” problems, i.e., the inconsistency that arises when governments announce anti-inflation policies and then act against them in pursuit of political or electoral gains that economic theory usually assumes to be transitory. The real or imagined discredit into which governments have fallen has resulted in central banks being made independent so that they can pursue price stabilization objectives without political contamination.⁸ External credibility is put first.

⁶ The systems tried have ranged from dollarization and currency boards, exchange rates fixed against a particular currency or basket of currencies, fixed or adjustable bands and crawling pegs to managed and free floats, among others. See Mussa and others (2000), Cartens and Werner (1999) and Ibarra and Moreno-Brid (2001). Fixed exchange-rate regimes have gradually become fewer. They are generally adopted by economies that are either small or integrating (like those of Europe) or have chosen the path of dollarization. See Eichengreen and Freden (1998), Obstfeld (1997), Ibarra and Moreno-Brid (2001) and Hauke and Schuler (1993).

⁷ The fiscal deficits of the emerging and developing countries now average 3% of output (1.5% in Mexico), while in the advanced

nations they average 4% (United States 5.9%, Japan 8.2%, Germany 4%, France 4.1%). The data are from IMF (2004).

⁸ Although governments can produce monetary and inflationary surprises, these efforts will fail, argues the theory, if economic agents anticipate them, so that the result will be more inflation without positive effects for development (see Barro and Gordon, 1983, pp. 101-121). More general or detailed approaches can be found in Rogoff (1985, pp. 1169-1190), Giavazzi and Pagano (1988, pp. 1055-1082) and Bernhard and others (2002, pp. 693-723).

Even so, the fact that central banks have less intrinsic credibility in a floating regime means that a complementary fiscal policy anchor is required in the form of a commitment to reducing budget deficits and ensuring that any spending growth is financed from taxes or through open market operations (deferred taxes) that balance out its monetary impact. Fiscal accounts in balance or surplus, independent central banks and the abolition of industrial policies represent a most impressive surrender of economic sovereignty by the Latin American countries, which some of them have taken or been prepared to take to the extreme of abolishing their national currencies, i.e., dollarization (or the creation of so-called currency boards), even in the absence of institutions and agreements for mutual support and participation in the design of joint economic policies, like those of the European Union. If these processes continued, the ultimate outcome would be monetary or economic unions in which the costs would be borne asymmetrically not by the dominant country, but by its periphery.

In short, the use of a combined fiscal and monetary anchor is an approach which is calculated to win external credibility for government anti-inflation policies, but which severely reduces the room for manoeuvre of domestic public policies and gives them a markedly procyclical and undemocratic character. In other words, it represents an effort to bear down on price and interest-rate differences between countries by means of deflation until these variables match those of

the leading countries, ignoring the different institutional arrangements and configurations of political forces in each nation.

In this swing back of the monetary pendulum, however, there is one difference from the earlier gold standard. Previously, recessionary policies were implemented as imbalances arose; now they are introduced pre-emptively, condemning many peripheral countries to a kind of chronic near-stagnation that prevents them from resolving the structural failings underlying payment imbalances. The monetary dilemma then comes down to the opposition between external credibility and democratic domestic scrutiny of public policies.

When it comes to currencies, the aspects emphasized by the economic paradigms have shifted with the new circumstances. In the 1990s the debate about the problem of crises moved away from methods of avoiding high and growing imbalances in the current account and unsustainable capital flows, or ideas about the comparative flexibility of prices, wages and interest rates, always with national objectives of growth and employment in mind. The analytical focus of anti-crisis policy now centres on how to maintain and increase international capital flows, while underlying this is the objective of price stabilization in economies. Thus, governments are no longer seeking room for monetary manoeuvre to pursue developmental goals, but have sacrificed monetary policy independence almost entirely to the demands of globalization.⁹

IV

The Mexican response

Mexico is no exception. The independence granted to the Bank of Mexico by a 1993 law sets it the single or overriding objective of combating inflation, while constraining lending to the government. As in other cases, it is unclear whether institutional independence extends only to the use of monetary instruments or includes the unilateral power to set goals of national scope that might differ from or even contradict those of the government and legislature themselves.

Certainly, our recent and not-so-recent history contains instances of governments using and abusing monetary and exchange-rate policy to avoid the political sacrifices involved in prompt action to achieve an indispensable economic adjustment. But the history

of the Bank of Mexico and its trusts also contains successes: by channelling private- and public-sector

⁹ Summers argues that the prerequisites for reducing the risk of financial and currency crises concern the capital account of the balance of payments, while he makes no mention of current-account problems, treating them as subordinate to the former. According to this way of thinking, foreign investment and lending play a leading role in the developing world, despite the volatility of such flows. These prerequisites are as follows: i) to maintain or create a strong financial system (well-capitalized and well-supervised banks, effective corporate governance codes, the rule of law, contract protection) that can make substantial debt build-ups sustainable; ii) to adopt a fixed-rate or free-floating currency regime to facilitate access to capital markets; iii) to have a stable macroeconomic climate that minimizes monetary and fiscal risks; iv) to build up reserves in proportion to the country's liabilities (see Summers, 2000, pp. 1-16).

funds into new production capacity (along with the development banks), they paved the way for the period of most rapid growth in the country's history, lasting from 1940 until 1980.¹⁰

Capital-account liberalization exposed the country to volatility, particularly where short-term capital flows were concerned.¹¹ Sharp movements in the values of the main international currencies (euro, dollar, yen) and recent instances of financial contagion show that developing countries are unlikely to find shelter from destabilizing financial movements when these arise in a globalized economy.

In our case, furthermore, inflation was combated with interest rates that were high by international standards, creating incentives for outside investors to bring in short-term funds that remained in the country only so long as expectations of devaluation did not increase. The resultant overvaluation of the currency can be combated only by costly sterilization measures and reserve build-ups, while there is also an inherent risk that capital inflows might dry up or even be abruptly reversed, as happened between 1994 and 1995. This tendency towards overvaluation intensified in the 1990s as foreign investors bought into numerous public- and private-sector companies, giving rise to large currency inflows that were not used to significantly increase production or export capacity.

The outcome has been a deflationary adjustment process that has been successful in bringing Mexican inflation down towards United States levels. The historical price paid has been an overvalued currency, which has undermined the competitiveness of domestic producers, and a retreat from the strategy of outward-oriented growth and consequent failure to capitalize on demand in international markets.

Abandonment of the fixed parity regime was due, then, to two central factors that perhaps have little to

do with development objectives as such. Mexico traditionally used fixed dollar-linked exchange rates as an anchor for monetary policy and, in general, for all public policies. The importance of this function was not minor: it provided certainty in a country where a hegemonic party ran a semi-authoritarian government whose decisions and actions were often opaque to the outside world, to economic agents and to citizens. Until the late 1980s the annual report of the President to Congress was almost the only document which, besides dwelling on government achievements, gave a clue to changes of economic and political direction. Here the amount of international reserves was stated and the information asymmetries between the government on the one hand, and political parties and citizens on the other, were partially remedied. However, trade and financial liberalization left the Mexican economy defenceless in the face of unrestricted—and not always stabilizing—capital and goods flows, and of contagion from external crises.¹² From the national policy perspective, meanwhile, it was and is desirable to avoid the devaluation crises that have tended to occur every six years, chiefly owing to the build-up of price differences with the outside world and their consequences in the form of trade deficits or unserviceable debts. Flotation provides an escape route for both problems, but demands greater monetary and fiscal rigour and greater sacrifices of growth if the goal of reducing price pressures (whether originating in the real economy or in problems of credibility) and bringing domestic inflation closer to the United States level is to be met.

Nor does flotation resolve all possible excesses in public policies, although it may well change their direction. The incentives have now been reversed: the temptation for independent central banks is not so much to facilitate economic expansion, whether sustainable or unsustainable, as to raise interest rates more than necessary or allow the currency to become overvalued to win a temporary and costly advantage in the fight against inflation, their sole or main responsibility. The lower growth that results reduces the incentive to invest, innovate and improve competitiveness, while the higher costs thus artificially generated for domestic producers make it easier for them to be displaced by foreign suppliers,¹³ increasing

¹⁰ In addition to the *cajones crediticios*, which lent to activities deemed to be of priority, the main providers of funding were the Fideicomisos Instituidos en Relación con la Agricultura (agriculture trusts) (FIRA), the Fondo de Fomento de las Exportaciones de Productos Manufacturados (manufacturing export promotion fund), the Fondo de Equipamiento Industrial (industrial equipment fund) (FONEI), the Fondo de Operación y Financiamiento Bancario de la Vivienda (housing operation and bank financing fund) (FOVI), the Fondo Nacional de Fomento al Turismo (national tourism development fund) (FONATUR) and the Fondo para el Desarrollo Comercial (business development fund) (FIDEC).

¹¹ The advantages or disadvantages of capital-account opening have been the subject of intense international debate; leading critics include Tobin, Bhagwati and Rodrik. See Ul Haq, Kaul and Grunberg (1996), Bhagwati (1998) and Rodrik (1998).

¹² See Garber and Svensson (1995, pp. 1865-1912), Obstfeld and Rogoff (2002, pp. 503-535), Bergsten and Williamson (2003) and Eichengreen (1996b).

¹³ See Ibarra (1999, pp. 139-160 and 2001, pp. 259-280). See also Villarreal (2003).

import dependency. Thus the circle of stabilizing stagnation is closed, as development incentives are repeatedly reduced and the competitive position of domestic companies in outside markets worsens.

Despite a degree of correction recently, the peso has been almost systematically overvalued between devaluation crises. Although this temporarily reduces inflationary pressures, it damages domestic producers. This is one of the factors accounting for the loss of external markets and for trade deficits averaging some US\$ 9 billion, while Latin America as a whole is in surplus (US\$ 27 billion in 2003).¹⁴ By contrast, China,

Japan, the Republic of Korea and Taiwan province of China have deliberately kept their currencies undervalued to bolster their export trade by means of direct interventions in the currency markets, even where this has contravened IMF rules.¹⁵

Fiscal policy completes the anti-inflationary anchor of monetary management by deliberately keeping fiscal deficits below the developing-country average¹⁶ and reducing public spending automatically, by law, whenever government revenues fall, irrespective of the position of the economy in the business cycle.

V

Conclusion

To sum up, the country has been drawn into a strategic vacuum that is relegating it to permanent near-stagnation or to a position in the rear of the international development process. The old is not working, and the new cannot be made to work. On the one hand, market and financial opening, the intensification of world technological change and the new forms of economic hegemony have made protectionist strategies anachronistic and unviable. On the other, the anti-inflationary obsession of cosmopolitan globalizers has resulted in our case in policies that are undermining the outward-oriented growth strategy. The use of high interest rates, an overvalued currency and balanced budgets (not just in the current account but in the capital account as well) as stabilization tools is confronting Mexican producers,

directly and indirectly, with the Herculean task of not only making up the historical lead enjoyed by the world's best producers, but of doing so under the artificial constraint of an economic policy that is reducing their competitiveness.

This strategic vacuum has effects not only in periods of deflation themselves, when the aim is to bring price rises down to international levels, but well beyond them. The resultant deficits in human capital formation, physical investment, technological modernization and participation in transnational production and trade networks often prove, over long years, to be difficult or impossible to make up. Achieving balance in social goals and their reflection of public policies is, unquestionably, the crucial unfulfilled task of national policy.

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¹⁴ The figures are from ECLAC (2003).

¹⁵ The reserves of these four countries now total more than US\$ 1.7 trillion, clear evidence of the enormous currency misalignments in the world and of the need to reconstruct the monetary architecture of the world order (see Bergsten, 2004).

¹⁶ See the figures in note 7.

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Brazilian fiscal institutions: the Cardoso reforms, 1995-2002

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This paper looks at Brazil's fiscal policy during the two administrations of President Fernando Henrique Cardoso: 1995-1998 and 1998-2002. It stresses that the authorities' austere attitude was as important as institutional and structural reform for the fiscal adjustment that followed the 1998-1999 crisis. The principal cause of the fiscal deterioration in 1995-1998 was the reduction in the primary balance rather than the increase in the interest burden, while the fiscal adjustment in 1999-2002 was largely due to increased revenues, as primary public expenditure by the federal government continued to grow in real terms. We consider the outlook for fiscal sustainability and conclude that, to preserve the country's hard-won fiscal discipline, the austere fiscal attitude shown recently by the authorities should be permanently embedded into fiscal institutions.

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I

Introduction

Following the Collor Plan (1990), the average public-sector primary balance recorded a surplus of 2.9% between 1991 and 1994. In contrast, following the Real Plan (June 1994),¹ this balance underwent a dramatic deterioration, averaging a deficit of 0.2% of GDP during 1995-1998. During those years, the authorities' rhetoric favoured fiscal austerity, but unrelenting pressure to increase expenditures more than offset increases in revenues or cuts in other spending items. Proposals to set public-sector deficit ceilings simply failed to generate broad support.

At the end of 1998, Brazil faced a deep external and fiscal crisis and signed a Stand-By Arrangement with the International Monetary Fund (IMF) for 1999-2001. Following the sharp exchange-rate devaluation of January 1999 the agreement was reassessed, and in 2001 it was extended until the end of 2002. In this context, there was a major policy regime change and during 1999-2002 the public sector recorded an average primary surplus of an unprecedented 3.6% of GDP.² During the second Cardoso term, the public sector was clearly operating under a hard budgetary constraint in the form of a floor for the consolidated primary surplus, implementation of which meant a major institutional change in the management of the Brazilian public finances.³

Although day-to-day fiscal policy continued to be based on floors for the primary surplus rather than

ceilings for the nominal deficit, in effect increases in financial expenditure had a direct effect on the primary target. This was apparent in the authorities' efforts to ensure that the nominal deficit did not exceed certain limits, corresponding essentially to a regime of deficit targeting. For example, the increase in interest rates during 2001 and its impact on the projection of higher interest payments in 2002 led the authorities to raise the primary surplus target for 2002. The original official target for the year of 2.7% of GDP was raised to 3.9% of GDP precisely in order to make up for the higher interest burden.⁴

This article provides a detailed account of public-sector finance trends during the two administrations of President Fernando Henrique Cardoso: 1995-1998 and 1999-2002.⁵ We argue that the change in the authorities' attitude to fiscal policy in the context of the 1998-1999 balance-of-payments crisis was as important as the legal and constitutional changes approved at the end of the first and beginning of the second Cardoso administrations to bring about the primary balance shift to 3.7% of GDP between 1995-1998 and 1999-2002. Only President Castelo Branco's reforms (1964-1967) can be compared in scope to President Cardoso's, and the latter were implemented under much more difficult political circumstances.⁶

Two important messages come out of our account. First, the principal cause of the fiscal deterioration in the first Cardoso administration was the deterioration in the primary balance rather than the increase in the interest payment burden. Second, the fiscal adjustment in the second Cardoso administration was to a large

□ This paper is a shortened version of Giambiagi and Ronci (2004), and it has benefited from comments by Max Alier, Fabio Barbosa, Nigel Chalk, Martin Gilman, Vincent Moissinac, Laura Papi, Murilo Portugal, Hemant Shah and Evan Tanner. The views expressed in this paper are those of the authors and do not necessarily represent those of the International Monetary Fund (IMF) or the Brazilian government.

¹ The year 1990 is usually disregarded in analyses of Brazilian fiscal policy in the 1980s and 1990s, as it was the first year of the Collor Plan and is considered atypical due to the extraordinary revenues collected.

² In this paper, the concept of the public-sector borrowing requirement (PSBR) refers to the nominal rather than to the operational result, except where otherwise specified.

³ For our purposes, fiscal institutions include both the legal framework of fiscal policy and the authorities' fiscal attitude, as enforcement of formal rules depends on this. It is important to emphasize that institutional arrangements are not primarily to be understood as formal organizations and written laws and regulations. Institutions are the rules of the game—formal or informal rules—that are used by societal actors (North, 1990).

⁴ The original primary surplus target of 2.7% of GDP for 2002 had been announced in 2000, in the context of a significant fall in interest rates, which, as was foreseen at the time, would continue in subsequent years. After this, however, the nominal Special System of Clearance and Custody (SELIC) rate, which fell to 15% at the start of 2001, rose to more than 20% during 2002, making it necessary to revise the projected numbers for the following year.

⁵ While the data for this study begin in 1994, for reasons of space we focus mainly on the fiscal adjustment that took place after 1998. For an account of the various aspects of fiscal policy during the 1995-1998 period, see Além and Giambiagi (1999). For the period before the Real Plan in 1994, see Giambiagi (1997).

⁶ For an account of Castelo Branco's reforms, see Barbosa, Salazar and de Faro (1989) and Skidmore (1988).

extent due to increased revenues, while primary federal public expenditure rose in real terms during the eight years of the two administrations. These aspects of Cardoso's fiscal adjustment underline the need to preserve hard-won fiscal discipline and improve the adjustment over the coming years. Key to achieving fiscal sustainability has been the austere fiscal stance of the recent authorities, which should be permanently embedded in fiscal institutions.

The article is divided into seven sections. After this brief introduction, section II reviews the evolution

of the public-sector borrowing requirement (PSBR) during 1995-2002. Section III highlights the major factors and structural reforms underlying the fiscal adjustment since 1999. Section IV deals with temporary revenue sources since the mid-1990s. Section V describes the evolution of the public-sector debt. Section VI demonstrates the importance of the change in the authorities' attitude to fiscal policy. Lastly, section VII presents a summary and conclusions. The appendix provides empirical evidence on public debt sustainability during 1995-2002.

II

Overview of the public-sector borrowing requirement, 1995-2002

The performance of the public-sector finances since the Real Plan (1994) can be divided into two periods: 1995 to 1998 and 1999 to 2002, each corresponding to one of President Cardoso's terms. There were two major turning points in the policy regime: the first in 1995, when the significant primary balance surpluses achieved in previous years were rapidly eroded, and the second in 1999, when a strong fiscal adjustment was carried out at all levels of government (table 1).

With regard to the major aggregates, four facts stand out:⁷

First, until 1998 the federal government recorded a progressive deterioration in its nominal deficit, partly because it "inherited" debts from individual states, which in effect represented a "socialization" of losses, and partly because tight monetary policy had a greater impact on its financing costs. As a result, the federal government's nominal borrowing requirements

increased from a third of the total PSBR in 1995 to two thirds in 1998.

Second, compared with 1991-1994, all three levels of government showed the same primary balance deterioration in 1995-1998, followed by a marked improvement in 1999-2002 (table 2).

Third, interest payments averaged 7% of GDP throughout 1995-2002, contributing a great deal to the high average nominal deficit of 5.5% of GDP during the same period. Although total public debt was relatively low during the first years of the Real Plan, interest payments were high as real interest rates came under severe pressure, partly because of the risk of lending to the government in an environment of growing fiscal deterioration, and partly because of the need to attract external financing to pay for external current-account deficits following the Asian and Russian crises.⁸ Using the extended national consumer price index (IPCA) as a deflator, the Special System of Clearance and Custody (SELIC) gross real interest rate averaged 22% during 1995-1998. Subsequently, it declined to an average of 10% during 1999-2002. However, this lower rate applied to a much higher public-sector debt and, in combination with the effects of currency devaluation, resulted in continued large interest payments (figure 1).⁹

⁷ Comparing the fiscal outcomes of the first Cardoso administration with those of the year of the Real Plan (1994) is problematic as 1994 was a relatively atypical year. The primary surplus of 5.4% of GDP recorded then was well above the average of 2.2% of GDP in the three preceding years. This is largely explained by the fact that in 1994 tax revenues benefited both from the end of inflationary erosion and from the economic boom in the first six months of the plan, while public spending lagged behind. On the other hand, in 1994 the "above the line" primary surplus published by the federal government was almost 1% of GDP below the figure published by the Central Bank (which is the official figure), leading us to believe that there may have been a methodological problem in determining the primary balance, so that this may have been overestimated to some extent. For these reasons, we chose to compare period averages.

⁸ see Ferreira and Tulio (2002), p.153.

⁹ See Garcia and Didier (2000) for an analysis of the determinants of interest rates in Brazil.

TABLE 1

Brazil: Public-sector borrowing requirement
(Percentages of GDP)^a

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Public-sector borrowing requirement</i>	-27.0	-7.3	-5.9	-6.1	-7.5	-5.8	-3.6	-3.6	-4.6
Federal government	-10.2	-2.4	-2.6	-2.6	-4.9	-2.7	-2.3	-2.1	-0.8
States and municipalities	-12.1	-3.6	-2.7	-3.0	-2.0	-3.1	-2.1	-2.0	-3.8
Public-sector enterprises	4.7	1.3	0.6	0.4	0.5	-0.1	-0.7	-0.6	0.0
<i>Primary balance</i>	5.2	0.3	-0.1	-1.0	0.0	3.2	3.5	3.6	3.9
Federal government	3.3	0.5	0.4	-0.3	0.6	2.3	1.9	1.8	2.4
Federal government and Central Bank	3.1	0.5	0.5	0.0	1.3	3.3	2.8	2.9	3.6
Social security ^b	0.2	0.0	-0.1	-0.3	-0.8	-1.0	-0.9	-1.1	-1.3
States and municipalities	0.8	-0.2	-0.5	-0.7	-0.2	0.2	0.5	0.9	0.8
Public-sector enterprises	1.2	-0.1	0.1	0.1	-0.4	0.7	1.1	0.9	0.7
<i>Interest payments</i>	-32.2	-7.5	-5.8	-5.1	-7.5	-9.0	-7.1	-7.2	-8.5
Federal government	-13.4	-2.9	-2.9	-2.3	-5.5	-5.0	-4.1	-3.9	-3.1
States and municipalities	-12.8	-3.4	-2.2	-2.3	-1.8	-3.4	-2.6	-2.9	-4.6
Public-sector enterprises	-5.9	-1.3	-0.7	-0.5	-0.2	-0.6	-0.3	-0.4	-0.7
<i>Memorandum items</i>									
Balance sheet adjustment (flows)	...	...	-1.9	1.8	-1.0	-6.9	0.1	-3.9	-7.6
Privatization	...	...	0.1	1.9	1.3	0.5	1.4	-0.4	-0.8
Other	...	...	-2.0	-0.1	-2.3	-7.4	-1.3	-3.5	-6.8
Domestic debt adjustment	...	...	0.0	0.0	-0.4	-3.8	-0.4	-1.4	-3.6
External debt adjustment	...	...	-0.1	-0.1	-0.3	-2.7	-0.6	-0.6	-3.6
Other adjustments	...	...	-1.9	0.0	-1.6	-0.9	-0.3	-1.5	0.4

Source: Central Bank of Brazil.

^a The minus sign indicates a deficit.

^b Social security revenues less benefit payments.

TABLE 2

Brazil: Public-sector primary balance
(Period averages as percentages of GDP)^a

	1991-1994	1995-1998	1999-2002
<i>Primary balance</i>	2.9	-0.2	3.6
Federal government	1.6	0.3	2.1
Federal government and Central Bank	1.0	0.6	3.2
Social security	0.6	-0.3	-1.1
States and municipalities ^b	0.7	-0.4	0.6
Public-sector enterprises	0.7	-0.1	0.9
Federal	1.1	0.2	0.7
State and municipal	-0.4	-0.3	0.2

Source: Central Bank of Brazil.

^a The minus sign indicates a deficit.

^b Social security revenues less benefit payments.

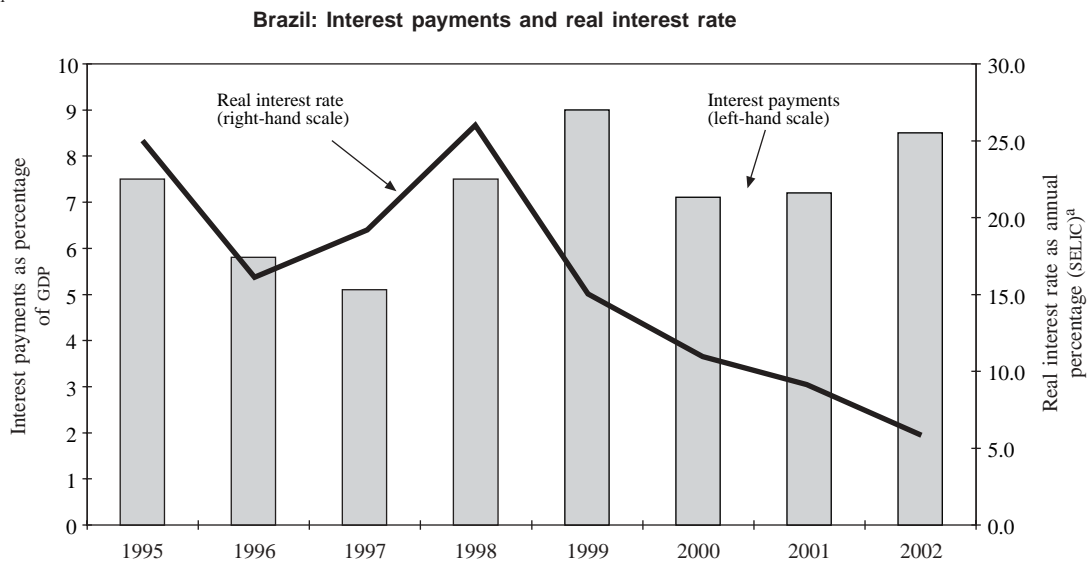
Fourth, there was the emergence in the fiscal accounts of a variable that would become crucial for the dynamics of the public-sector debt: the “balance sheet adjustment”, which dates back to the period

1995-1998.¹⁰ This variable involves “below the line” factors that do not affect PSBR flows but that modify the value of the public-sector debt. Privatizations

¹⁰ Strictly speaking, the recognition of previously unrecorded old debts as a balance sheet adjustment began with the Collor

administration with the “resetting” of obligations through the so-called “privatization currencies”, i.e., debts that were accepted as a means of payment in the sale of State-owned companies.

FIGURE 1



Source: Central Bank of Brazil.

^a SELIC: Special System of Clearance and Custody.

reduce public debt, while recognizing previously unrecorded debts and revaluing public debt denominated in foreign currency due to exchange-rate

devaluations increase it. In net terms, these effects generated a cumulative change in the public-sector debt of 19 percentage points of GDP between 1994 and 2002.

III

Fiscal adjustment and reforms

As we explained in the previous section, interest payments did not account for the decline in the nominal deficit, because they remained high throughout the 1995-2002 period. We shall now turn our attention to the causes of the fiscal adjustment since 1999, focusing on the primary balance results, which exclude interest payments. At the federal level there was a significant increase in tax revenues, while non-financial expenditure grew continuously. At state and municipal levels, structural and institutional changes led to a gradual improvement of the primary balance after 1998. Public-sector enterprises' primary balances have also improved greatly since 1999, mainly due to the results of the State oil company (Petrobras).

Both during the first Cardoso administration and, in particular, during the second one, a number of important structural and institutional reforms were carried out in five areas: the fiscal regime of states and

municipalities; privatization of public-sector enterprises; social security; the financial system, and budget procedures (box 1). These reforms were closely associated with the authorities' ability to carry out the fiscal adjustment in 1999-2002.

1. The federal government

Table 3 shows the revenue and expenditure breakdown of the federal government primary balance from 1994 to 2002, based on data published by the Ministry of Finance.¹¹ Two trends stand out:

¹¹ The data refer to the "above the line" statistics calculated by the Brazilian Treasury, which also cover the Social Security and Central Bank balances. The difference between that figure and the "below the line" primary balance published by the Central Bank, calculated as borrowing requirements minus nominal interest, is adjusted for a "statistical discrepancy" akin to the errors and omissions statistic in the balance of payments.

Box 1
CARDOSO'S FISCAL REFORMS

The fiscal regime of states and municipalities

There was without doubt a genuine change in the fiscal regime of states and municipalities, characterized by the removal of various sources of structural fiscal imbalances. Among the changes observed, we note:

- the privatization of the majority of banks owned by state governments, closing off a financing source for state treasuries;
- rigid restrictions on the practice of providing advances on budgetary resources, which was effectively a mechanism for borrowing from the financial system;
- the blocking of mechanisms for issuing judicial credits (*precatórios*), i.e., securities for the payment of judicial settlements with the private sector, which were often used in practice for other purposes and contributed to the fiscal deterioration of state governments during part of the 1990s;
- the refinancing of state and municipal debts through the federalization of debt securities issued by state and municipal governments in return for collateralization of their future revenues. This measure prompted state governments to make fiscal adjustments to repay their debt over a 30-year period (subject to a ceiling of 30% of revenues in most cases), under penalty of the federal government using its legal powers to withhold constitutional transfers and even appropriate part of the revenues from the state sales tax on merchandise and services (ICMS);
- among other things, the Fiscal Responsibility Act (*Lei de Responsabilidade Fiscal*, supplementary law No. 101 of 4 May 2000) provided for ceilings on payroll expenses in relation to the total revenues of the state and federal governments, restricted the authorities' powers (particularly in election years), introduced transparency rules for reporting public-sector accounts, and prohibited new refinancing of state and municipal debt by the federal government.

The privatization of public-sector enterprises

Privatization also represented a significant structural change. It removed what had previously been a potential source of pressure on public-sector spending, associated with the investments of public-sector companies. Had these returned to the high levels of investment of the early 1980s, they would have put considerable pressure on the public debt. At the same time, the sale of a number of traditionally loss-making public enterprises such as the federal railway company eliminated what had been a permanent source of pressure on the public-sector accounts. With regard to individual state governments, not only did these rid themselves of several loss-making companies, but the discipline of preparing these companies for privatization in itself brought about a significant improvement in the management of the remaining state-owned companies.

Social security

The constitutional amendment to the social security scheme, approved in 1998, permitted:

- the introduction of a minimum retirement age for public-sector employees, and a progressive increase in the retirement age for employees with shorter lengths of service;
- the hiring of new public employees under the general social security regime, without the privileges of the public-sector employee pension regime, and the setting up of pension funds for new public employees;
- removal from the federal constitution of the formula for calculating pension benefits, thereby making it possible to enact legislation for this purpose. This was done during 1999-2002 with the passing of a law on the "social welfare factor";^a this helped to contain the social security deficit, as the new formula for calculating pension benefits discouraged early retirement and the underreporting of income.

The financial system

By strengthening the financial system, the reforms addressed potential sources of deficits. The reforms included:

- approval of the Incentive Programme for the Restructuring and Strengthening of the National Financial System (PROER);
- privatization of various state banks, in a number of cases following federalization, thereby ending what had been one of the main sources of fiscal imbalances during the 1980s and 1990s;
- opening up the financial sector further to foreign capital, with the sale of a number of banks to multinational banking groups, thereby increasing competition within the banking system;

- the requirement by the Central Bank that banks adopt more rigid lending criteria, leading to a substantial improvement in the health of the system and reducing its exposure to risk;
- the strengthening of federally owned banks through capitalization, provisions for non-performing loans, and compliance with the Basel guidelines.

Budget procedures

The Fiscal Responsibility Act also changed the budget procedures for the Budget Guidelines Act (*Ley de Diretrizes Orçamentárias*), which is approved by Congress by June of each year and sets the parameters for the next year's general federal budget, submitted to Congress in August. The Fiscal Responsibility Act stipulated that the Budget Guidelines Act should include not only the federal government's primary result target for the general federal budget, but also the targets for the following two years. This embryonic medium-term budget framework has provided an effective form of budgetary constraint: it limits total expenditure and attempts to make additional expenditure conditional on the resources available. The medium-term budget is a genuine institutional innovation in Brazil, where budgetary restrictions have traditionally been circumvented.

^a See Ornelas and Vieira (1999).

TABLE 3

Brazil: Government primary balance (Percentages of GDP)^a

	1995	1996	1997	1998	1999	2000	2001	2002	Period averages		
									1991-1994	1995-1998	1999-2002
<i>Total revenues</i>	18.3	17.5	18.4	20.1	21.7	21.5	22.7	24.4	16.5	18.6	22.6
Transfers to states and municipalities	2.8	2.7	2.8	3.0	3.6	3.7	3.9	4.3	2.7	2.8	3.9
Net revenues	15.5	14.7	15.6	17.2	18.1	17.8	18.8	20.1	13.8	15.8	18.7
<i>Non-financial expenditures</i>	14.8	14.5	15.4	16.6	16.0	15.9	17.1	17.9	12.4	15.3	16.7
Payroll expenses	5.6	5.2	4.8	5.0	5.1	5.0	5.4	5.6	4.4	5.2	5.3
Social security benefits	5.0	5.3	5.4	5.8	6.0	6.0	6.3	6.7	4.4	5.4	6.3
Other costs and capital expenses ^b	4.2	4.0	5.3	5.7	4.9	4.9	5.4	5.6	3.7	4.8	5.2
<i>Statistical discrepancy^c</i>	-0.1	0.2	-0.5	0.0	0.2	-0.1	0.1	0.2	0.2	-0.1	0.1
<i>Primary balance</i>	0.5	0.4	-0.3	0.6	2.3	1.9	1.8	2.4	1.6	0.3	2.1
Federal government and Central Bank of Brazil	0.5	0.5	0.0	1.4	3.3	2.8	2.9	3.7	1.0	0.6	3.2
Social security	0.0	-0.1	-0.3	-0.8	-1.0	-0.9	-1.1	-1.3	0.6	-0.3	-1.1

Source: Secretary of Economic Policy, Ministry of Finance.

^a The minus sign indicates a deficit.

^b Includes Central Bank primary balance.

^c A positive figure indicates an increase in the primary balance surplus.

- Fiscal revenues increased significantly throughout the period. Gross federal government revenues increased from an average of 16.5% of GDP in 1991-1994 to 22.6% in 1999-2002.
- At same time, federal government non-financial expenditure grew considerably. All the major categories contributed to this expenditure growth. Between 1991-1994 and 1999-2002, payroll

expenditure (mainly due to the weight of retired workers), social security benefits and "other expenses" (excluding transfers to states and municipalities, payrolls and social welfare benefits) increased by 0.9, 1.8 and 1.5 percentage points of GDP respectively. In addition, transfers to states and municipalities grew by 1.2% of GDP between the same periods.

a) *Fiscal revenues*

For the federal government, the two major sources of additional revenues were: i) the provisional financial transactions contribution (CPMF), which was introduced as a permanent tax (IPMF) at the end of 1993, since when it has been abolished and reintroduced several times; ii) the contribution to the financing of the social security system (COFINS), which was associated with increases in tax rates and a series of court rulings favouring the government, thanks to which resistance to the introduction of the contribution during the early part of the decade was overcome.¹² Between them, these two contributions accounted for about two thirds of the change in revenue between 1991-1994 and 1999-2002. At the same time, there was a continuous decline in industrial products tax (IPI) revenues (table 4).

Federal expenditure as a proportion of GDP was contained in 1999-2000 and began to grow again in 2001-2002. A detailed analysis of non-financial expenditures follows.¹³

b) *Payroll expenses*

Federal government payroll expenses rose from 18.5 billion reais in 1995 to 33.2 billion reais in 2001 in nominal terms, despite the fact that public employees' pay was "frozen" between the two dates; the first linear adjustment in such salaries since 1995 occurred only in 2002. The reason for this seeming paradox is that, over time, almost every category benefited from career reviews, adjustments to the "curve", promotions, etc.

Another important component of total government payroll spending was the expenditure on public-sector retirees. Overall payroll expenditure was 5.6% of GDP in 2002 compared to 5% in 1994, as the reduction in active duty employee payroll expenses was more than offset by the increase in expenditure on public-sector retirees, particularly military personnel. The combination of population ageing and indulgent retirement rules for

public-sector employees contributed significantly to payroll expenses.¹⁴

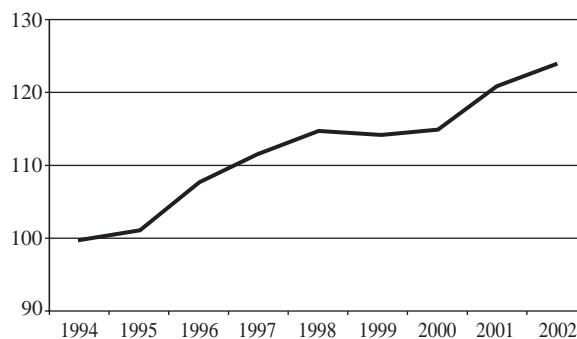
c) *Social security benefits*

The other crucial element determining public spending was social security expenses. After the Real Plan, social security benefits were adjusted by more than inflation, resulting in an increase in their average real value. The social security index rose until 1998, marked time in 1999 due to higher inflation, and then resumed its growth trend due to the policy followed in 2000-2001 of increasing the minimum wage in real terms (figure 2).¹⁵

Social security benefits also grew during the first years of the Real Plan, the main growth item being length-of-service pension benefits, which were more expensive than other pensions (table 5). The length-of-service pension enshrined in the Brazilian Constitution grants men and women the right to retire after 35 and

FIGURE 2

Brazil: Social security benefit index^a
(Base: June 1994 = 100)



Source: Social security and authors' estimates.

^a Deflated by the extended national consumer price index (IPCA).

¹² From the federal government's point of view, it made sense to give priority to an adjustment funded from these contributions rather than from taxes such as income tax or the industrial products tax (IPI); as these contributions are not shared with states and municipalities, the entire revenue gain remains with the federal government. Conversely, in the case of income tax and the IPI, the net revenue gain for the federal government is much smaller as about half the revenues must go to the revenue-sharing fund of the states and municipalities.

¹³ See Velloso (1997) for an account of the fiscal situation at the start of the Real Plan.

¹⁴ Retired military personnel have generous pension benefits, including the transfer of such benefits to unmarried daughters after the death of the original beneficiary. Some military privileges have been reduced over the last few years.

¹⁵ The social security index was calculated by deflating the nominal rise in social security benefits by the IPCA price index. Social security benefits have increased in line with the minimum wage, albeit with some divergence in a number of years. In cases where basic remuneration was adjusted by a factor different to that used for benefits above this floor, the index was weighted by the multiplication factor (total number of benefits times the floor) with reference to total with-benefits expenses. The index would allow us to infer the potential evolution of expenditure in the event that the quantity of benefits remained constant.

TABLE 4

Brazil: Federal revenues
(Period averages as percentages of GDP)^{a-b}

	1991-1994	1995-1998	1999-2002
<i>Total revenues^c</i>	11.9	13.2	16.6
Import tax	0.4	0.7	0.7
IPI	2.3	2.0	1.6
Income tax	3.7	4.5	5.6
Personal	0.2	0.3	0.3
Corporate	1.1	1.5	1.7
Individuals	1.3	1.5	1.7
Capital yields	0.7	0.8	1.2
Other	0.3	0.4	0.7
IPMF/CPMF	0.3	0.4	1.3
IOF	0.7	0.4	0.3
COFINS	1.5	2.2	3.7
PIS/PASEP	1.1	0.9	1.0
Contribution on net profits	0.7	0.9	0.8
Civil service social security contributions	0.1	0.3	0.3
Other	1.2	0.9	1.3
<i>Memorandum items</i>			
Tax burden	25.7	28.8	32.8
ICMS	6.7	7.0	7.6

Source: Federal Revenue Secretary, Brazilian Geographical and Statistical Institute (IBGE).

^a IPI = Industrialized products tax.

IPMF/CPMF = Provisional financial transactions tax/provisional financial transactions contribution.

IOF = Financial operations tax.

COFINS = Contribution to the financing of the social security system.

PIS/PASEP = Social Integration Programme/Public Servants Asset Formation Programme.

ICMS = Sales tax on merchandise and services.

^b Data differ from those of table 3 because of different criteria for settling accounts.

^c Not including social security contributions.

TABLE 5

Brazil: Structure and growth of social security benefits

	As percentage of legal minimum wage (as of December 2002)	Average annual growth (%)	
		1994-1998	1998-2002
<i>Total benefits</i>	164	4.2	3.5
Social security	172	3.7	3.4
Pensions	187	4.1	2.9
By retirement age	113	1.9	3.4
By length of service	360	11.5	2.2
For disability	135	1.0	2.5
Allowances	130	3.8	3.0
Other	224	-3.0	12.6
Aid support	114	7.3	4.5

Source: Ministry of Welfare and Social Assistance (various years).

30 years of contributions, respectively, which can reduce the retirement age considerably. From 1995 to 1998, length-of-service pension benefits increased by an annual average of 11.5%, compared to 4.2% for

overall benefits (table 5). This situation has changed in recent years with the approval of the social security reform and the consequent reduction in retirement applications. Lastly, the number of social security

TABLE 6

Brazil: Real growth of federal government non-financial expenditure^a
(Percentage averages)

	1994-1998	1998-2002	1994-2002
<i>Non-financial expenditure</i>	7.0	4.6	5.8
Payroll expenses	2.0	4.2	3.1
Social security benefits	7.4	5.0	6.2
Transfers to states and municipalities	6.6	11.0	8.8
Other costs and capital expenditure ^b	12.3	0.7	6.3
<i>Memorandum item</i>			
Real GDP growth	2.6	2.1	2.1

Source: Economic Policy Secretariat, Ministry of Finance.

^a Implicit GDP deflator.

^b Includes Central Bank primary balance.

beneficiaries increased at rates above GDP growth, leading to an increase in the ratio of social security expenditure to GDP. This was partly associated with the increase in the assistance component of social welfare, which covers people on the minimum wage who have never previously contributed to social security.

d) *Other costs and capital (occ) expenses*

The major increase in occ expenses took place in 1997-1998 (table 3). By contrast, they were squeezed in 1999-2000, following the signing of the Stand-By Agreement with IMF at end-1998.¹⁶ However, they increased in 2001-2002, partly reflecting their increasing rigidity as some public-sector agencies committed to higher expenditure to protect their resources. The division of responsibility between the executive and legislature for the increasing rigidity of occ expenses is a matter of controversy.¹⁷

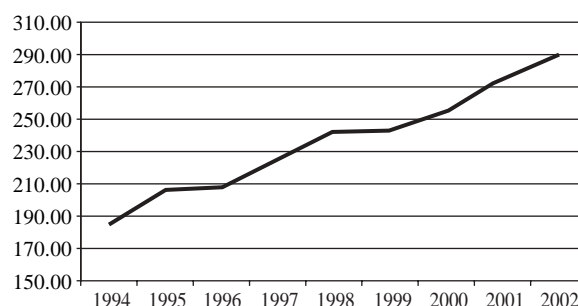
The share of non-discretionary expenditures in the occ expenses increased substantially, from 20% in 1999 to 60% in 2002, including health, employment insurance, and the anti-poverty fund. Most of the commitments are relatively new ones, arising from legal or constitutional provisions approved in recent years. The existence of this spending rigidity reduces

¹⁶ In 1999, other costs and capital expenses excluding the Workers' Protection Fund (FAT) fell by 11% in nominal terms. At the start of 1999, this item was considered impossible to cut despite the increase seen since 1994. The contraction of 1999 suggests that occ expenses in previous years could have been lower.

¹⁷ Although the executive bears most of the responsibility for the increasing rigidity of occ expenses, in some years the rigidity was the result of larger commitments due to legislature initiatives such as the anti-poverty fund.

FIGURE 3

Brazil: Federal government non-financial expenditure^a
(Billions of 2002 reais)



Source: National Treasury, Ministry of Finance.

^a Expenditure corrected by the implicit GDP deflator.

the authorities' room for fiscal adjustment in the short run.

Summing up, overall non-financial expenditure, including transfers to states and municipalities and the Central Bank deficit, grew by 7.0% a year in real terms during the first Cardoso administration and 4.6% a year during the second. Expenditure growth was well above real GDP growth during the same period (table 6 and figure 3 show expenditures deflated by the implicit GDP deflator).

2. States and municipalities

The primary balances of states and municipalities deteriorated progressively from 1994 to 1998 and improved gradually after 1998, particularly in the case

of the states (tables 1 and 2). The improvement in state and municipal primary balances, which was substantial, was due partly to the constraints placed on their budgets by the bilateral agreements they signed with the federal government to refinance their debts, partly to the provisions of the Fiscal Responsibility Act. Their finances also benefited from higher tax revenues on some products and services that experienced large price increases and represented a large share of their revenues, such as oil, telecommunications and electricity.

The efforts to control state and municipal finances started in 1993, when Cardoso was still Finance Minister at the end of the Collor administration. On 17 March 1993, an amendment to paragraph 4 of article 167 of the Constitution was passed, allowing the states to pledge their own revenues and federal government transfers as collateral for debt rescheduling agreements with the federal government. This amendment was instrumental in the success of the bilateral debt agreements and meant that all later disputes brought by states to the Supreme Court were defeated. On 5 November 1993 Law 8727 was passed, allowing the federal government to refinance state debts with five federal banks, provided that the states paid over at least 11% of their revenues and allowed transfers from the federal government to be withheld if payments were missed. The first bilateral debt agreements under the terms of this law were signed in 1994. On 30 November 1995, the National Monetary Council approved Vote 162/95, making debt refinancing conditional for the first time on fiscal commitments by the states. These three measures paved the way for the passing of Law 9496 of 1997, which allowed the refinancing of states' remaining bonded debt.¹⁸ Under the 1997 law, the bilateral agreements between the federal government and states and municipalities established minimum monthly payments of 13% to 15% of revenues (with a ceiling of 30%) over 30 years, and real interest rates of 6% a year. The refinancing of the debts was collateralized with federal government transfers and revenues from the sales tax on merchandise and services (ICMS, the state VAT), which effectively prevented states from defaulting on their obligations to the federal government since such a default would block transfers and allow the National

Treasury to appropriate states' ICMS revenues directly. These bilateral agreements prompted states and municipalities to modify their fiscal stances and generate primary surpluses to meet their debt obligations.

In addition to the bilateral agreements, the other important institutional landmark was the passing of the Fiscal Responsibility Act in 2000. Among other things, this set ceilings for public-sector payrolls in terms of government revenues and prohibited the refinancing of state and municipal debts by the federal government, putting an end to the moral hazard resulting from the private sector lending to state and municipal governments in the expectation that the National Treasury would ultimately pick up the bill. For the first time states and municipalities faced a tight budget constraint.

The fiscal adjustment at state and municipal level also benefited from the increase in state tax revenues, as well as transfers from the federal government. After 1998, ICMS (state VAT) revenues increased, reflecting improved fiscal administration by the governors elected that year and the fact that ICMS revenue was partly concentrated in sectors that led the recovery in growth, such as telecommunications, and/or underwent tariff increases, such as petrol and oil derivatives in general. Between 1998 and 2002, ICMS revenue rose from 6.7% to 7.9% of GDP. At the same time, transfers to states and municipalities rose from 3% to 4.3% of GDP, as a result of changes made to legislation after pressure from state governors, particularly the revision of the Kandir Law.¹⁹ Owing to these two effects, state and municipal revenues rose by 2.5% of GDP during the period 1999-2002, explaining most of the improvement in their primary balance.

3. Public-sector enterprises

The primary balance of public-sector enterprises has also improved since 1999 (table 7). In the case of federal enterprises, the improvement was mainly due to the results of the State oil company (Petrobras), which benefited from the increase in international oil

¹⁸ In the case of the states, the first bilateral agreement under Law 9496 was signed in May 1997 and the last in October 1999. In the case of the municipalities, the first agreement was signed in July 1999 and the last in May 2000.

¹⁹ The Kandir Law was negotiated between the federal and state governments before the 1999 devaluation to provide a tax incentive for exporters: states would lift ICMS tax on exports in exchange for compensation payments from the federal government. Subsequently, the states claimed that the compensation payments had been wrongly calculated, and succeeded in obtaining from the federal government a commitment to provide substantial supplementary transfers over a period of several years.

TABLE 7

Brazil: Primary balance of public-sector enterprises
(Percentages of GDP)^a

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total balance</i>	1.2	-0.1	0.1	0.1	-0.4	0.7	1.1	0.9	0.7
Federal enterprises	1.6	0.4	0.3	0.3	-0.2	0.7	0.9	0.6	0.5
Revenues	9.0	8.8	8.7	8.2	7.0	6.8	8.1	8.4	...
Non-financial expenditure	9.0	8.5	8.3	7.9	7.2	6.7	7.5	8.5	...
Wages	1.6	1.4	1.4	1.1	0.9	0.6	0.6	0.5	...
Other costs	5.8	5.6	5.0	4.9	4.5	4.8	5.6	6.4	...
Investments	1.5	1.3	1.6	1.6	1.3	0.8	0.8	1.0	1.3
Other capital expenses	0.1	0.2	0.4	0.4	0.5	0.6	0.5	0.5	...
Adjustments	1.7	0.2	-0.2	0.0	-0.1	0.6	0.3	0.7	...
State and municipal enterprises	0.0	-0.5	-0.2	-0.2	-0.1	0.0	0.1	0.3	0.3
State enterprises	...	-0.5	-0.2	-0.2	-0.1	0.0	0.1	0.3	0.3
Municipal enterprises	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Ministry of Planning and Central Bank of Brazil.

^a The minus sign indicates a deficit.

prices in 1999. This rise in international market prices increased domestic prices but affected only part of Petrobras's costs, since most of the oil products it sells derive from domestic production. The improvement in Petrobras's balance also created some scope for public-sector enterprises in general to invest more without affecting the PSBR.²⁰

The primary balance of state and municipal enterprises improved because of the privatization of loss-making enterprises and changes in the management of those that remained in state hands. In general, state authorities appointed managers who were committed to efficiency, and they faced a much more competitive environment.

IV

Temporary revenue sources

Making up for the gradual loss of temporary revenues will be a challenge. The adjustment will have to include a combination of spending cuts, the phasing out of temporary revenues, and possibly the transformation of some temporary revenues into permanent ones.

At the end of 1993, the provisional financial transactions tax (IPMF) was approved, only to be abolished a year later. At that point the government introduced "temporary" or "one-off" revenue-raising measures, and this would become a common practice

in subsequent years.²¹ Taken all together, extraordinary revenues peaked at over 3% of GDP in 1999, and continued to contribute an average of 2.5% of GDP in 2000-2002 (table 8).

While the IPMF was abolished in 1994, the same tax was reintroduced as the provisional financial transactions contribution (CPMF) in 1997 and extended in subsequent years. In 1994, the Social Emergency Fund (FSE) was created as a mechanism whereby the federal government retained part of its transfers to states and municipalities for a two-year period (1994 and 1995). This fund was

²⁰ In 2001-2002 the average aggregate primary surplus for federal enterprises, including Itaipu Binacional, was approximately 0.5% of GDP. This primary surplus breaks down into a surplus of 0.4% of GDP for Petrobras and 0.2% of GDP for Itaipu, and a primary deficit of 0.1% for the Eletrobrás group, explained by the fall in revenues due to the energy crisis, combined with an increase in investments. The other federal enterprises generated a primary result close to zero.

²¹ "Temporary revenues" means a source of adjustment that is not protracted over time. The definition of what exactly constitutes such revenues is to some extent arbitrary. We include in that category only strictly temporary revenues (in force for only a year) or revenues that would tend to disappear in the absence of any modification to the legislation giving rise to them.

TABLE 8

Brazil: Temporary federal government revenues
(Percentages of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total</i>	0.5	0.5	1.4	2.8	3.2	2.3	2.3	2.9
IPMF/CPMF ^a	0.0	0.0	0.8	0.9	0.8	1.3	1.5	1.5
Concessions	0.0	0.0	0.2	1.0	0.9	0.5	0.4	0.3
Additional personal income tax	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1
Additional income tax on securities	0.0	0.0	0.0	0.3	0.0	0.0	0.0	0.0
Additional income tax on external remittances	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.0
End of COFINS rebate	0.0	0.0	0.0	0.0	0.3	0.3	0.3	0.3
Fiscal stability fund (FEF)	0.5	0.5	0.4	0.3	0.3	0.0	0.0	0.0
Collection of arrears	0.0	0.0	0.0	0.2	0.6	0.1	0.0	0.7

Source: Authors' estimates.

^a IPMF/CPMF = Provisional financial transactions tax/provisional financial transactions contribution.

subsequently renewed in 1996 for a year and a half, with the same characteristics and a new name (Fiscal Stabilization Fund, FEF). The FEF was further renewed—albeit subject to a gradual increase in transfers to municipalities—for another two and a half years in mid-1997, not being abolished until December 1999.

In addition, significant revenues were generated from the auction of mobile telephony concessions and

the privatization of the State telecommunications company (Telebras). Part of the Telebras privatization receipts (40%) were treated as tax revenues for the purpose of determining the public-sector deficit, by contrast with other privatizations, which did not affect the public-sector deficit. Also, overdue taxes were collected after relief had been granted on penalty interest for arrears.²²

V

Hidden liabilities and the growth of public debt

The ratio of public debt to GDP, including the monetary base, fell from a peak of 56% in 1984 to 30% in 1994 due to a combination of high seigniorage, low operating deficits in the first half of the 1990s, below-inflation correction of the face value of the debt, and accumulated economic growth of 32% over the period 1985-1994. Between 1994 and 1998 the ratio rose sharply, mainly as a result of persistent public-sector

deficits. By the end of 1998 the government had run out of alternatives for financing the deficit (table 9): seigniorage was low, a return to inflation was unanimously rejected by all political groups, the high level of external debt had led to a collapse in the exchange rate, the domestic debt was becoming ever costlier to roll over and privatization was coming to an end. Under these circumstances, the government initiated the process of fiscal adjustment under an IMF-supported programme.²³

During the period 1995-1998 the total public debt increased, owing mainly to the issuance of public securities and partly to the transfer of individual state debts to the federal government. This increase in the

²² Other measures were also implemented, including a personal income tax surcharge for higher bracket taxpayers from 1998 onward; exceptionally, in 1998, the double taxation of income from financial applications; an income tax surcharge on profits made by certain operations from the 1999 currency devaluation; the temporary suspension, from 1999 onward, of the tax-deductibility of a portion of the contribution to the financing of the social security system (COFINS) that was initially allowed for the purpose of paying corporate income tax; the payment of overdue tax by pension funds in 2002, etc.

²³ See Pastore (1995), Tanner (1995) and Rocha (1997) for an account of the historical roots of Brazil's public-sector debt.

TABLE 9

Brazil: Net public-sector debt
(Percentages of GDP)

	1994	1995	1996	1997	1998	1999	2000	2001	2002
<i>Total debt^a</i>	30.0	30.6	33.3	34.3	41.7	48.7	48.8	52.6	55.5
Federal government	13.0	13.3	16.0	18.6	24.9	29.8	30.6	32.7	35.3
States and municipalities	9.9	10.7	11.5	12.9	14.2	16.2	16.0	18.3	18.5
Public-sector enterprises	7.1	6.6	5.8	2.8	2.6	2.7	2.2	1.6	1.7
<i>Domestic debt</i>	21.5	25.1	29.4	30.0	35.5	38.4	39.2	42.2	41.2
Federal government	6.7	9.8	14.4	16.7	20.8	21.9	23.2	24.5	22.9
Monetary base	3.6	3.1	2.4	3.6	4.2	4.6	4.2	4.2	4.6
Securitized debt ^b	11.7	15.6	21.4	28.1	34.5	38.6	41.8	48.1	37.8
Central Bank credits	-4.6	-5.3	-8.5	-7.8	-5.6	-4.4	-3.7	-3.2	-2.6
Refinancing of states and municipalities and PROES	0.0	0.0	0.0	-5.4	-9.3	-12.4	-13.4	-13.9	-13.7
Workers' Protection Fund (FAT)	-2.0	-2.5	-2.5	-2.6	-3.5	-3.9	-4.4	-4.9	-4.8
Other	-2.0	-1.1	1.6	0.8	0.5	-0.6	-1.3	-5.8	1.6
States and municipalities	9.6	10.4	11.1	12.4	13.5	15.3	15.1	17.3	17.1
Refinancing of states and municipalities	0.0	0.0	0.0	5.4	9.3	12.4	13.4	13.9	13.7
Securitized debt	4.8	5.6	6.2	4.3	2.4	1.3	0.2	0.2	0.1
Other	4.8	4.8	4.9	2.7	1.8	1.6	1.5	3.2	3.3
Public-sector enterprises	5.2	4.9	3.9	0.9	1.2	1.2	0.9	0.4	1.2
<i>External debt</i>	8.5	5.5	3.9	4.3	6.2	10.3	9.6	10.4	14.3
Federal government	6.3	3.5	1.6	1.9	4.1	7.9	7.4	8.2	12.4
States and municipalities	0.3	0.3	0.4	0.5	0.7	0.9	0.9	1.0	1.4
Public-sector enterprises	1.9	1.7	1.9	1.9	1.4	1.5	1.3	1.2	0.5
<i>Memorandum items</i>									
Fiscal debt ^d	30.0	30.6	31.4	34.2	40.6	40.7	40.9	40.8	36.1
Balance sheet adjustment (stock)	0.0	0.0	1.9	0.1	1.1	8.0	7.9	11.8	19.4
Privatization	0.0	0.0	-0.1	-2.0	-3.3	-3.8	-5.2	-4.8	-4.0
Other	0.0	0.0	2.0	2.1	4.4	11.8	13.1	16.6	23.4
Domestic debt adjustment	0.0	0.0	0.0	0.0	0.4	4.2	4.6	6.0	9.6
External debt adjustment	0.0	0.0	0.1	0.2	0.5	3.2	3.8	4.4	8.0
Other	0.0	0.0	1.9	1.9	3.5	4.4	4.7	6.2	5.8
Dollar debt	9.5	6.3	5.9	8.7	13.5	19.6	19.6	25.0	28.9
(as percentage of total debt)	31.7	20.6	17.7	25.4	32.4	40.2	40.2	47.5	52.1

Source: Central Bank of Brazil.

^a Includes the monetary base and balance sheet adjustments.

^b Includes swap operations from 2002.

^c Central Bank lending to financial institutions.

^d Debt originating from issuance of public securities only.

federal government's liabilities did not immediately affect the net public debt, but it was not neutral as the assets and liabilities in question involved different costs and maturities (Werneck and Bevilacqua, 1998). As a consequence, the total public-sector debt, including the monetary base, rose by 12% of GDP between 1994 and 1998, while the domestic debt in public securities increased by 23% of GDP in the same period.

After 1999, despite the adjustment of the primary balance, total public debt increased because of the impact of the devaluation on the foreign public debt and the dollar-denominated domestic public debt,

whose share of the total had risen sharply over the previous two years. At the time of devaluation, the dollar-denominated public debt represented 14% of GDP (or 30% of the total public debt). With the sharp fall of the Brazilian currency against the dollar in 2000-2002, the dollar-denominated debt increased substantially in value, reaching 29% of GDP (or 50% of total public debt) in late 2002 (table 9).

Central to the evolution of the public-sector debt that began in the mid-1990s were the "balance sheet adjustments" (Passini, 2000; Kawall, Costa and Gomes, 2000) resulting from three factors:

- the recognition of old debts that had affected aggregate demand in the past but were not properly registered in the fiscal statistics at the time (the so-called “skeletons”);
 - variations in the value of the debt due to exchange-rate fluctuations, and
 - privatization receipts, which were used to reduce the public debt.
- Prior to 1995, these factors were not clearly recorded in the fiscal statistics. In all, between 1999

and 2002 the sum of the first two effects represented a cumulative increase of 19% of GDP in the public-sector debt, while privatization reduced the debt by 1% of GDP, the result being a net increase of about 18% of GDP. This partly explains why, although Brazil met its fiscal commitments and even exceeded the targets set in its agreement with the IMF, the public-sector debt-to-GDP ratio increased from its pre-devaluation level of 1999.²⁴

VI

The fiscal attitude of the authorities

The authorities did not display the same rigour in controlling the public-sector accounts prior to 1998 as they did after 1999 in the context of an external and fiscal crisis.²⁵ Expenditures that were under direct government control and not subject to legal or constitutional restrictions expanded vigorously during the first Cardoso administration, and proposals for adopting fiscal targets did not receive any support before 1998.

As had previously happened for more than two decades, Brazil experienced a situation of “soft budget constraint” (Kornai, 1986, p. 4). The natural tendency of a “soft budget constraint” is for the adjustment to take place either through higher inflation, when monetary policy is accommodating, or through higher public-

sector debt, when a tight monetary policy means that fiscal imbalances leave prices unaffected in the short term, only to aggravate future fiscal imbalances by way of a higher interest burden (Sargent and Wallace, 1981).

The crisis of 1998-1999 changed this situation, strengthening the advocates of tighter fiscal policy in the Cardoso administration. In fact, the fiscal adjustment was imposed by circumstances, since without it Brazil would certainly have headed towards a domestic public debt moratorium. Sure enough, President Cardoso—who was convinced that higher taxes and spending cuts were an important precondition for IMF support—gave the necessary backing to the austere fiscal measures required and took the lead in the negotiations with the National Congress to pass the necessary enabling legislation. Under these conditions, the relatively passive fiscal attitude of the first Cardoso administration gave way to active support for a fiscal effort to curb the rising public debt.

Two qualifications are important. First, rather than a change of attitude on the part of the authorities, some have suggested that there was simply a greater concern with financing expenditure adequately, since the public-sector spending-to-GDP ratio was never reduced. Second, the adjustment was partly based on temporary revenues such as the CPMF and the additional earnings of Petrobras due to the rise in fuel prices. This by no means detracts from the fiscal effort made in 1999-2002, but it does highlight the need to persist with and improve the adjustment over the coming years.

²⁴ The exchange rate has a twofold impact on the debt through a balance sheet adjustment: the foreign public debt increases, as does the dollar-denominated domestic debt. This effect was particularly strong in 1999, 2001 and 2002, and explains the jumps in the ratio of debt to GDP despite the solid primary results observed after 1998.

²⁵ A more generous view of the official stance prior to 1999 would acknowledge that during 1995-1998 the government had an ambitious reform agenda involving the passing of constitutional amendments, some of which were important for the subsequent fiscal adjustment (such as social welfare reform, which took a long time to negotiate with Congress). The focus on the reforms, it can be argued, led to a relaxation in short-term fiscal flows, favoured by a benign external environment that financed growing current-account deficits until 1999. To conclude that, in such an environment, it would have been possible to achieve the same type of budgetary constraint during 1995-1998 as was observed during 1999-2002 is counterfactual and not easy to demonstrate.

VII

The future of fiscal sustainability

The government's attitude to fiscal policy changed dramatically with the external and fiscal crisis of 1998-1999. As a result, the supporters of more austere fiscal policies in Cardoso's administration had their case strengthened and were able to sway policy decision-making towards tighter policies of a kind which had gathered little support prior to 1998. Just 10 days before the 1998 elections, President Cardoso made a speech that gave a clear indication of the approaching austerity. He emphasized that "we have to ensure that the State lives within its means" by generating primary surpluses "that are sufficient to prevent the public-sector debt from growing at a rate above that of GDP, so that the ratio of the two is kept stable over time".²⁶ While this might sound trivial, the contrast between the President's statement and the trend in the public debt in previous years was remarkable. Even such an obvious point would have been extremely hard to make as little as six months before. The political conditions for adopting a more austere fiscal attitude were created by the dramatic external crisis, when outflows of foreign currency reserves had reached US\$ 1 billion a day as a result not only of the overvalued exchange rate but also of the unsustainable fiscal situation.

The problem President Cardoso inherited in the mid-1990s was deep-rooted: since 1954, populist expansionary policies had alternated with brief intervals of conservative reformism.²⁷ The crisis of 1998-1999 created the conditions for a political climate favourable to measures for addressing deep structural fiscal imbalances and, most importantly, to austerity as a norm of public administration, a genuine departure from the old fiscal extravagance. Whether this change in the authorities' fiscal attitude will last is something that the coming years will show.²⁸

Yet the adjustment observed after 1999 was based to a large extent on increased revenues, since overall public-sector spending was unaffected in real terms. Non-financial expenditure by the federal government, including transfers to states and municipalities and the

small Central Bank deficit, increased continuously in real terms in every year of the eight-year period covered by the two Cardoso administrations, without exception.

Also, it seems justifiable for Brazil —whose credibility has been undermined by years of repressed hyperinflation, large deficits and rising public-sector debt— to continue to sustain large primary surpluses for several years, before gradually reducing the primary surplus at a time when this does not affect the evolution of the public-sector debt.

These aspects of Cardoso's fiscal adjustment underline the need to preserve hard-won fiscal discipline over the coming years. To improve the quality of the adjustment, it will be necessary to offset the gradual phasing out of temporary revenues by making some of these revenues permanent and by cutting public expenditure across the board in the budget. Non-discretionary expenses will also have to be reduced to make more room for fiscal adjustments in the short run.

Key to achieving fiscal sustainability has been the austere attitude of the authorities, which should be permanently embedded in the fiscal institutions. One possible alternative would be to have the Fiscal Responsibility Act complemented by a fiscal solvency act that established clear and permanent rules for public debt sustainability over the medium term, in the form of either a ceiling on borrowing requirements or a floor for the primary surplus.²⁹ The fiscal solvency act would help to address the fiscal consequences of political fragmentation, as well as the legitimate pressure for more social spending in the coming years. Also, it could improve the trade-off between fiscal adjustment and economic growth in the short term by strengthening credibility and allowing lower interest rates. However, the outcome of any legal reform of

²⁶ Translated from *Jornal do Brasil*, September 24, 1998.

²⁷ See Rabello de Castro and Ronci (1991).

²⁸ An important element in greater fiscal control has been the improvement of public-sector statistics since 1995.

²⁹ While the Fiscal Responsibility Act and the refinancing of state and municipal debts placed a tight budgetary constraint on the fiscal regimes of states and municipalities, the federal government budget has not been constrained in the same way. The federal government's primary surplus targets are valid only for the current budget year and can be revised in the following year: in principle, there is no clear and durable constraint on the federal government budget that can prevent a substantial reduction in the primary surplus, leading potentially to a rising debt-to-GDP ratio.

Brazil's fiscal institutions will depend crucially on policymakers and politicians understanding that fiscal sustainability is a valuable public good, and a necessary

condition for economic growth. Without this understanding, any legal reform of Brazil's fiscal institutions will inevitably be short-lived.

APPENDIX

Public debt sustainability, 1995-2002

Despite Cardoso's fiscal reforms and the remarkable shift to austerity after 1999, the evidence suggests that the public debt was not sustainable either in 1995-2002 or in 1999-2002; in other words, fiscal policy was not tight enough to contain the growth in the public debt.

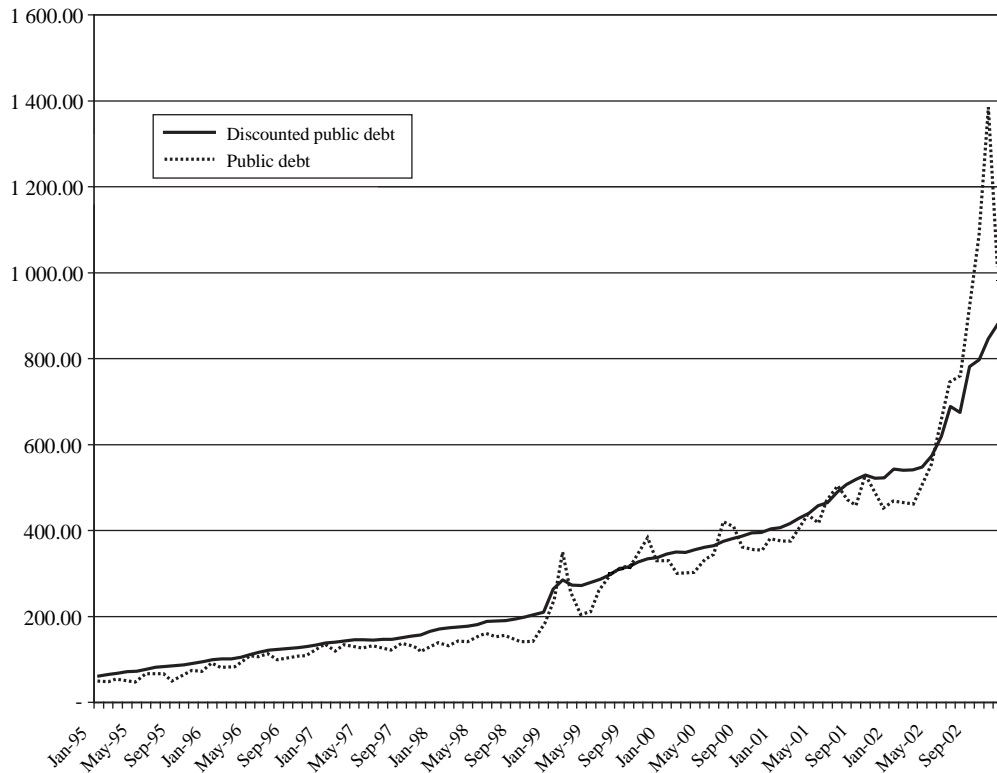
We follow the technique presented by Wilcox (1989) and Luporini (2000) to test for fiscal sustainability during the period from January 1995 to December 2002. This consists in testing the discounted public debt for stationarity (unit roots). If the discounted public debt were stationary (rejection

of unit root hypothesis), the public debt would be sustainable on the basis of the fiscal policy followed during the sample period.

The data set consists of monthly data on the consolidated net public debt at par value. Nominal debt was divided by the general price index. The real discount factors were calculated by dividing the Special System of Clearance and Custody (SELIC) interest rate by the general price index.³⁰ Figure A.1 shows the public debt and the discounted public debt, both expressed in December 2002 reais.

FIGURE A1

Brazil: Total net public debt
(Billions of December 2002 reais)



Source: Central Bank of Brazil.

³⁰ Ideally, the net-of-taxes real interest rate should be used. Estimating the net-of-tax yield on securities is virtually impossible,

however, as tax rates vary between holders and there is limited information on the identity of these.

Table A.1 summarizes the testing for stationarity of the discounted net public debt t using the augmented Dickey-Fuller test.³¹ The unit root hypothesis is not rejected for all sample periods, confirming that, despite all

government efforts, fiscal policy was not tight enough to make the public debt sustainable between January 1995 and December 2002 and between January 1999 and December 2002.

TABLE A.1

Brazil: Testing for stationarity of the discounted public debt

Sample period	January 1995-December 2002	January 1995-December 1998	January 1999-December 2002
<i>Null hypothesis of unit root</i>	<i>Not rejected at 10% level</i>	<i>Not rejected at 10% level</i>	<i>Not rejected at 10% level</i>
<i>Augmented Dickey-Fuller test (Probability)</i>	0.17651 (-0.9976)	-3.048911 (0.1281)	-1.880546 (0.6522)
Test critical values			
1% level	-4.045236	-4.118444	-4.118444
5% level	-3.451959	-3.486509	-3.486509
10% level	-3.151440	-3.171541	-3.171541
Number of lags	6	2	6
Number of observations	96	48	48

Source: Authors' estimates.

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³¹ We carried out the augmented Dickey-Fuller testing following the methodology described by Enders (1995).

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Local economic development and territorial competitiveness in Latin America

Iván Silva Lira

This article argues that the local and regional governments of Latin America, in an increasingly globalized world, must face new challenges that include establishing or improving their competitive strengths and transforming their local production systems. These two aspects must be linked to territorial policies and, more specifically, to the development of a territorial culture that embraces both. While it is true that enterprises are the ones that actually compete, their competitiveness may be enhanced if the territorial environment encourages this dynamic and if they themselves realize the importance of being enterprises “of the territory” rather than “in the territory”. This objective may be thwarted, however, by the existence of territories that are unequally prepared to meet these challenges. Different types of intervention need to be used, therefore, in terms of local and regional policies, to enhance the competitive strengths of such territories.

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I

Introduction

In formulating subnational public policies today, it should be assumed that the scientific and technological revolution has had, and continues to have, a very significant impact on territories. National economies, in particular, have become more interdependent; this process has been accompanied by a thorough restructuring of production processes, which have become more flexible as new technologies arise requiring the development of fresh know-how in order to apply them.

Globalization brings with it many important changes for the future of subnational territories. From the cultural standpoint, a two-pronged movement can be seen: on the one hand, there is a tendency towards homogenization of cultural identities; on the other hand, a certain resistance to that trend and a return to a localized approach may be observed. Meanwhile, in terms of the time variable, the style and pace of life continue to accelerate, and barriers and distances between places continue to fall, owing to transport and telecommunications developments, which help make the territories more accessible from the standpoint of traditional territorial attraction factors.

All these recent changes are fostering increasingly open and decentralized societies, redefining the place and meaning of territories in the global village (Boisier, 1996); territories must therefore face new challenges in designing their development strategies in a context of greater complexity, openness, competition, uncertainty and rapid change.

Thus, it has been suggested that in the new global economy the only territories that can compete are those that learn, that is, those capable of adapting to the world's changing production patterns, on the basis of knowledge (broadly understood) and its application to the advanced tertiary sector, high-tech industry and/or agribusiness. This means that subnational territories need to develop their skills and advantages, or their capacity to build them, in order to become specialists in areas or sectors that have possibilities for being

incorporated into the global market. To the extent that globalization encourages the transformation of subnational territories into spaces in the international economy, territorial division and the social division of labour will be reinforced. This dynamic, moreover, may obey a different logic depending on the horizontal or vertical division of territories, based on their links with other areas of the world (vertical logic) or their capacity to build networks or organizations within the same territory (horizontal logic).

Vertical logic could be defined as that applying to transnational firms, which can segment their production processes and spatially distribute production; this encourages the prioritizing of territorially selective criteria through the development of a limited number of locations that have the necessary strategic factors to promote the expansion and competitiveness of their enterprises. Horizontal logic, on the other hand, is closely related to the social construction of territories and, more specifically, with the idea of building innovative and competitive territories, making the territorial meso-economy an essential unit of analysis in promoting key opportunities for encounters between actors—public, social and private—with a view to modifying the production apparatus and encouraging economic growth with equity.

In this last context, the development of competitive advantages has a clearly local character: the national economic structure can be expressed in terms of local production chains, which foster the development of small and medium-sized enterprises (regardless of their links with large enterprises and methods for attracting foreign investment). These tend to seek associative and coordinated ways to gain competitive advantages, by forming clusters of enterprises organized on the territory or other types of productive associations where the achievement of economies of scale is regarded as external in the case of firms, but internal with regard to territories.

II

Objectives of local economic development

The deep-seated transformation of the economic system in most Latin American countries that began in the 1980s showed that the opening of domestic markets, deregulation and privatization were not enough either to ensure that firms would be internationally competitive or to produce high levels of economic growth with a clear improvement in income distribution and living conditions.

Especially at the territorial level, it is increasingly important to design public management tools and policies to stimulate the exploitation of endogenous local resources that will foster new development styles based on the potentialities of local economies, as an essential complement to national development policies.

In general, the main objectives of territorial development are to change local production systems, increase production, create jobs and improve living standards. In pursuit of these objectives, it is important to bear in mind the institutional design and public management styles that have been adopted by subnational governments in Latin America to promote productive development policies and thereby change local enterprise systems in a climate of greater competitiveness.

In this context, to varying degrees, and particularly since the 1990s, a number of Latin American countries have begun to incorporate a territorial approach in their policies for encouraging productive development and promoting small enterprises that is more consistent with the objectives of establishing or enhancing the competitiveness of local production systems. Productive development organized from a local/regional perspective¹ has the advantage, first, of being more closely in line with business demand, owing to the greater proximity to “customers”. Secondly, it may be directed towards local enterprise systems rather than individual firms, which yields the obvious benefits of agglomeration, stimulates learning by interaction and therefore promotes innovation in economic activities.

The achievement of these objectives, however, requires, among other things, a decentralized,

subnational institutional setting and an active process of strategic planning of territorial productive development, setting priorities and channelling the existing development tools towards common goals. The full operation of a system of decentralized productive development makes it possible to take advantage of potential increases in productivity in the territories, which then has an impact on the national aggregate growth rate in an environment of greater competitiveness.

The recognition that, in order to develop competitive strengths, small enterprises need to join together and also count on government support to help to correct market failures primarily linked to weaknesses in the capital, finance and credit markets, the training of human resources and technological innovation, largely justifies the development policies that have been designed. Thus, as seen in one of the excellent evaluation studies made on small enterprises in Chile (Bianchi and Parrillo, 2002), there are basically three factors that contribute to the success of small and medium-sized enterprises (SMEs):

- (i) Integration into a dynamic productive and social system to allow for economies of sufficient scale and scope to compete with large enterprises in the global market;
- (ii) Improvement in the quality of output, production processes and human resources, since it is impossible to continue to compete in global markets by price (there are actors that are too powerful, because their use of economies of scale enables them to squeeze out any competing country);
- (iii) Dissemination of know-how and competencies so as to build a local economy that can produce high added-value, good quality and innovative goods. Know-how gives the enterprise a competitive advantage that makes it more resistant to being squeezed out.

Thus, besides the more traditional reasons for supporting the advance of small enterprises, there are also considerations related to the idea of local enterprise systems, collaboration to promote competitiveness, associative enterprises, public-private linkages, generation of know-how through interaction and development of competitive advantages that go beyond

¹ In this article, unless otherwise indicated, the term “regional” means subnational regions.

the notion that enterprises are the only ones that compete.

In this context, we strongly suggest the concept of territory as the cultural basis for enterprise systems that can develop competitive strengths in collaboration with their environment, accomplishing much more than the single, isolated development strategy of small enterprises. The scheme presented in figure 1 summarizes this concept. It is proposed that local and regional development is an eminently endogenous process that seeks to take advantage of its own potentialities —natural, human, institutional and organizational— to change local production systems in order to improve living conditions.

Innovation is necessary in order to make local enterprise systems more competitive; this requires, from the standpoint of social organization, consensus-based development projects that represent all territorial actors sharing a common view of the strategic areas that must be promoted.

Local production systems are of course made up of enterprises. According to statistical evidence, microenterprises, small and medium-sized enterprises

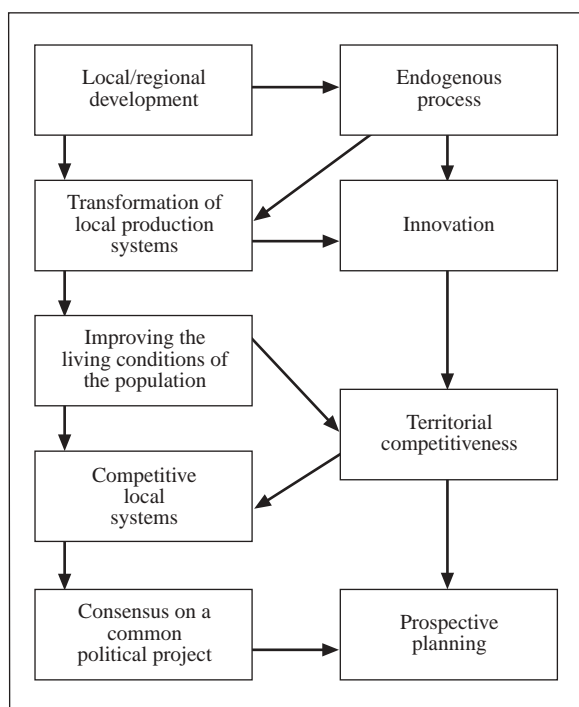
are, in that order, the most homogeneously distributed over the territories. In Chile, for example, large enterprises constitute slightly less than 1% of formal enterprises in the country (4,814 in 1997), and nearly 73% of these are concentrated in the Metropolitan Region. Microenterprises and small enterprises, at the other extreme, constitute 97% of all enterprises and are distributed fairly homogeneously throughout the whole country, similarly to the relative population distribution (table 1).

Thus, when we speak of changing local production systems, in practical terms we are saying what must be done, for example, to improve the competitive strengths of some of the 3,757 enterprises in the Aysén region in Chile (1,600 km south of Santiago), of which 3,256 are microenterprises and 486 are small and medium-sized (table 1). This region has a particular production and service profile, and some of its greatest advantages are associated with aquaculture and tourism, so that all policies proposed in this region to modernize the entrepreneurial system must necessarily take into account the local production network. It is unlikely that this can be tackled solely on the basis of a national perspective deriving from the centre of the country.

Moreover, from the standpoint of better strategy and more efficient allocation of resources, it is unlikely that all the enterprises in the region can be helped. Many of them will inevitably disappear,² as a result of the dynamics of the markets themselves, although a

FIGURE 1

Conceptualization of local and regional development processes



Source: Prepared by the author.

² See Cabrera, de la Cuadra and others (2002), which notes that the high failure rates among SMEs, the category of enterprises that is less successful than large enterprises, only confirms the pattern of behaviour of the emergence, development and disappearance of enterprises in a number of countries of all types. This trend is more a result of the habitual functioning of the economy than to any periods of recession it may pass through. Moreover, these processes favour aggregate economic growth, since most of the increase in productivity is due to the replacement of inefficient plants and enterprises by more efficient ones. Therefore, and this is the most striking conclusion, policies of support for ailing microenterprises and small and medium-sized enterprises will only postpone the disappearance of a great number of relatively less productive enterprises, waste government resources that could be put to more urgent use, and hinder the growth of productivity, employment, wages and the economy in general. In other words, according to this view, government policies to promote growth among microenterprises and SMEs will do nothing but block the progress of the economy, waste resources and delay the elimination of enterprises that are doomed to fail anyway; logically speaking, it would be better to let the market automatically resolve these allocation problems. Even if we disagree with this approach, the lesson that can be drawn from it is that development tools must be allocated to enterprises whose future technical and economic viability has been accurately assessed.

TABLE I

Chile: Number and percentage of enterprises, by size and region, 1997

Region	Micro	Small	Medium	Large	Total
I Tarapacá	14 776 87.5%	1 834 10.9%	213 1.3%	67 0.4%	16 890 100.0%
II Antofagasta	12 650 82.6%	2 291 15.0%	273 1.8%	103 0.7%	15 317 100.0%
III Atacama	7 619 85.6%	1 142 12.8%	108 1.2%	33 0.4%	8 902 100.0%
IV Coquimbo	17 647 86.8%	2 373 11.7%	236 1.2%	70 0.3%	20 326 100.0%
V Valparaíso	4 528 83.9%	7 343 14.1%	793 1.5%	245 0.5%	51 909 100.0%
VI O'Higgins	23 864 85.6%	3 582 12.8%	346 1.2%	91 0.3%	27 883 100.0%
VII Maule	35 250 88.7%	3 996 10.1%	376 0.9%	116 0.3%	39 738 100.0%
VIII Bío-Bío	48 672 85.2%	7 394 12.9%	811 1.4%	254 0.4%	57 131 100.0%
IX Araucanía	24 723 86.2%	3 545 12.4%	333 1.2%	90 0.3%	28 691 100.0%
X Los Lagos	31 447 84.6%	5 095 13.7%	450 1.2%	197 0.5%	37 189 100.0%
XI Aysén	3 256 86.7%	439 11.7%	47 1.3%	15 0.4%	3 757 100.0%
XII Magallanes	5 014 80.8%	1 032 16.6%	130 2.1%	28 0.5%	6 204 100.0%
Metropolitan area	150 001 75.5%	38 464 19.4%	6 734 3.4%	3 500 1.8%	198 699 100.0%
No information	13 984	275	20	5	14 284
<i>Total</i>	<i>432 442</i> <i>82.1%</i>	<i>78 807</i> <i>15.0%</i>	<i>10 870</i> <i>2.1%</i>	<i>4 814</i> <i>0.9%</i>	<i>526 933</i> <i>100.0%</i>

Source: Production Development Corporation (CORFO), on the basis of information from the Chilean Internal Revenue Service (SII).

strategic intervention should also be devised to support those enterprise systems that are most likely to succeed. Hence the need for a shared public-social-private view of what such intervention should look like.

A similar situation exists in the Atacama region (800 km north of Santiago), which has more enterprises than the Aysén region but represents a much higher proportion of microenterprises (86.8%) and has a very different production profile; its productive development policies should therefore be designed on the basis of

other considerations. The culture of different territories represents, among other things, different histories, varied skills and unique ways of doing things that are linked with specific natural environments and geographical features. All these aspects influence the existing forms of economic and social organization and must be taken into account when intervention strategies are designed. This is where the local approach to productive development policies in general, and promotion policies in particular, have the greatest validity.

It is natural to suppose, then, that productive development policies should have a definite territorial stamp, at least with regard to local enterprise systems. Many governments have begun to see the situation

this way, and they have gradually incorporated this view into their strategies, although to varying degrees of depth and with only relative but recognizable success.

III

Local development in a globalized world: towards the building of competitive and innovative territories

The building of competitive strengths may in fact be linked to territorial policies and, more precisely, to the development of a territorial culture that integrates local enterprise systems and helps to reverse the deteriorating situation of the most backward territories. In other words, although it is the enterprises that actually compete, their competitiveness may be reinforced if the territorial environment is conducive to this dynamic and if the enterprises, for their part, recognize the importance of being enterprises “of the territory”, whose inhabitants are entitled to some benefit, rather than enterprises “in the territory”, totally divorced from its future development plans.

It is important to understand, in particular, that in a local approach, public management may lead to the development of networks, or clusters, of enterprises having a base in a particular territory, where the collaborative and associative nature of the enterprises are key factors in promoting their competitiveness.

The word “clusters” refers to a geographical concentration of enterprises and institutions, in which interaction generates and sustains competitive advantages. No consensus yet exists on the Spanish equivalent of the term, with various phrases (*agrupamientos industriales*, *distritos industriales* and *agrupaciones locales* being used, often with different meanings. ECLAC practice is to use the term *aglomeraciones productivas*. The main idea is that, by developing such agglomerations, or clusters, it would be possible to create further competitive advantages (chiefly know-how and innovation) that are of particular importance for groups of SMEs concentrated in a single territory.

In other words, there is convincing evidence that organized collective action in general, and government

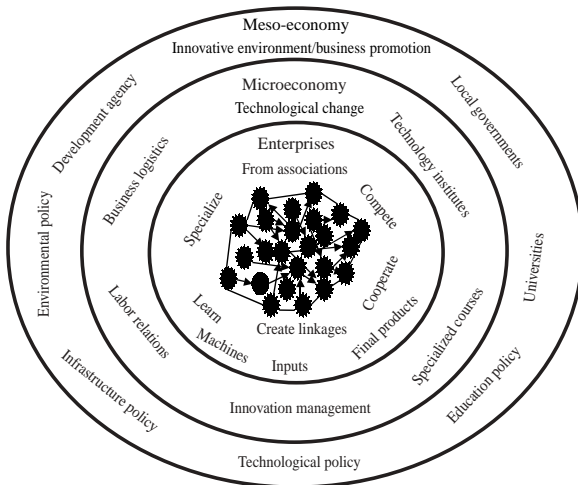
action in particular, represent important sources of competitiveness. Porter (1991) has noted that the strength and durability of these clusters’ ability to compete lie in their innovative capacity. These “superior” sources of competitiveness stem from interaction between enterprises that are able to both compete and cooperate with each other. In this particular model, government action is exogenous; that is, it may have an impact (beneficial or detrimental) on competitiveness, but cannot explain it. In this view, the role of government action is similar to that of causality. This approach is unsatisfactory, however, for those who design and carry out collective actions and public policy, particularly when today there is a need to promote public-private linkages to drive the development of these groups of enterprises (Buitelar, and 2001b).

It has become quite clear, therefore, that a basic element of competitiveness, especially in today’s information and knowledge society, is the capacity for learning and innovation that seems to be latent in local institutions and organizations and that could and should be exploited. Thus the shaping of the concept of territorial competitiveness should be one of the basic lines of action taken by subnational governments.

Figure 2 combines the concepts of clusters and local development. It attempts to illustrate that a number of enterprises may coexist in a territory and may develop the capacity to join forces, compete, cooperate, form linkages, learn and specialize in order to exploit the whole chain of value of a given production process as much as possible. To gain strength, these clusters require, in the local and regional context, the activation of two types of competition, the meso-economic and microeconomic levels of systemic

FIGURE 2

Clusters and local development



Source: Prepared by the author.

competition, which make the most sense and have the greatest economic impact at the territorial level.³ Figure 2 shows that, at the microeconomic level, technological changes are introduced that are feasible and necessary to boost the local system of production, for which various methods could be used. Meanwhile, at the territorial meso-economic level, an innovative environment is encouraged, which will help promote industry; this will require the development of a whole local institutional framework to tackle the challenge effectively.

In order for this step to be feasible, however, and for real progress to be made towards the

implementation of successful local development initiatives, subnational governments must take on a new role, particularly with regard to the territorial meso-economy and microeconomy and public-private linkages, to help strengthen the competitiveness of the enterprises belonging to local systems, with all the demands and consequences this entails at the social, cultural, political and educational levels. These new subnational government functions, added to the traditional roles of government, are basically as follows:

- A role as creator of a favourable environment for local development;
- A leadership role, capable of activating and channelling social forces towards a common development plan;
- A role as public-private coordinator and promoter of business associations;
- A role in fostering production and the development of the meso-economic and microeconomic levels of systemic competitiveness.

Ultimately, for territories to become more competitive and innovative, they must take advantage of their endogenous resources, encouraging the formation of associations and public-social-private linkages with a view to making production processes more flexible. These dynamics are still rarely seen in the approaches taken by Latin American subnational governments. The meso-economic and microeconomic levels are more pertinent to the territorial context: if they are not strengthened, they are unlikely to succeed. The idea is gaining ground that it is actually territories that compete, even when they are unevenly prepared to undertake this task, as will be seen in the next section.

³ In this context, the words “meso-economy” and “microeconomy” stem from the concept of systemic competitiveness, whose purpose is to find the economic and political determinants of successful industrial development and whose key ingredients, according to Altenburg, Hillebrand and Meyer-Stamer (1988) are “at the metalevel: first, development-oriented cultural values which are shared by a large part of the society; second, a basic consensus on the necessity of industrial development and a competitive integration into the world market; third, the ability of social actors to jointly formulate visions and strategies and to implement policies; at the macrolevel: a stable and predictable macroeconomic framework. This should include a realistic exchange-rate policy and a general foreign-trade policy that stimulates local industry; at the mesolevel: specific policies and institutions to shape industries and their environment (technology institutes, training centers, export

finance, etc.) and create a competitive advantage. Moreover, it is the [role] of local and regional industrial competitiveness initiatives to strengthen the firms’ environment. Many of the institutions that act at the mesolevel are typically, or can in principle be, nongovernment entities, e.g. business associations or nonprofit entities; at the microlevel: capable and continuously improving firms, and networks of firms, with strong externalities”. As a way of summarizing the idea of systemic competitiveness, one could say that the metalevel refers to the actors’ capacity for community development and strategic consensus-building; the macrolevel is related to the ability to ensure the right conditions for reproducing the accumulation regime; the mesolevel responds by creating an innovative environment for industrial promotion, and the microlevel ensures technological change in the existing productive and entrepreneurial network.

IV

Territorial growth, convergence and disparities

The first element to be taken into account in terms of the varying strengths of territories is the issue of territorial convergence, a traditional concern of students of regional topics involving territorial inequalities and their behaviour through time. This concern is closely related to the various neoclassical theories of economic growth that have postulated the existence of automatic mechanisms leading to convergence, as opposed to those theories that have stressed the need for definite intervention to correct any disparities, and is also associated with the investigation of factors that could boost growth in the poorest regions of a given country.⁴

One of the authors who most strongly revived this debate in the 1990s was Sala-i-Martin, who pointed out in one of his studies on convergence that in the mid-1980s the new notions of endogenous growth⁵ had held that the assumption of decreasing returns to capital led the neoclassical model to predict convergence among nations. On the other hand, the underlying constant returns to capital in all endogenous growth models led to the prediction of non-convergence. An empirical study of the convergence hypothesis was presented, therefore, as a simple matter of saying which of the two paradigms represented a better description of reality (Sala-i-Martin, 2000). Later in the same study, the author argues that in the early 1990s, neoclassical economists started their own counterrevolution. Sala-i-Martin (1990), Barro and Sala-i-Martin (1991, 1992a and 1992b) and Mankiw, Romer and Weil (1992) refuted the notion that the neoclassical model predicted convergence, thereby denying that the evidence

presented until then could be used to dispute the neoclassical model.

Beyond the interesting theoretical debate and the continuing empirical evidence generated by it, this section presents two of the definitions of convergence used, whose purpose, in this case, is to enquire into the evolution of territories within some Latin American countries. One of the concepts is the so-called beta convergence, which holds that there is convergence if poor countries grow faster than rich ones. The other is the sigma-convergence, whereby there is convergence if the real per capita income dispersion between economic groups tends to decrease through time.⁶

The sigma-convergence is presented below, but only for those countries on which disaggregated economic information could be obtained for intermediate subnational territories, namely, Bolivia, Brazil, Chile, Columbia, Mexico and Peru.⁷

First, we will review what has happened in terms of territorial convergence, that is, whether the growth of intermediate territories has been convergent, neutral or divergent in the periods analysed. It is interesting to see whether the poorest intermediate territories are growing at higher rates than the richest, and thereby determine whether there is greater equity in their growth at the national level. This verification, as we have already noted, is done in terms of sigma-convergence (S) and beta-convergence (B). In both situations the per capita gross domestic product is used; while the first method means that there is convergence to the extent that the dispersion of real per capita GDP is reduced over time, that is, that the disparities between intermediate territories tend to diminish, the second refers to the speed of convergence, that is, the time it would take for the poorest intermediate territories to catch up to the richest. In this latter case, therefore, there is a beta-convergence between the intermediate territories if there is an inverse relationship between the

⁴ For a detailed analysis of this topic and its application to different countries and regions, see Mancha Navarro and Sotelsek Salem (2001).

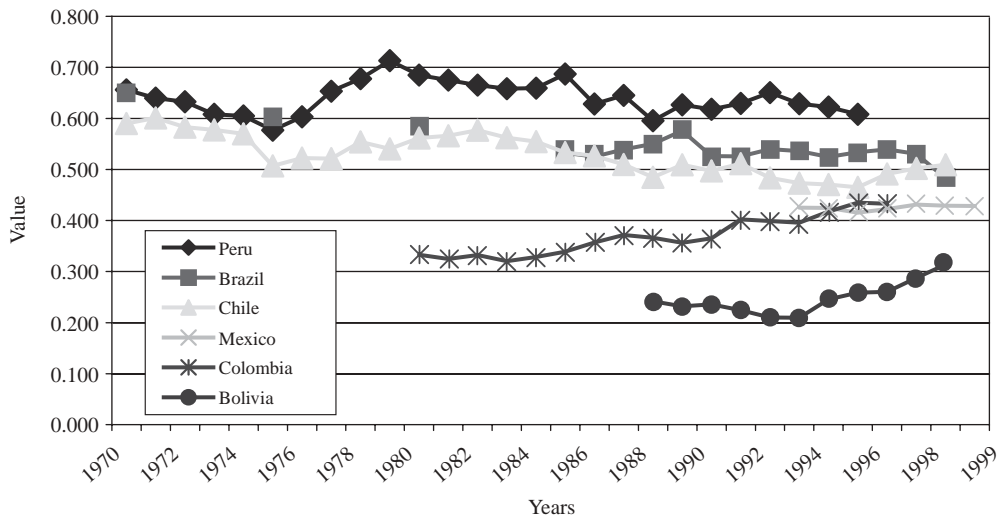
⁵ The term "endogenous growth" as used here denotes the incorporation of technical progress as an endogenous process in the model associated with research and development (R&D) costs, as opposed to the former postulates of Solow's neoclassical model, whose key feature was to consider technical progress as an exogenous factor, with a production function characterized by replaceable factors of production, constant yields to scale and decreasing yields from the variable factors of production.

⁶ Sala-I-Martin (1990) was the first to use these definitions.

⁷ The intermediate subnational territories correspond to departments in Bolivia, Colombia and Peru; states in Brazil and Mexico; and regions in Chile.

FIGURE 3

Latin America (six countries): Sigma-convergence for various countries
(Standard deviation of the natural logarithms of per capita GDP)



Source: Prepared by the author.

growth rate of per capita GDP and the initial level of GDP, in other words, if the relatively poorer territories tend to grow more rapidly than the richer ones.

Figure 3 presents the results of the sigma-convergence for a number of countries. When the indicator approaches 1, the disparities are very much accentuated, and when it approaches zero there is a greater degree of territorial equality. The time series are different: as can be seen, long series were obtained for Peru, Brazil and Chile, while for Mexico the series is very short, since it covers only the period from 1993 to 1999; in the case of Columbia it goes from 1980 to 1996, and for Bolivia, from 1988 to 1998. In other words, the difficulty of obtaining disaggregated information for intermediate territories is compounded by the fact that the series are not uniform for all countries and that they are not all as up-to-date as would be desirable.

As the figure shows, the greatest disparities between intermediate subnational territories are found in Peru, followed by Brazil, Chile, Mexico, Columbia and Bolivia, in that order. Besides showing the lowest degrees of inequality among these territories, Bolivia is the least developed, relatively speaking, of the territories studied, which could suggest that this situation reflects the low level of territorial development in all departments; in any case, this country started to show a growing increase in territorial disparities in 1994.

In Peru, from 1970 to 1995, the indicator fluctuated between 0.60 and 0.70, with a small decrease in disparities (greater convergence) between 1970 and 1976, after which they increased and then began to decline until 1989, when they again started to rise slowly. The periods of greater convergence in the Peruvian case seem to coincide with times of severe national economic crises, such as those of 1982-1983 and 1988-1989; in other words, this convergence is associated with poor economic performance during those periods.

In the case of Brazil, indicators fluctuated between 0.50 and 0.60 in the period 1970-1997, and also show fluctuations that do not reflect a clear trend towards an increase or decrease in disparities. A slight reduction in disparities is observed in Chile beginning in 1983, the year when, paradoxically, there was also a serious recession in the country; this trend reversed itself in 1996. For Mexico, the series is very short and indicates a virtually constant situation in terms of territorial inequalities from 1993 to 1999, while for Columbia there was a steady increase in territorial disparities from 1980 to 1996.

In brief, figure 3 shows that territorial disparities in the countries studied tend to remain steady or increase slightly through time, and that their decrease tends to coincide with periods of economic crisis; this suggests that the reason lies more in the sudden collapse of growth in the richer territories than in

TABLE 2

Latin America (six countries): Analysis of subnational convergence and divergence (beta)

Period	Time required to reduce gap by half	Period	Time required to reduce gap by half
Perú		Mexico	
1970-1980	No convergence	1993-1999	No convergence
1980-1990	51 years		
1990-1995	No convergence		
1970-1995	No convergence		
Brazil		Colombia	
1970-1980	35 years	1980-1996	No convergence
1980-1990	48 years	1990-1996	No convergence
1990-1997	No convergence		
1970-1997	54 years		
Chile		Bolivia	
1970-1980	No convergence	1990-1998	No convergence
1980-1990	53 years	1988-1998	No convergence
1990-1998	No convergence		
1960-1998	61 years		

Source: Prepared by the author.

explicit policies to encourage growth in the more backward territories.

The data contained in figure 3 can be compared with those presented in table 2, which shows the results of the beta-convergence, an indicator of the speed of convergence.⁸

In general, the speeds of convergence obtained are extraordinarily low. In the case of Chile, during the long period between 1960 and 1998, the results of the model show that it would take 61 years to halve the gap in per capita GDP between regions, whereas if the model is applied to the period 1990-1998, one of the highest growth periods in the history of the country—when it could be said that globalization forces were fully operative—there is no evidence of convergence between the subnational territories.

A similar situation is found in Mexico, where the model does not show any evidence of convergence between 1993 and 1999. Nor are there any indications of convergence for Bolivia during the periods studied, or for Peru in 1990-1995; the same is true of the situation of Columbia in the period 1980-1996 and also

in 1990-1996. In the case of Brazil, in periods where there are signs of convergence, the time it would take to reduce the gap by half steadily increases from 35 years in 1970-1980 to 54 years in 1970-1997. If the period 1990-1997 is taken in isolation, despite the fact that the correlation coefficient is not significant, there are no indications of convergence.

It may be concluded that there are no signs of territorial convergence in the countries studied, and it would therefore be useful to persist in seeking a more detailed diagnosis of the characteristics of the various subnational economies that might explain this behaviour to some extent. To that end, we propose to build a typology of territories, distinguishing, for example, between rich and poor, or winners and losers, in order to enquire into what attributes make some of them winners, and what shortcomings cause others to be losers, with a view to identifying clear policies to enable the latter to converge towards stages of greater growth and development.

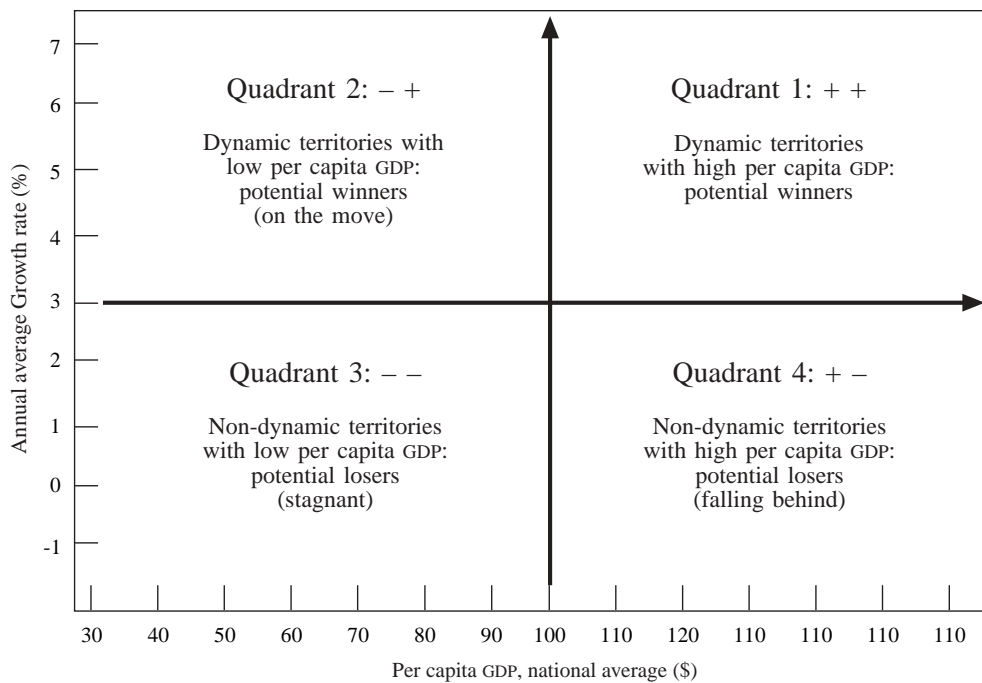
Figure 4 was prepared on the basis of available information. This figure⁹ shows the point of intersection

⁸ See the attached table in the appendix, which presents further details on the results of the nonlinear regression for the various countries in the study.

⁹ A more detailed explanation of the construction of figure 4 is as follows: the horizontal line of the x axis corresponds to the average growth rate of GDP at national level for the period under consideration. Thus, intermediate subnational territories located

FIGURE 4

Typology of economic performance of intermediate subnational territories in comparison with average growth and per capita GDP



Source: Prepared by the author.

of two Cartesian axes which determine the configuration of four quadrants, which have different growth dynamics and allow for a possible interpretation of what is occurring in the various territories of the countries analysed. The specific territories corresponding to each quadrant are presented in table 3.¹⁰

above this axis will be the ones that have grown more than the national average. The example in figure 4 shows that the national economy grew, in a given period, by an annual average of 3%. Therefore, the territories located above this average growth will be considered dynamic and will be found in quadrants 1 and 2. The vertical line, or y axis, corresponds to average per capita GDP at national level, so that territories located to the right of this axis will have a higher per capita GDP than the national average. In the example in figure 4, the average per capita GDP at national level is 100 monetary units, meaning that territories with average GDP above this level will be considered as having a high per capita GDP and would correspond to quadrants 1 and 4. It can be seen that quadrant 3 represents the worst economic performance, since the territories in that quadrant have grown more slowly than the national average and also have a lower per capita GDP than the national average.

¹⁰ For a more detailed analysis of this classification, see Silva Lira (2003).

Quadrant 1: Dynamic territories with high per capita GDP, “potential winners”

This quadrant contains territories that have grown faster than the national average and whose per capita GDP is also higher than the national average; they could therefore be considered as having the most successful behaviour in the context of globalization.¹¹ They correspond to potentially winning geographic areas whose differences or gaps with the relatively less developed territories are accentuated or expanding.

This quadrant contains territories in situations that could be classified as follows:

- (a) *Potentially winning territories with exportable natural resources*; these territories take advantage

¹¹ In reality, this classification first seeks to interpret what is occurring in intermediate subnational territories in different countries, and hence this framework of analysis will probably raise questions that will require other data to be processed in order to provide the right response. We speak of “potentially” winning territories, since, in view of the dynamic behaviour of economic events, being a winner today does not necessarily mean being one tomorrow; to continue to be a winner, very proactive policies are needed to deal with the globalization of the economy.

TABLE 3

Latin America (six countries): Typology of subnational territories

<p>2. Dynamic territories with low per capita GDP: “potential winners” (on the move)</p> <p>Peru : Huancavelica, Huánuco, Cuzco, Cajamarca, Puno, Ayacucho</p> <p>Brazil : Minas Gerais, Mato Grosso do Sul, Mato Grosso, Goiás, Pernambuco, Ceará, Rio Grande do Norte, Piauí, Maranhão</p> <p>Chile : Aysén, Maule, Los Lagos</p> <p>Mexico : Durango, Puebla, Michoacán, Tlaxcala, Zacatecas, Yucatán, Guanajuato</p> <p>Colombia : Caldas, Cesar</p>	<p>1. Dynamic territories with high per capita GDP: “potential winners”</p> <p>Peru : Moquegua, Pasco, Arequipa, Lima, Callao, Lambayeque, Junín, Ica, La Libertad</p> <p>Brazil : D. Federal, Río de Janeiro, Río Grande do Sul, Espírito Santo, Paraná</p> <p>Chile : Antofagasta, Atacama, Tarapacá, Región Metropolitana</p> <p>Mexico : D.F., Nuevo León, Chihuahua, Coahuila, Querétaro, Sonora, Tamaulipas, Aguascalientes, Colima</p> <p>Colombia : Cundinamarca, Bogotá, Valle del Cauca</p> <p>Bolivia : Pando, Oruro, Tarija</p>
<p>3. Non-dynamic territories with low per capita GDP: “potential losers” (stagnant)</p> <p>Peru : Apurímac, Piura, Ancash, Tumbes, San Martín, Amazonas</p> <p>Brazil : Paraíba, Acre, Bahía, Sergipe, Alagoas, Amapa, Pará, Rondonia, Roraima</p> <p>Chile : Araucanía, Coquimbo, G.B. O’Higgins, Valparaíso, Bío-Bío</p> <p>Mexico : Chiapas, Veracruz, Oaxaca, Hidalgo, San Luis Potosí, México, Guerrero, Nayarit, Tabasco, Sinaloa, Morelos</p> <p>Colombia : Sucre, Nariño, Magdalena, Bolívar, Boyacá, Tolima, Atlántico, Huila, Norte de Santander, Caquetá, Córdoba, Quindío, Risaralda, Cauca, Chocó</p> <p>Bolivia : Potosí, Chuquisaca, Beni, La Paz</p>	<p>4. Non-dynamic territories with high per capita GDP: “potential losers” (falling behind)</p> <p>Peru : Tacna, Madre de Dios, Loreto</p> <p>Brasil : São Paulo, Santa Catarina, Amazonas</p> <p>Chile : Magallanes</p> <p>Mexico : Quintana Roo, Campeche, Baja California Sur, Baja California, Jalisco</p> <p>Colombia : Nuevos Deptos., La Guajira, Antioquia, Santander, Meta</p> <p>Bolivia : Santa Cruz, Cochabamba</p>

Source: Prepared by the author.

of very clear and marked comparative advantages, such as mining resources, which have allowed them to attract investment and gain an international position through their exports. Openness to private capital probably helped these types of territories, which largely compete on the basis of a natural advantage. It does not appear, however, that their productive and service networks have become sufficiently densified and diversified to effectively produce territorial clusters. In other words, although they are dynamic territories today, it remains to be seen whether they will be able to build advanced competitive advantages.

- (b) *Potentially winning territories that include metropolitan areas*: this category contains metropolitan areas that have normally seen a considerable concentration of economic activity over time and have become important financial and service centres. These territories have either

capital cities or large cities that have undergone a significant process of tertiarization of their economies, and whose urban environment is the source of the country’s main connection with international financial markets.

Quadrant 2: Dynamic territories with low per capita GDP, “potential winners”, on the move

This category includes territories that have grown faster than the national average but have a lower per capita GDP than the national average. They could be somewhat poorer or more backward than the others (as reflected in their lower per capita GDP), but they have good rate of growth and are thus approaching a situation that is closer to convergence with more dynamic territories, especially if their relatively greater vitality is maintained.

Generally speaking, these territories have initiated promising growth processes associated with new technologies and more recent restructuring of

production,¹² developing latent comparative advantages, mainly as an economic basis for commodity exports or for potentially adding value to their production processes on the basis of local resources. These could be characterized as potentially winning territories that have taken advantage of latent local resources, thanks to globalization.

Quadrant 3: Non-dynamic territories with low per capita GDP, “potential losers”, stagnant

This quadrant is exactly the opposite of quadrant 1. It includes territories that have grown more slowly than the national average and whose per capita GDP is also lower than the country average. They are called “stagnant” and “potential losers”, since if this trend continues their backwardness will increase, and they will fall still farther behind the more advanced countries.

In this quadrant, the following situations could be characterized:

- (a) *Potentially losing territories that have de-industrialized and have been unable to fully modernize their economies*: these territories have industrial structures that were overly protected, and their economic performance has continued to fall behind; they have been unable to modernize their systems of production, and economic opening and globalization still represent a threat. Some local territories, however, coexist among them and might represent opportunities for change and innovation.

- (b) *Potentially losing territories, with rural low-productivity economies and scant human capital, which have been unable to gain a position in the global economy*: these are traditional agricultural territories that have been normally backward, some of them with large indigenous populations; they require considerable attention from the central State in the form of compensatory policies to help stop their deterioration and identify specific recovery programs for each specific situation.

Quadrant 4: Non-dynamic territories with high per capita GDP, “potential losers”, falling behind

This quadrant includes territories that have grown more slowly than the national average and yet have a higher per capita GDP than the national average. In the recent past these territories have done very well, having reached high per capita GDP levels, but they have undergone periods of recession that could threaten their recently improved situation; they are therefore considered to be falling behind.

This quadrant includes territories that have become less dynamic because their natural resources have been partially exhausted or because they have lost competitiveness and/or markets. It could be said that they have suffered a loss of comparative advantages, which could be permanent or temporary, depending on the local capacity for repositioning. These territories could be characterized as potential losers whose competitive strength has waned.¹³

¹² For example, new technologies that have allowed for the mining of deposits whose exploitation was not previously profitable.

¹³ There is probably no exact correspondence between the established classification and the “cultural” knowledge one might have about some of the territories in the countries studied, in particular with regard to the use of expressions like “potential winners or losers”. Some territories may feel that they have not been correctly classified. Although they may have this impression, we are simply trying to see whether it is possible to find some trends or behaviour patterns that would enable public policies to be identified and differentiated for each territory. What is clear is that if an intermediate subnational territory (region, department or state) has grown more slowly than the national average and also has a per capita GDP below the national average, it is a completely objective fact about

which little can be done, at least in terms of statistical manipulation. One example might be the case of Santa Cruz in Bolivia, which is generally known as one of the most dynamic and modern departments in the country. It is classified in quadrant 4, however, as “potentially losing or falling behind”, because although its per capita GDP is high, it has a lower annual growth rate than the national rate. What is happening is that, in absolute terms, the economy of Santa Cruz has shown great vitality, higher than that of the country in general, but this vitality has not managed to compensate for the large influx of migrants; therefore, its GDP growth in per capita terms is below the national average rate, to which it paradoxically contributes significantly. This is clearly an exception to the rule that more typically applies to the behaviour of territories that tend to be located in this quadrant.

V

Responses for local development

By linking the information discussed in the previous sections, particularly the analysis of territorial disparities and typologies, to the creation of competitive and innovative territories, we can try to establish what type of policies should be promoted depending on the characteristics of each particular territory. Some additional background information that should be taken into account in order to accomplish this includes the following:

- Not all territories are equally prepared to deal with the processes of opening and globalization;
- There are significant territorial disparities that call for different types of intervention in terms of local public policies;
- The technical and leadership capacities of subnational governments (local and intermediate) are not all the same;
- The rationale of comprehensive development and, in particular, of support for productive development processes is not fully incorporated into the subnational government agenda;
- Subnational development must be accompanied by decentralization, and additional efforts must also be made to decentralize the tools for productive and entrepreneurial development;
- Meso-economic and microeconomic plans for systemic competitiveness, although they may make more sense in the territorial environment, must be accompanied and supported by national industrial incentive policies and encouragement of technological innovation. Otherwise, subnational efforts may turn out to be ineffective.

What is ultimately important is to determine what can be done at the national level, and within each territory, to help the backward regions grow more rapidly, while allowing the more advanced territories to maintain their good economic performance. As noted by Cuadrado Roura (2001), in the context of his studies on regional convergence in Europe, that macroeconomic growth models continue to suffer from a significant omission. The spatial factor, or territory, almost always remains on the sidelines, whereas many of the factors whose importance is crucial because they explain, or might explain, the higher economic growth rate are localized. In other words, these factors are not objectively transferable from one place to another; they

are either not very mobile or they tend to remain in a given area. This explains why, although the shortage of capital in the most backward subnational regions should make these regions, according to conventional theory, more attractive to investment and external saving, what really happens is usually the opposite, because the productivity of a capital-deepening investment or an investment in physical capital may be low if it is not accompanied by investments in human and technological capital.

Accordingly, in another section of the above-mentioned study, Cuadrado Roura (2001) adds that the latent advantages and better resources in a given territory not only make it more attractive to external investment and easier for it to mobilize its own potential, but they incorporate factors that may produce higher yields. Ultimately, these factors mean that the territory in question can be *more competitive* than others, and hence the enterprises that set up business there can also be more competitive. Moreover, this also makes it easier to make local production systems more competitive, as explained earlier.

Cuadrado Roura analysed the factors explaining the faster growth of 16 subnational territories in the European Union. The factors that seem to determine better economic success in the European Union, and which should be taken into account when trying to identify specific public policies to encourage the development of the most backward regions, include the following:

- (i) A system of mid-level cities with medium-sized populations (40,000 to 150,000 inhabitants), which seems to constitute a clear advantage for the growth and localization of activities, together with the availability of skilled human resources and a moderately solid educational base. If relative labour costs are also moderate, the territory has an added advantage;
- (ii) Physical accessibility of the territory; accessibility of the territory and its agents to international markets; possibility of access to political and administrative decision makers in the country; access to innovations and technological advances;
- (iii) Availability of advanced production services, such as strategic planning, technological advisory assistance, design, marketing and exporting,

research and development (R&D) and specialized financial services;

- (iv) Advanced territorial institutional framework: for example, a territorial government with high levels of competencies and autonomy with respect to the central administration, a system of regular cooperation between authorities and with civil society organizations (chambers of commerce, business and social organizations);
- (v) Favourable social climate, associated with low levels of labour conflict and good cooperation between the various public and private institutions;
- (vi) Significant presence of small and medium-sized enterprises (SMEs), representing a local entrepreneurial base that is prepared to take new initiatives (Cuadrado Roura, 2001).

These factors, although they represent the European way of thinking, should make us think about the type of capacities we need to develop in order to succeed in an increasingly globalized world. At least this is how Boisier understood it, from the standpoint of a Latin American scholar, since he has stressed in innumerable articles the need for territories to develop greater technological and innovative complexity in order to stand up to the challenge of an increasingly complex world. In one of these articles, in particular, he said that the new strategic scenario¹⁴ derives from the intersection of two processes. On the one hand, a new geography is emerging, more virtual than physical, which is generating new ways and means of territorial organization, and new types of regions are arising, based on a systemic rationale rather than technocratic voluntarism. Once the organized territories have become new actors in the international competition for capital, technology and markets, there will be a need to maximize their opportunities for emerging as

“winners” in this fierce global battle. In their empirical or speculative analysis of the characteristics of winning regions, various authors have drawn attention to such aspects as systemic complexity, speed of organizational decision-making, innovative capacity, flexibility, urban networking, infrastructure (heavy and light), autonomy of each government, culture, etc. Many of these characteristics are inversely associated with size, and the “small”, whether beautiful or not, increases in value. Boisier suggests the concept of a **pivotal region**, arising as the basic unit of a pyramidal structure in which **associative regions** then appear as a result of agreements between contiguous territories; ultimately, the most powerful and post-modern **virtual regions** emerge, which are not subject to the limitations of spatial contiguity. Under these arrangements, respect for popular democratic will is unlimited. On the other hand, the strategic scenario is based on new forms of territorial management that make room for the notion of region as **quasi-State** and also as **quasi-enterprise**, using the first concept as a reminder of the fact that the regional development question is a political issue expressed in the form of relationships of dominance and dependence (hence the need for any region to accumulate political power), and the second concept as an indication of the need to imbue regional governments with good management practice, in particular, the practice of strategic management (Boisier, 2000).

In brief, in the light of the above-mentioned studies, which basically address the issue of the “winning” or “losing” nature of certain territories, whether the proposal is made, in the one case, on the conceptual level and, in the other case, more on the empirical level, it is possible to list some of the conditions that would presumably make a territory a “winner”. In general, these include heavy infrastructure (related to transport and communications) and light infrastructure (associated with production services), and the structural conditions of the territorial system in question.

From another standpoint, we may also speculate about what conditions should be present in the productive and institutional networks of the “winning” territories, and from that perspective focus on the “speed” of organizational decision-making, the “flexibility” of these structures that would give them a high level of adaptability to the environment, the systemic “complexity of territorial organizations” that would bring them into line with the complexity of the “globalizing game”, the “resilience” or capacity to reconstitute a network damaged by exogenous factors,

¹⁴ This refers to the new scenario that must be faced by the territories, in which two processes of openness may be observed, one external and the other internal, which in turn stem from more complex processes. Boisier argues that the external openness is driven by globalization (which is in turn accelerated and enabled by the scientific and technological revolution) while the internal openness results from the ongoing functional, territorial and political decentralization (a mega-trend set in motion by this revolution, civil society’s demands for autonomy, State reform and privatization); he suggests that there is a decisive interaction mechanism between the two forms of openness: there is no way to be competitive today if decision-making structures are centralized. In other words, one of the factors of success referred to by Cuadrado Roura, the presence of autonomous and decentralized governments, is seen here again as an essential condition for territories to be successful.

and, finally, the territorial “culture”, which produces identity and particular features that can be transformed into a market niches.

Finally, given this picture —which is somewhat sophisticated— of all the conditions that territories should meet if they want to be winners, we see that although these conditions may be true and necessary, it may be difficult, in view of the significant existing territorial heterogeneity, for many territories to reach higher stages of development. Instead, we have the impression that most of the territories of Latin America would be far from capable of developing the aforementioned capacities, and thereby gain a successful position in the international economy.

Aware of this difficulty, we believe that, taking as a frame of reference the challenges we have presented here, it is crucial to be able to recognize the point of departure of each specific territory —for example, the typologies listed in the previous section— and then to identify differentiated public policies for each of them. Thus, it is not a matter of using the conditions listed as a sort of verification list to find out

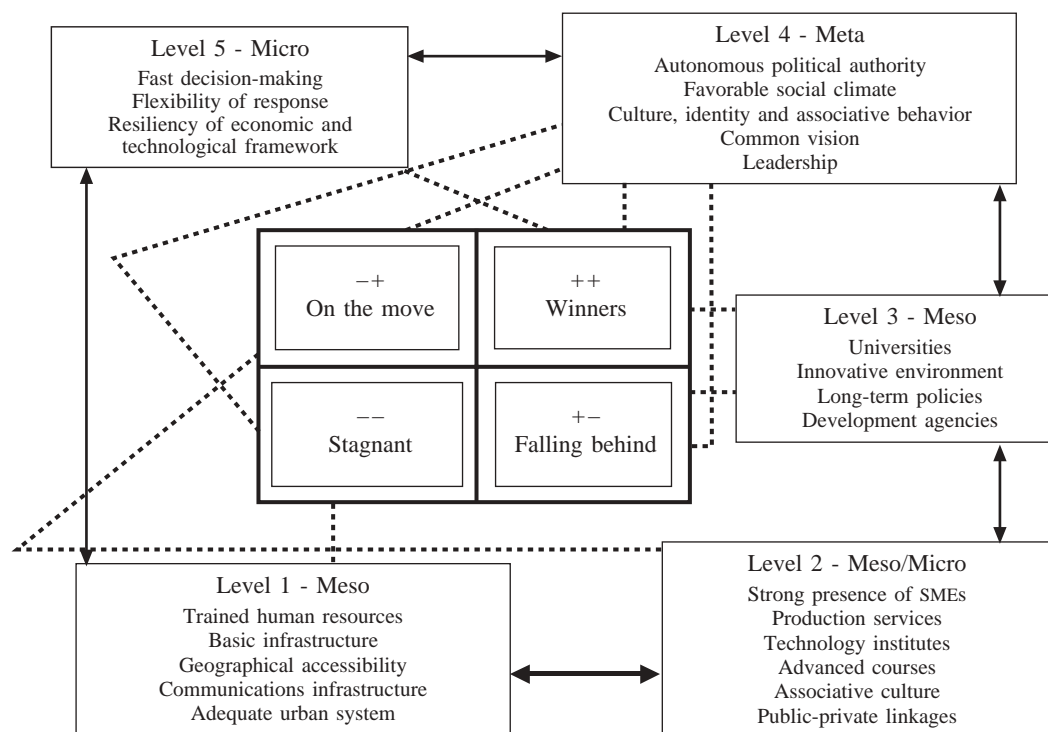
whether each territory has been able to meet all the requirements, but rather of seeing how the various responses can be put into play at the social level, moving in the direction of territorial competitiveness, innovation, technological change, complexity, etc., that will be appropriate to the needs and possibilities of each particular territory.

On the basis of the above reasoning, this verification list should be only a reminder of some of the past or present characteristics of certain “winning territories”, including perhaps the most important, the development of the ability to efficiently exploit endogenous local resources, while promoting the formation of associations and public-social-private linkages with a view to making production processes more flexible in the context of territorial-level strategic management processes aimed at changing local production patterns.

Figure 5 seeks to illustrate the possible meaning of the differentiation of policies depending on the typologies of territories and the factors bearing on the success of the so-called “winning territories”.

FIGURE 5

Winning territories, disparities and public policies



Source: Prepared by the author.

Figure 5 groups together, at different levels, the presumed conditions of winning territories, and shows the relationship of these levels of conditions with the various types of territories. This figure may be interpreted as follows:

(i) *Stagnant territories* (– –): in this case, the dotted lines identify the actions required at levels 1 and 4. Generally speaking, given the characteristics of these territories, more stress must be placed on the identification of policies aimed at the training of human resources—probably by increasing the number of years of schooling—and the development of basic infrastructure and other aspects mainly having to do with the lack of investment in tangible infrastructure, which may be blocking the advance of these territories (level 1 conditions). Level 4, which is common to all the territories, should be important for all of them, since it is mainly related to institutional and intangible conditions that usually do not require financial resources, such as autonomous political authority, favourable social climate, territorial culture and a common view of development.

(ii) *Winning territories* (+ +): At this other extreme, since these are winning territories that have presumably already met many of the conditions mentioned, there is more emphasis on promoting conditions classified in levels 3 and 5, that is, the existence of universities committed to the development of the territory, which provide the scientific and technological research associated with the regional production network; on encouraging and promoting innovative environments; and on building skills to promote faster decision-making and more flexible responses to a changing world. In other words, greater stress is placed on more highly sophisticated conditions, assuming that a critical mass exists to support them.

(iii) *Territories on the move* (– +): In this case, since these territories are making positive changes, but continue to experience backward social and economic conditions, there is more stress on promoting actions aimed at developing support services for production and encouraging technological institutes and advanced courses to train and retrain human resources, all of which characteristics are related to an active production apparatus that requires effective support in order to consolidate.

(iv) *Territories falling behind* (+ –): Since these are territories whose economic and social evolution in the recent past has been positive, more emphasis is placed on aspects relating to the development of innovative capacity to resume the effort to recover lost

growth and development. In these territories, where many of the efforts with regard to infrastructure, accessibility, urban system and other areas have probably already achieved some satisfactory results, the bigger challenges may be associated with certain transformations that might be necessary in order to gain a better position in the global economy.

Although the above-mentioned factors effectively help to reach “winning” positions, we should not discount the significance of development processes themselves and the different forms they can take. Thus, Celso Furtado’s observation in the 1980s is even more relevant today:

I will make one final comment, derived from my contact in this and other countries with the problems of regions that have accumulated a long series of economic setbacks. For a long time there was a tendency everywhere to imagine that development was something quantifiable whose substratum was accumulation, investment, and the building of plant capacity. Experience has amply demonstrated, however, that true development is mainly a process of activating and channeling social forces, improving associative capacity and exercising initiative and inventiveness. Therefore, it is a social and cultural process, and only secondarily an economic one. Development occurs when there is a kind of energy in a society that is able to channel, in a convergent way, forces that were previously latent or dispersed. A real development policy must be an expression of the concerns and aspirations of social groups that are aware of their problems and try to solve them. Nevertheless, only political activity can channel these energies so as to produce the synergistic phenomena in question. What else but the growing weakness of political life can explain why, for us, development problems have become a matter of simple technical questions, with an overly simplified view of social and cultural processes (Furtado, 1982, translated from Portuguese).

Furtado’s words are quite applicable to territorial development, since it is in the realm of relations established at the territorial level where it is most feasible “to channel, in a convergent way, forces that were previously latent or dispersed”. This can be seen, to a large extent, as a matter of uniting behind a common vision, with the necessary leadership to inspire, at the local level, public and private agents who

join together in a territorial culture that is their own, distinct culture and who are capable of undertaking innovative development projects based on the endogenous resource potential of the territory. In other words, without losing sight of the background chart which reminds us of the characteristics of the so-called “winning” territories, it is a matter of developing certain synergistic forms of capital, normally associated with intangible capital, to allow for a convergent channeling of dispersed forces and thus, with the same available resources, make faster and better progress towards the proposed objectives.¹⁵

This is a challenge that is still pending, for which many of the subnational territories of Latin America should be prepared because they have certain potentialities, such as very strong local identities; communities with fairly well-developed cultures of cooperation; decentralization processes going on at several stages of development; local governments that are increasingly aware of the need to guide and coordinate local development processes; a strong presence of SMEs with a relatively homogeneous territorial distribution; and industrial capacities that could be further promoted.

Finally, by elaborating responses to promote subnational development and build competitive and innovative territories, although based on very diverse realities because of the huge existing territorial inequalities, it is possible to see certain common and characteristic aspects:

(i) First, we have endogenous processes, in which we must develop the capacity to discover the

potentialities —natural, human, institutional and organizational— of the territory, in order to know what we are “good at”. In other words, we must have some area in which we are better endowed and trained and that could inspire our visions of the future;

(ii) The strategies to be formulated must be based on the concept of territorial solidarity through the affirmation of cultural identity. This ultimately means building, as a society, a territorial-level political project that gives the entire community a sense of ownership and manages to transform itself into a common vision of development that, having its own identity, will ultimately differentiate one territory from another;

(iii) The strategy should be based on the concept of partnership between public and private representatives; this entails the conviction that we cannot move forward alone and that we must therefore promote consensus-based projects that are also long-term and that transcend the sphere of any one particular government.

Without doubt, the challenge of promoting subnational development processes in Latin America will require enormous efforts, some of which are related to areas such as institution-building, organization, coordination and linkages, which do not always require financial resources, although of course some resources will be necessary. Thus, it is clear that there are opportunities for innovative political projects aimed at building competitive territories and hence transforming local production systems.

¹⁵ Boisier (2000) describes in detail the intangible capital involved in development processes. In one section of this study he argues that, in any case, since development is an intangible result, its causality in this cultural dimension must be identified. In other words, what must be identified, in space and time, is what intangible factors lie behind development. Since these factors are very different, but can be grouped into relatively homogeneous categories, it is not inappropriate to introduce the concept of intangible capital to refer to groups of intangible factors. The author later lists the

types of intangible capital that might be present in a particular region: cognitive, symbolic, cultural, social, civic, institutional, psychosocial and human; in another section he adds that the finding of intangible capital more easily in small-scale territories only confirms the notion that development has always been and will continue to be a phenomenon that starts out on a small, local, decentralized and certainly endogenous scale. This statement is very important theoretically and practically, since in this view the community level and, at least in Chile, the provincial level take on a higher value.

APPENDIX

Latin America (six countries): analysis of subnational convergence and divergence (beta)

Period	Results of nonlinear regression					Time required to reduce the gap by half
	Correlation coefficient β_1	Standard error (β_1)	T	Significance of correlation coefficient	R ²	
Peru						
1970-1980	0.011	0.013	0.858	No	0.038	No convergence
1980-1990	0.014	0.006	2.382	At 5%	0.237	51 years
1990-1995	0.009	0.011	0.852	No	0.035	No convergence
1970-1995	0.010	0.006	1.768	No	0.160	No convergence
Brazil						
1970-1980	0.020	0.010	2.063	At 10%	0.185	35 years
1980-1990	0.014	0.006	2.250	At 5%	0.196	48 years
1990-1997	0.011	0.012	0.866	No	0.033	No convergence
1970-1997	0.013	0.005	2.698	At 5%	0.311	54 years
Chile						
1970-1980	0.006	0.005	1.235	No	0.129	No convergence
1980-1990	0.013	0.004	3.203	At 5%	0.516	53 years
1990-1998	0.004	0.013	0.320	No	0.010	No convergence
1970-1998	0.011	0.005	2.232	At 5%	0.414	61 years
Mexico						
1993-1999	0.002	0.006	0.318	No	0.00339	No convergence
Colombia						
1980-1996	-0.006	0.008	-0.814	No	0.025	No convergence
1990-1996	-0.017	0.013	-1.308	No	0.063	No convergence
Bolivia						
1990-1998	-0.019	0.026	-0.727	No	0.061	No convergence
1988-1998	0.002	0.032	0.046	No	0.000	No convergence

Source: Prepared by the author.

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Dimensions of poverty and gender policies

Irma Arriagada

This article holds that poverty is multidimensional in nature, and that the ways to measure it and the policies to fight it are determined by how it is defined. After reviewing various definitions, the article notes that there is some consensus that poverty means the deprivation of the basic assets and opportunities to which all human beings are entitled; it examines concepts related to poverty, such as vulnerability, inequality, marginality, exclusion and discrimination, and analyses specific forms of gender-based poverty. It then discusses the link between the definitions of poverty and some of the policies being implemented; it compares poverty reduction policies with gender policies; and it proposes a typology that distinguishes four types of policies involving various actions, projects and programmes aimed at fighting gender-based poverty.

I

Introduction

It is now recognized that poverty and inequality are on the rise rather than on the decline in the Latin American region: the reduction of poverty and mitigation of social inequality are still elusive development objectives that have been hard hit in recent years by our macroeconomic vulnerability (Ocampo, 2002).

The processes of poverty are aspects of certain broader phenomena related to current development models and strategies. These models and strategies have delimited the options for trade and financial openness, for macroeconomic and mesoeconomic policies mediated by institutions, for norms and practices that together define access by individuals and families to the use and control of resources and, specifically, for access to the labour market and income. The traditional Latin American backwardness with regard to poverty and income distribution is compounded by the recent impoverishment of large sectors of the Latin American middle-class as a result of the economic crises in the region during the 1990s, which have hit some countries harder than others. Moreover, there is growing evidence that these crises have affected men and women differently (ECLAC, 2003 and 2004b).

A certain consensus has been reached that poverty means the deprivation of essential assets and opportunities to which all human beings are entitled. Poverty is related to unequal and limited access to productive resources and to a low level of participation in social and political institutions. It stems from restricted access to property, low income and

consumption levels, limited social, political and job opportunities and insufficient access to education, health, nutrition, the use and control of natural resources and other areas of development. According to Amartya Sen and his capabilities and achievements approach, a person is poor if he or she lacks the necessary resources to carry out a certain minimum of activities (Sen, 1992a and 1992b). Desai, quoted in *Control Ciudadano* (1997), proposes five basic and necessary capabilities: capability to stay alive and enjoy a long life; capability to ensure intergenerational biological and cultural reproduction; capability to have a healthy life; capability for social interaction (social capital); and capability to have knowledge and freedom of expression and thought. Thus, poverty is linked with the right to a decent life that provides for a person's basic needs, in other words, for his or her economic, social and cultural rights.

Likewise, it is held that poverty is complex, relational and multi-dimensional in nature. The causes and characteristics of poverty differ from one country to another, and the interpretation of the exact nature of poverty depends on cultural factors such as gender, race and ethnic group, and on the economic, social and historical context.

This study examines various ideas about poverty and its connotations from a gender perspective; it briefly analyses poverty reduction policies; and lastly, it proposes a typology that relates these policies to gender policies.

II

The many dimensions of poverty

More than two decades ago, ECLAC defined poverty as a situational syndrome that combines infraconsumption, malnutrition, precarious living conditions, low levels

of education, an unstable position in the production system, attitudes of discouragement and anomie, little participation in social integration mechanisms, and perhaps adherence to a particular scale of values, to some extent differentiated from that of the rest of society (Altimir, 1979). This first definition contained elements that took into account the many dimensions of poverty: aspects relating to nutrition, housing,

□ A preliminary version of this article was presented at the expert meeting on gender and poverty held by the Women and Development Unit of ECLAC and ILO at ECLAC, Santiago, 12 and 13 August 2003.

education, health, jobs and social participation, together with other subjective and symbolic elements that also describe various areas requiring the intervention of social policies.

The concept of poverty has been further elaborated, at times being measured on the basis of deficiencies or unsatisfied basic needs, using indicators such as food intake, income level, and access to health, education and housing. ECLAC has developed a methodology to measure poverty on the basis of the cost of satisfying basic needs by drawing poverty in terms of consumption or income. This indirect method focuses on measuring material deficiencies. It has the advantage of allowing for international comparisons and an accurate estimate of household consumption capacity. According to the latest ECLAC figures for 2002, 44% of the Latin American population were living in poverty that year. This percentage represents 221 million people, of whom about 97 million were indigent. For 2004, these percentages are projected to fall slightly: it is estimated that poverty now affects 42.9% of the Latin American population, and extreme poverty 18.6%, meaning that 222 million people are living in poverty, and 96 million in extreme poverty (ECLAC, 2003 and 2004b).

However, the income-based method does not take into account that household living conditions partly depend on accumulated assets, or that the internal distribution of resources is uneven among sex and age groups. Moreover, income is a difficult variable to measure, since it is subject to systematic under-recording and significant proportions of "no response". In addition, by exclusively taking into account cash income, it ignores accumulated household resources (assets), indirect transfers and in-kind State subsidies (health and education services, for example). Moreover, the poverty lines often intersect with modal intervals of income distribution, where population is more highly concentrated. Thus, poverty measurements tend to be very sensitive to changes caused by current conditions (increases in inflation or unemployment, for example), registering sharp rises or drops in the incidence of poverty (Martínez, 2002).

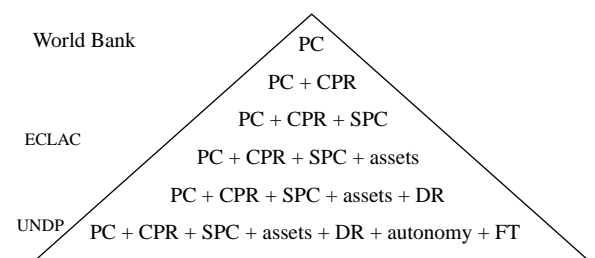
Attempts are currently being made to incorporate into these measurements certain non-material aspects of poverty related to the expansion and build-up of the social capital of the poor through their participation in social exchange networks, such as education, work, information and political power. This enhanced involvement of the poor strengthens the democratic culture and solidarity of society, and increases the free

time available to them for rest and recreation, representing a valuable asset in situations where the difficulty of earning enough to survive tends to make the workday longer. In brief, six sources of well-being for individuals and families have been identified: (i) income; (ii) right of access to free or subsidized government services or benefits; (iii) ownership or rights in respect of assets for basic use or consumption (accumulated basic assets); (iv) educational levels, with skills and abilities as expressions of the capability to act and understand; (v) time available for education, rest and recreation; and (vi) the dimensions that together strengthen individual autonomy. Thus, poverty is defined in its broadest sense by little or no income; lack of access to State-provided goods and services, such as social security and health; non-ownership of housing or other assets; little or no education and training; and lack of free time for educational activities, recreation and rest, all of which is expressed in a lack of autonomy and in nonexistent or limited social and family ties. Of course, as the number of dimensions included in the notion of poverty increases, the concept becomes less specific and its measurement becomes more complex.

As we see in Figure 1, non-material aspects relating to individual well-being and other, more qualitative aspects such as those linked with vulnerability, insecurity and social exclusion are increasingly being incorporated into the definition. In addition, poor people's view of their own situation and the concept of poverty in the various national and local cultures have gradually been gaining importance as variables in the analysis. The fundamental premise is that there is a set of aspects that are difficult to measure in

FIGURE 1

Pyramid of poverty concepts^a



Source: Prepared on the basis of Baulch (1996) and UNIFEM (2000).

^a PC = private consumption; CPR = individual and family property resources; SPC = State-provided commodities; DR = dignity and rights; FT = free time.

quantitative and monetary terms, but that have a strong impact on poverty: these variables are linked to psychosocial and cultural components, together with normative, institutional and cognitive elements. In addition, from a philosophical standpoint, some have drawn attention to the ethical aspects of poverty and the need to make certain principles of equality and freedom compatible with distribution criteria, the rights of the poor and respect for their preferences (Dieterlen, 2003).

The placement of poverty at the centre of public policy concerns may have a strong impact on the possibilities for overcoming it, because it may change the scope and nature of relations between the poor and non-poor sectors; in brief, it may modify the scope of social networks and the existing degree of associative behaviour between families and groups (“bonding social capital”), between similar groups (“bridging social capital”) and between groups with different access to economic, social and symbolic resources (“linking social capital”).¹ This means emphasizing the role of social relations such as trust, reciprocity and cooperation, the sustainability of community initiatives and of various life strategies to mitigate the effects of poverty. As for the concept of social capital, although it was originally used to denote the capacity of poor groups to react to economic crises, “market failures” and the effects of economic inequality, the current debate has also focused on factors that help perpetuate social exclusion and the reproduction of poverty. In the context of State intervention, it is estimated that the promotion of social capital in development strategies will allow actors to participate more and become protagonists in solving their own problems (Arriagada, I., Miranda and Pavez, 2004).

Briefly then, it could be said the poverty has certain basic dimensions that must be taken into account in designing appropriate public intervention policies:

- Sectoral dimension: education, employment, health, income and jobs, housing.
- Other factors: gender, race and ethnic group, which cut across sectoral dimensions. Individual age and stage in the life cycle should also be taken into account.
- Territorial dimensions. Efforts to reduce poverty should be based on existing initiatives and

potentialities in the poor sectors (social capital) and on the environment where they live or work (Raczynski, 2003).

- Family dimension: the stage and cycle of family life, together with economic exchanges and distribution of work in the family, must be taken into account. This could indicate that some members of non-poor households (for example, women without their own income) could be considered poor, just as men living in poor households might not be poor themselves if the distribution of household income is inequitable and they keep most of their income for themselves.

1. Poverty from a gender perspective

A look at poverty from a gender perspective shows that women are poor because of gender discrimination. The subordinate nature of women’s participation in society, for example, limits their opportunities for owning property and controlling economic, social and political resources. Their fundamental economic resource is paid work, on very unequal terms, given the present gender-based division of labour in which women do the domestic work and care for children almost exclusively, and the persistence of traditional and new forms of discrimination with respect to women’s wages and permanence in the job market. Although the situation in Latin America is not the same for all women, there is no country where they earn equal pay for equal work in comparison with men; the existence of considerable occupational segmentation, both vertical and horizontal, means that women do not have the same jobs or the same upward career path as men. This adverse situation is compounded by essentialist views which attribute characteristics to women that place them in a lower position than men, linking their reproductive potential to the attribution of reproductive tasks.

Kabeer (1998a) writes that poverty may be seen from two points of view: as deprivation of the opportunity to meet basic needs and as deprivation of the means to satisfy them. Women are poor to the extent that they do not have time available to seek more appropriate ways of meeting their needs, and a large proportion of them do not have their own income.

Thus, besides measuring female poverty in terms of income, it is important to also measure it in terms of time. To understand the dynamics of poverty, one must analyse the concept of time, especially because

¹ See the conceptual and methodological study of the social capital approach in Arriagada, Miranda and Pavez, 2004, and Arriagada, 2003.

a large part of women's work —housework— is not valued monetarily, but it can be measured as time spent. Various studies, especially time use surveys, have shown that women's workday is longer than that of men if unpaid housework, done by all women in their homes, is included.² In addition, the growing number of women joining the workforce has not meant that men have started doing more housework or caring for children, older people, other family members and the sick.

Moreover, traditional ways of measuring poverty, which stress family income, obscure the poverty of the less favoured members of the household, namely, women, young people, children and older people. Thus, it makes sense to examine the different use of time made by men, women, young people, children and older adults. This measurement requires a dynamic analysis of poverty and the ways it increases or decreases throughout the family life cycle.

With regard to paid work, four different forms of exclusion affect women more severely: (i) unemployment; (ii) unsteady types of jobs; (iii) unpaid jobs; and (iv) exclusion from opportunities to develop their talents. These forms of exclusion are compounded by inequalities in the types of jobs they take (horizontal and vertical job segmentation) and wage discrimination in the labour market.

In brief, in order to analyse gender poverty, we must look at various power relationships, such as those linked to exclusion, inequalities and gender discrimination in the labour market, the unequal division of unpaid labour, physical and symbolic violence against women and the differences in time use between men and women.

2. Relational aspects of poverty

In Latin America, the relationship between poverty and inequality has existed for a long time. The evolution of both phenomena in recent decades has been uneven: although the proportion of poor and indigent people has declined, inequality has persisted in terms of regional income. The concentration of income is a variable that directly influences how much time it will take to

overcome poverty (UNDP, 1997). "Inequality (understood as the degree of concentration and polarization of urban income distribution by population groups), although a broader problem than poverty, is a necessary and complementary referent in the case of Latin America, since it has common determinants and marks both the economic growth levels and social spending that will be required to eradicate urban poverty, and the estimated amount of time it will take to achieve this objective in the various countries" (Arriagada, C., 2000). It is estimated that inequality in income distribution in Latin America —as measured by the Gini coefficient— increased between 1990 and 2002, mainly because of the large proportion of income concentrated in the decile of high-income households (ECLAC, 2004b).

It should also be noted that there is an interrelationship between the concept of poverty and the notions of distribution, exclusion, vulnerability, discrimination and marginality, to name a few. When the concept of poverty is defined in its broadest terms, exclusion and inequality tend to be included in it, although it is possible to differentiate them analytically. The distinction is important, however, since the chosen approach will dictate different policies and programmes to deal with the phenomenon (table 1).

In this context and from a gender approach, we draw attention to the following seven specific gender-based inequalities proposed by Amartya Sen: (i) mortality inequality, meaning that in some regions of the world (North Africa, Asia including China and South East Asia) there is a disproportionately high index of female mortality; (ii) natality inequality, when parents prefer male children and selectively abort female foetuses; (iii) basic facility inequality (prohibition or inequality of access to basic education and health, the cultivation of one's natural talents or social functions in the community, among others); (iv) special opportunity inequality (difficulty or prohibition of access to higher education); (v) professional inequality in access to the labour market and better jobs; (vi) ownership inequality (property and land); and (vii) household inequality, reflected in the gender-based division of labour, where women are exclusively responsible for household duties (Sen, 2002). In addition, any analysis of poverty must take into account the average societal pattern of well-being, because this standard sets the conditions for integration, without which there can be no citizenship.

The concept of marginality arose in the 1960s in Latin America to denote population groups migrating from the rural areas and forming a band of poverty

² The latest time use surveys done in Mexico and Uruguay in 2002 and 2003, respectively, showed that Mexican women contribute 85% of total housework time, while men contribute 15%; Uruguayan male heads of households devote an average of 31 hours a week, and female heads of household 50 hours a week, on housework and childcare (INEGI, 2004; Aguirre, 2004).

TABLE 1
Poverty-related concepts and dimensions

Concepts	Dimensions
Marginality	Geographical and ecological context Economic, employment and educational marginality Reserve labour force
Vulnerability	Insecurity and risks in crisis situations Incapacity to respond Inability to adapt Target groups and their assets
Inequality	Unequal assets/endowments Justice and equity Rules and norms for resource distribution
Exclusion	Broken social, community and individual ties with the system Emphasis on processes and multiple causality Interrelationship among aspects of poverty Relational dimension Institutionality
Discrimination based on gender, ethnic group or race	Implicit or explicit mechanisms of discrimination by sex/ethnicity Cultural attribution of inequality based on gender/ethnicity Uneven distribution of resources Cultural construction justifying discrimination Discriminatory division of domestic, social and community work

Source: Prepared by the author.

around major Latin American cities. According to Nun and Marín (1968), marginality is defined as the structural process characterized by the formation of a proletariat, the “new poverty” and the constitution of social classes. The marginalized population is described as lacking infrastructure and educational and job opportunities, and constituting a reserve army of labour that is functional to the economy because its pressure on the job market tends to keep workers’ wages low.

The notion of vulnerability is related to two dimensions: one is external and objective, referring to the external risks to which a person, family or group may be exposed (greater instability of family income or more uncertainty in the job market, as reflected in the growing proportions of people employed under temporary or part-time contracts, or without contracts or social security); the second is internal and subjective, referring to the lack of resources to enable the poor to face these risks without suffering some losses. This approach combines three main dimensions: the assets

(physical, financial, human and social capital) of individuals and communities; strategies for using these assets; and the series of opportunities offered by markets, the State and society (Moser, 1996).

The concept of social exclusion, although it arose from the European debate, is broadly applicable to the Latin American region, specifically with regard to the new situations of poverty and exclusion caused by economic crises. Social exclusion has two dimensions: lack of social ties linking the individual with the family, community and, more generally speaking, society, and lack of the basic rights of citizenship. What differentiates the concept of social exclusion from that of poverty is that the former refers to relations between aspects of poverty. The process elements included in the debate on exclusion are interesting to consider, to the extent that they relate to the various mechanisms and types of exclusion, whether they be institutional, social, cultural or territorial. The ties that bind the individual with society may be divided into three types: functional ties, which enable the individual to become an operational part of the system (job market, social security institutions, legal system, etc.); social ties, which incorporate the individual into social groups and networks (family, primary groups, trade unions, etc.); and cultural ties, which enable individuals to become part of societal patterns of behaviour and understanding (participation in socially accepted norms and beliefs). Spatial exclusion, related to territory and geographical location, may also exist.

Discrimination based on gender and ethnic group has its roots in the attribution of certain personal and behavioural characteristics to people because of their sex, the colour of their skin or other physical features. It is based on essentialism, for it relates a person’s sex and physical features to certain socially constructed characteristics that segregate these groups.

In analytical terms, and for the purposes of designing a suitable poverty reduction policy, a distinction must be made between:

- Differentiation factors of poverty, such as ethnic group, gender and generation, educational and job level and area of residence, among others;
- Reproduction factors in the causes of poverty (intergenerational transmission) that are related to the individual and family life cycle and with access to property, assets and social and symbolic economic resources;
- Consequences of poverty, such as loss of opportunities and well-being, and accentuation of inequality.

In view of the multidimensional nature of poverty, its study should take into account the diversity of causes of deprivation, while the heterogeneity of poverty reinforces the importance of recognizing its different manifestations. From this standpoint, in order to formulate social policies to fight poverty, it is essential to identify the main sources of poverty and the heterogeneity of its manifestations in different groups or countries.

3. Poverty as a process rather than a static situation

One fact that is usually overlooked in studies on poverty, and especially in the social policies designed to reduce it, is that poverty is a situation that in some cases persists over time (structural poverty, extreme poverty), but in many other cases varies. Most analyses tend to see it as a static situation. The situation of poverty, however, may change over a short period of time, especially in relation to unemployment/employment, or the effects of an economic crisis that may lead, among other things, to a devaluation of local currency. The permanent precariousness of some people's situation, especially those with lower levels of education and skills, together with new kinds of jobs that entail instability and high turnover in the workplace, increases their vulnerability to interruptions

in income as a result of job loss. Other interruptions in income may be related to health problems, age, retirement or withdrawal from the labour market, or separation and divorce, especially in the case of wives who lack their own income.

Thus, it is of crucial importance to understand the dynamics of poverty in order to determine who among the poor may be able to escape from it, and who are more likely to fall into it owing to problems of health, unemployment, divorce and/or absence of a spouse, among other factors.

Some of the contributions made by gender studies to a better understanding of poverty are the following: (i) they point out the heterogeneity of poverty, thereby helping to better understand it and adjust the policies designed to reduce it; (ii) they take a new look at differences in behaviour between men and women; (iii) they improve the analysis of the household, focusing on power asymmetries, both gender-based and generational, within it; (iv) they contribute a multidimensional perspective on poverty, by examining the multiple roles played by men and women; (v) they show other types of discrimination that combine with gender discrimination, such as those based on age and ethnic group; (vi) they add a dynamic view of the notion of poverty by demonstrating how it changes over time; and (vii) they distinguish among various strategies for escaping gender-based poverty.

III

Poverty reduction policies

Changes and reforms in Latin America during the 1990s resulted in a reduction in the size of the State and its functions. This was due to an increase in the privatization of public enterprises; changes in the State's functions, whereby it no longer acted as a producer of goods and services; growing decentralization of services and resources; appearance of new actors in non-State public policies, where non-governmental organizations began to play a part in the delivery of public services and to promote grass-roots participation and control. Against this backdrop, approaches to reducing poverty also changed, resulting in more resources, fresh institutions and programmes, new ways of managing more decentralized and participative policies and programmes, with more input

from civil society, and the application of new tools for allocating resources (Raczynski, 2003). In brief, beginning around 2000, together with an increase in the poverty levels of the population, new forms of public management appeared that re-focused State efforts to promote poverty reduction programmes, but especially to fight extreme poverty.

The concept of poverty is not new in history. Already by the mid-16th century in England, laws were proposed to combat it (the English poor laws, enacted in 1563, 1572, 1576, 1597 and 1601, in the Elizabethan era) for a number of reasons: first, because of economic conditions and popular pressure; secondly, because of changes in the idea (based on Puritanism and Protestantism) of what governments could and should

do for the poor; and lastly because of the political ambition to control those whom the elites considered “inferior” subjects (Dieterlen, 2003). What is relatively new is the idea that the State (together with international and non-governmental organizations) should intervene continually and systematically in order to improve the situation of those living in poverty and extreme poverty. Newer still is the confirmation that the causes of poverty and the situation of poverty itself are different for women and men, and that policies and programmes are therefore needed that will take into account gender differences in the processes that cause and sustain poverty.

Explanatory models of poverty and the way that it is measured may also help determine the best policies for reducing it. If poverty is measured on the basis of situations of deficiency and by the income method, the most frequent result is that action is taken to correct deficiencies by the transfer of monetary subsidies, job-training courses, street paving, sanitation, education and health services, granting of loans on favourable terms, and other short-term compensatory measures (Raczynski, 2003). On the other hand, the proposals made in the 1960s for reducing marginality considered the provision of urban infrastructure, organization of marginal groups and incorporation into the job market as the primary mechanisms to help the poor become more socially and economically integrated. Policies designed in that era to reduce social inequality included reallocation of resources through taxes and redistributive social and economic policies, such as the special earmarking of resources for basic health and education and affirmative-action policies for disadvantaged individuals and groups (Raczynski, 2003).

As for discrimination on the basis of gender and ethnic group, the proposed steps in both cases consist of promoting affirmative action policies to help women and ethnic groups in more disadvantaged situations, and cultural deconstruction policies to combat prejudices against these groups (table 2).

Before designing poverty reduction policies it is important to make one clarification. Policies for reducing poverty, which lay stress on its causes and correction, and are related to macroeconomic management, regulations and institutional policies to promote equitable development and prevent crises and inequality, must be distinguished from policies aimed at alleviating and dealing with poverty (social protection) which are designed to lower the social risk in crisis situations, that is, they seek to attenuate the

TABLE 2

Poverty-related concepts and policy proposals

Concepts	Policy proposals
Marginality	<ul style="list-style-type: none"> • Expansion of urban services • Organization of marginal population • Incorporation into labour market
Vulnerability	<ul style="list-style-type: none"> • Targeted support to increase incomes • Promotion of new sources of income or subsidies • Strengthening of individual, family or social safety nets
Inequality	<ul style="list-style-type: none"> • Redistribution of resources • Redistributive social and economic policies • Affirmative action policies
Exclusion	<ul style="list-style-type: none"> • Creation of conditions for broader citizenship and full exercise of rights • Comprehensive social policies • Participatory and integrative policies • Access to institutional services
Discrimination based on gender/ethnicity	<ul style="list-style-type: none"> • Affirmative action • Cultural deconstruction • Policies to reconcile paid work with family responsibilities

Source: Prepared by the author.

consequences of the various manifestations of poverty. Policies for reducing poverty include those aimed at establishing economic and social rights; policies for alleviating and dealing with poverty include compensatory measures (social assistance) and those aimed at providing sectoral goods and services to target population groups.

1. Various perspectives on gender-based poverty

The public policy agenda of governments and international organizations shows a wide diversity of approaches to poverty and gender, which have been applied either separately or in combination in the past three decades; these are summarized below.³

(i) *Assistance-based approach*: this includes specific programmes for poor women, as a “vulnerable group”. It provides support to women on the sole basis of their reproductive functions, as wives and homemakers. It was more widely used in the 1970s and 1980s, but some remnants exist in current programmes

³ See Moser (1991).

of the Inter-American Development Bank (IDB), the World Bank, the Food and Agriculture Organization of the United Nations (FAO) and the United Nations Population Fund (UNFPA).

(ii) *Efficiency-based approach*: under this approach, in order to achieve a higher level of development, it is more efficient to consider the whole population, both men and women, as available to the job market or, in a more elitist version, from the standpoint of the contribution which the incorporation of educated women, as highly qualified human resources, can make to the economy. This is used by the World Bank, IDB, ECLAC and the International Labour Organization (ILO).

(iii) *Equity-based approach*: this suggests that improving the situation of poor women would contribute to equity, since there is a higher incidence of poverty in households headed by women; women's wages are lower and their position in the job market is precarious and segmented, which translates into poor living conditions and difficult access to equity. This approach is used in studies by ECLAC and ILO.

(iv) *Approach based on empowerment, exercise of social citizenship and decision-making*: under this relatively recent approach, in order to improve the quality and efficiency of programmes targeted to women and other groups (ethnic groups, classes), these groups must become involved in the elaboration and execution of the programmes, reinforcing their capabilities through organization, raising of self-esteem, access to material resources and strengthening of their social ties, so that they can fully exercise their citizenship and take decisions at the individual, family and social levels. This approach is used by the United Nations Development Programme (UNDP), ECLAC and the United Nations Research Institute for Social Development (UNRISD).

This last approach emphasizes the promotion of poverty reduction policies that take into account all the factors that cause poverty, from the most personal—lack of self-esteem and autonomy, or violence against women—to social and economic factors such as access to jobs, health, education and technical and financial services. To this end, the approach advocates involving the target groups and State, trade union and business actors in the design and execution of these policies and assigns an important role to the new criteria of empowerment and social capital.

In turn, gender policies include two important types: recognition policies, dealing with differences in identities, and redistribution policies, such as equal

opportunity measures (Fraser, 1998 and 2000). Recognition policies, which Fraser calls “the identity model”, include policies aimed at recognizing unfairly devalued identities. Redistribution policies, on the other hand, are aimed at socioeconomic transformation or reform in order to correct injustices based on gender or ethnic group.

Equal opportunity policies have become more widespread throughout the world. Equality of opportunities in the classic liberal political tradition involves the belief that all individuals should have the same opportunity, and that existing inequalities are due to different personal merits. In other words, everyone has the same opportunities, but since people are different, some are more capable than others, and therefore they become unequal. Therefore, when the same opportunities were not available in the beginning, unfair inequalities arise which must be corrected, whereas inequalities that merely express differences in merits are legitimate. In order to correct unfair inequalities, affirmative actions have been designed to establish equal opportunities from the start (Astelarra, 2003).

Nonetheless, since equal opportunities do not immediately produce equal results, emphasis is placed, from a democratic perspective, on creating the social conditions for real equality of opportunity. But even if an egalitarian situation existed initially, unequal retribution would tend to be perpetuated from one generation to another through “inheritance” and “gender biases”, thereby affecting equality of conditions and opportunities for women.

Recognition policies focus on topics relating to the identity that defines the groups being discriminated against. The aim of these policies is to encourage the dominant culture to recognize the rights of those groups. One of the main criticisms of this approach is that it could tend to stigmatize the groups by focusing on the maintenance of an identity that keeps them apart from the rest.

According to Fraser, recognition and redistribution policies are not mutually exclusive.

2. Interrelationship between poverty and gender policies

Poverty reduction policies with a gender perspective cut across two important groups of policies established and implemented for a number of decades in Latin America: those aimed at eliminating gender inequalities and those designed to fight poverty.

TABLE 3

Poverty reduction policies with a gender perspective

Poverty reduction policies	Gender policies	
	Rights	Compensatory and sectoral/ Services
	Recognition	Rights and cultural recognition	Recognition and compensatory
Redistribution and equal opportunity	Rights and redistribution ("empty pigeonhole")	"Economic" redistribution and compensatory

Source: Prepared by the author.

By combining these two groups, we may obtain a potential set of policies to reduce gender poverty, using very different types of approach. The array of actions, projects and programmes designed to reduce gender poverty gives rise to four types of combined policies (table 3).

Within the set of policies applied so far, we may distinguish four types, whose most salient features are as follows:

(i) *Gender-blind universal policies*. These policies do not distinguish between men and women. They are applied in various social sectors, such as education and employment, and they perpetuate gender inequalities.

(ii) *Redistributive and compensatory "economic" policies*. This type of policy was put in place with a more redistributive bias in the 1960s, and with a more compensatory and assistance-based approach in the 1980s. It was reflected in many programmes for female heads of households that were carried out, with varying degrees of success, throughout the region. Towards the 1990s, programmes devoted to extreme poverty incorporated a more specific territorial focus, and their execution was more decentralized, with cash transfers directed primarily to mothers; but these policies did not change the view of women in general, and of mothers in particular, as people whose role it is to serve others, nor were they linked in any clear way with sectoral policies.

(iii) *Policies involving rights and cultural recognition*. These are more recent policies—they have been applied since the 1990s—and their purpose is to ensure recognition of the rights of excluded groups, including women. They primarily involve legislative measures to promote gender equity.

(iv) *Policies involving redistribution and economic and cultural rights*. This group is the so-

called "empty pigeonhole", because it deals with future policies that have never been applied in any country. Although their design requires a careful balance, they are not mutually incompatible, and they will require a strong political will and consensus in order to be set up and executed. In particular, these policies should offer more autonomy and power to women, correcting the existing gender imbalance and making gender roles more flexible with a view to increasing options for both men and women.

As for the design of social policies, the heterogeneity of poverty requires the elaboration of policies that are both universal and selective, targeted to specific groups. A woman living in poverty who is a teenage mother is in a situation unlike that of a widow without her own income, and their needs, strengths and the programmes and policies most suited to them will also be different.

If poverty is seen as a process that goes beyond a mere "snapshot" (Kabeer, 1998b), it is clearly important to formulate heterogeneous, flexible and appropriate policies to deal with the increasingly diverse and changing situations among the poor and their constant shift between stages of well-being, poverty and indigence.

Poverty reduction policies, as seen from a gender perspective, must therefore take into account the individual, family and social resources of both men and women; measure the use of time by both genders; support the strengthening of poor women who are in weaker positions; take into account subjectivity and the different needs of men and women; incorporate the dynamics of poverty, including the movement into and out of poverty; and deal with the relations between the various aspects of these processes.

3. Assessment of poverty reduction policies from a gender perspective

A first step in evaluating gender policies is to determine their basis (ethical, cultural, economic and others) and to find out whether the methods of conceptualization, measurement and application have detracted from their primary objectives. It is therefore worth asking whether the implementation of these policies has promoted gender equity or, rather, new forms of inequality, and whether the process is strengthening autonomy or, rather, dependence with regard to the programmes being established (Arriagada, I., 1998). Another fundamental element is to encourage the active participation of men and women in the design, execution and evaluation of the social programmes and interventions that affect them. The incorporation of the population in decision-making could slow down the process somewhat, but in the long run it will result in a greater commitment to the programmes, making them more sustainable, and a considerable enhancement of self-esteem.

It is worth stressing the need to make a precise assessment of each change as it is introduced, in order to learn from past and recent experience in the design

of social programmes and projects. This will help formulate a gender policy that is consistent with the initial objectives, preventing them from weakening during the execution phase. Likewise, the uneven impact of social and economic policies on men and women should be constantly reassessed. This evaluation should deal with all the policies comprehensively, since it has sometimes occurred in Latin America that the adverse effects of one policy (such as a given economic policy) has had to be mitigated by others, as in the case of compensatory social programmes. In order to assess the expected and unexpected results of programmes, up-to-date information must be available both before and after social interventions.

Particular care must be taken to incorporate gender-based poverty reduction policies into the public agenda; to strengthen the political will to carry out such policies; to broaden the coverage and quality of services and programmes for poor women from a gender perspective; and to continually evaluate the degree of participation and growing autonomy of the individuals, especially women, who are targeted by these policies.

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Mortgage loans and access to housing for low-income households in Latin America

Gerardo M. Gonzales Arrieta

On the basis of a study on mortgage loan options available in eight Latin American countries, this article identifies two pending tasks for most of the countries: the need to make long-term funds available to mitigate the risk of a mismatch of maturities and rates, and the need to harmonize profitability criteria for lenders with the criterion of access to credit for the low-income population. The paper recommends the creation of linkages between the housing finance market and the capital market through secondary mortgage markets, for which the housing finance market must use instruments other than subsidies. In addition, the paper proposes a number of options to ensure that the State helps to create mortgage markets that will provide the low-income population with better access to housing.

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I

Introduction

The financing of housing is a key element of any housing policy. In general, two objectives should be taken into account in order to make finance options viable and sustainable. First, the options should offer profitability to market participants; otherwise, it will not be feasible to attract investment, particularly private investment, to the housing sector. Secondly, they should be adapted to the potential borrowers' ability to pay; otherwise, the low-income population will be marginalized from market operations.

Since these two objectives are not necessarily compatible, the State has at various times become a key player; this has often resulted in a paternalistic approach and an inappropriate allocation of resources—with loans being granted at subsidized interest rates—together with inefficient recovery of funds and serious problems of payment arrears.

Other schemes have also been tried with the aim of making more room for private management in the construction and financing of housing, reserving for the State, at least in theory, the role of basically regulating and subsidizing the purchasing power of the lower-income strata. To that end, State intervention has focused on the contribution of direct, non-reimbursable subsidies, with the prerequisite of prior savings on the part of beneficiary families. Since this system is frequently inadequate to allow low-income families to purchase the kind of housing they want or can afford, these two sources of financing are supplemented by some type of housing credit.

The provision of mortgage loans on more appropriate terms for low-income families, however, has not been an easy task. In general, institutional schemes for mobilizing resources for housing have not made long-term funds available, although housing finance involves precisely this type of time frame. The availability of short-term funds, basically family savings, has not formed a stable basis for housing finance systems; rather it has created potential—and often real—risks of a mismatch of maturities and rates.

Moreover, the relatively limited development of capital markets has also had a negative impact by weakening the linkages between these markets and the financing of housing.

Furthermore, the small amounts involved in mortgage loan operations for low-income sectors and the high transaction costs with respect to these amounts has tended, given the competitive scenario, to discourage financial intermediaries from granting mortgage loans to these sectors. In other words, many of the market-based mortgage options are, in practice, mainly available to the higher-income sectors.

This paper proposes a series of considerations on the functioning of available mortgage options in a sample of eight Latin American countries,¹ and policy recommendations to help develop the housing finance markets and enhance their impact on access to housing, especially for low-income sectors.

Section II below discusses the conceptual aspects of resource mobilization for housing, taking into account various institutional and operational models and considering their implications for the functioning of intermediaries and the management of their risks, on the one hand, and the linkages between housing markets and financial and capital markets, on the other. In view of the dual objective—profitability and accessibility—of any mortgage instrument, and the predominance in Latin America of large population sectors with low purchasing power, a theoretical

□ This article is an abridged version of a study of the same title published by ECLAC in the *Financiamiento del Desarrollo* series (ECLAC, 2002). The opinions expressed herein are the exclusive responsibility of the author.

¹ The countries considered in the study are: Brazil, Chile, Colombia, Costa Rica, Dominican Republic, Ecuador, Mexico and Peru. Besides the availability of information, other criteria used to form the sample were: geographical distribution (five South American, one Central American, one North American and one Caribbean country); economic size (two large countries: Brazil and Mexico; three medium-sized countries: Chile, Colombia and Peru; and three small countries: Costa Rica, Ecuador and Dominican Republic); and institutional aspects that affect the housing sector: (for example, one country, Ecuador, is legally dollarized); another, Peru, is de facto dollarized; three countries (Chile, Colombia and Mexico) currently have indexation systems; one country, Brazil, has some indexation experience; and two countries (Costa Rica and the Dominican Republic) have no indexation tradition. The study also includes an analysis of two other countries—Argentina, an economically large South American country with, until recently, a convertibility system, and Panama, an economically small Central American country with a dollarized system—with regard to the development of secondary mortgage markets.

analysis is made of the contribution of housing subsidies to the demand for easier access to housing.

On the basis of existing institutional mortgage schemes and instruments, section III formulates a series of conclusions and policy recommendations for developing a type of housing finance management that

may lead to an efficient and sustainable expansion of mortgage markets, and may also effectively enable low-income sectors to gain access to housing. Special attention is given to the State's role in the development of mortgage markets and the enhancement of access to housing and financing for low-income sectors.

II

Housing credit: conceptual aspects

1. Models for financial resource mobilization for housing

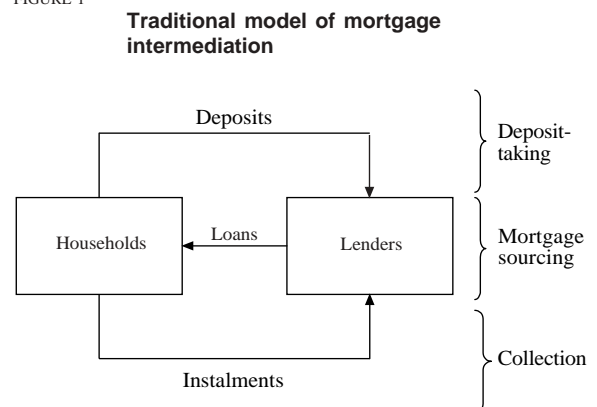
Housing is a durable good; it is perhaps the most important physical asset for the majority of family units, and its price is usually several times higher than the income of the potential buyers. In most cases, therefore, purchasing a house is only feasible by means of a long-term loan, which enables the buyer to ease the pressure of this high price on family income. The availability of long-term housing credit, however, not only raises questions about its volume in relation to demand, but also about the need for transforming maturities on the part of the originators of these loans.

The most traditional model for mobilizing resources for housing is the one based on intermediation by the financial system (figure 1). It is carried out by multi-spectrum banks or financial institutions—which finance various activities, including housing—or, as was in the past and is still the present case of many Latin American countries, specialized mortgage institutions. As a primary source of funds for this purpose, the latter raise family savings, mainly through relatively short-term deposits.

Loans originated by these institutions remain as assets on their balance sheets for the entire length of the loan. Lending institutions also take charge of administering and collecting payments on these loans. In other words, they perform all the functions of the mortgage process: funding and loan origination and servicing. That these institutions grant long-term loans with short-term savings exposes them to potential risks of mismatch of maturities, and possibly of rates, where ceilings exist on mortgage interest; these risks are concentrated in lending institutions.

In order to attract more funds to the housing sector, taking into account that capital markets have

FIGURE 1

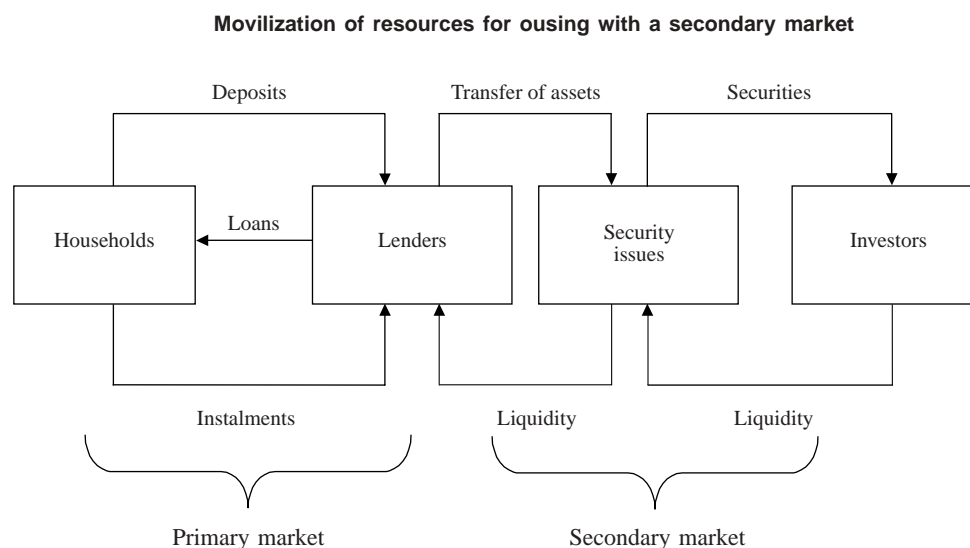


Source: Prepared by author.

new investment agents and more long-term funds available, and in order for the maturities of these resources to match the maturities of the loans they are financing, increasing attention is being paid to an emerging model of resource mobilization. This model is based on the development of a secondary mortgage market, in which mortgages are first sold, generally to agencies that specialize in acquiring mortgages from various lenders, and then issue securities and bonds which are backed by those mortgages; these are then sold to investors (generally institutional investors) in the capital markets (figure 2).

This process of selling of mortgages and their later securitization makes possible, first of all, a faster rotation of the resources being managed by lending institutions, since these assets come off their balance sheets before their maturity, in return for funds to originate new loans and, secondly, the establishment of a linkage between the housing finance and capital markets, which facilitates the transformation of maturities required in the former case. In the more

FIGURE 2



sophisticated version of this model, there is a tendency towards specialization of functions within the mortgage process: the lending institution basically becomes a loan originator, whose risks are transferred and spread to the capital market, diversifying its sources of funds and even transferring loan administration to specialized agencies that may emerge.

Of course, the above description is overly simplified and mainly serves to illustrate the differences between a model of financial intermediation for housing and a model for mobilizing resources backed by a secondary mortgage market. Other variations also exist, both theoretically and practically. One example would be housing funds—generally government funds—to provide resources to lending institutions; the latter, under certain terms, originate mortgage loans that, depending on the degree of development of the markets, could be securitized or not. Another example might be for lending institutions to raise resources through the issue of bonds or other mortgage securities, which would also serve to establish linkages, although less sophisticated ones, with capital markets.² In fact, these and other variations have been used at different times in a number of countries in Latin America.

There is certainly a clear trend towards reassessing institutional schemes for mobilizing resources for the housing sector. An attempt is being made to provide a greater volume of residential mortgage loans and, at the same time, to obtain resources on terms of maturity that are compatible with housing finance. There is thus a shift in the traditional model, limited to the financial market, based on the mobilization of short-term family savings for the origination of long-term mortgage loans. But this shift does not mean discarding the traditional model, which will remain important in the great majority of developing countries, but rather complementing it with a scheme for obtaining resources from both the financial market and the capital market, through traditional methods of attracting family savings and mechanisms for raising institutional savings, in order to originate mortgage loans that can be securitized.

Ever since the origination of mortgage loans began to be separated from the mobilization of savings from the public, a trend has been seen towards the attraction of general savings from the economy—whether they be savings deposited in many different banks or in specialized financial institutions, savings administered by institutional investors or even savings from abroad—to channel them in some way to housing finance, through innovative mortgage instruments.³ This probably occurs at the expense of the mobilization of compulsory savings specifically allocated for

² One notable case in the region is the well-developed system of mortgage securities (*letras de crédito hipotecario*) in Chile; its consolidation was fostered by the pension reform initiated in Chile in 1981, which generated increasing long-term domestic savings, as well as the emergence of life insurance companies as another important institutional investor in these securities.

³ See Hausmann (1998, p. 11).

housing finance, among other reasons because of the constraints it imposes on the amount of resources that can be mobilized in this manner. The emerging scheme described above should help to solve the problem of maturities mismatch and the need to spread risk.⁴

2. Linkages of housing credit with direct housing subsidies and prior savings

Housing finance institutions will have to compete for resources in the financial and capital markets. They will therefore require instruments that offer attractive rates of return, to both savers and investors; thus they will need to design mortgage instruments on market terms. This means that housing credit amortizations must permit the recovery of loans in real terms, to enable the financing of a new house and the sale of mortgages on the secondary market. It is argued that subsidizing one family places a burden on 20 savers, who will receive low or even negative rates of return on their deposits, thereby providing a disincentive to saving and hindering the growth of the financial system.⁵

This objective, however, is not necessarily compatible with the possibilities of access to mortgage credit options by potential borrowers, mainly in the low-income segments. The chief obstacle to solving the housing deficit of these sectors has been precisely their difficulty in gaining access to existing finance opportunities, for three basic reasons: (i) their insufficient purchasing power, which prevents them from converting their enormous potential demand into effective demand; (ii) their lack of adequate collateral to qualify for a mortgage loan; and (iii) their inability, especially in countries with large informal sectors, to show evidence of a steady income. The combination of prior saving/mortgage loan is clearly insufficient to enable low-income sectors to gain access to housing, although it may be feasible for the higher-income strata.

Tripartite schemes have emerged to address this problem and facilitate access to housing. Their components are as follows: prior saving on the part of buyers, a State-provided, non-reimbursable demand subsidy and, where appropriate, a complementary mortgage loan on market terms. The main objective of

the direct housing subsidy (DHS) is to supplement the purchasing power of low-income families, a segment where the bulk of potential housing demand is concentrated, to allow these families to solve their housing problems through the market by purchasing a home that meets their goals and is compatible with their own efforts and economic possibilities. It is considered that demand subsidies are clearly more efficient than supply subsidies (in the form of State-provided housing), since they entail fewer losses in terms of the consumer's welfare, less detriment to the consumer's sovereignty and lower housing costs.⁶

The impact of direct housing subsidies on the purchasing power of beneficiaries is illustrated in figure 3.⁷ To simplify the analysis, let us suppose that the consumption basket of the family in question is composed of two goods: housing and other goods.⁸ Given its level of (monthly) income, this family has a feasible consumption set represented by area AOB and, based on its preferences, chooses, for example, basket C (it consumes OD in housing and OE in other goods). Suppose that this family receives a housing subsidy, by which its feasible consumption set increases and is now represented by the area AOFG. This produces an increase in the family's real income that shifts the budget line, now denoted by the line FG; this line is cut off at point G, since the subsidy can only be used to consume housing (the subsidy is not granted in cash and is therefore not fungible).

Figure 3 may well represent the case of a family receiving a direct housing subsidy under a housing leasing program (rental with commitment to purchase) such as the one in Chile. Since this is a subsidy granted by the State partially and regularly over time, the choice of the new consumption basket will most probably be located on section HI, since the subsidy can be added to the budget in order to purchase a better and more expensive house (point H), or to free some of the budget used by the beneficiary family to pay rent, for the equivalent of the subsidy, in order to consume more of the other goods (point I) or a combination of the two (section HI).

Direct housing subsidies have a number of advantages, but we will list only three here that are

⁴ This trend can be seen in the contents of some recently introduced reforms in the legal and institutional frameworks for housing finance in a number of countries in the region.

⁵ See Renaud (1997, p. 13).

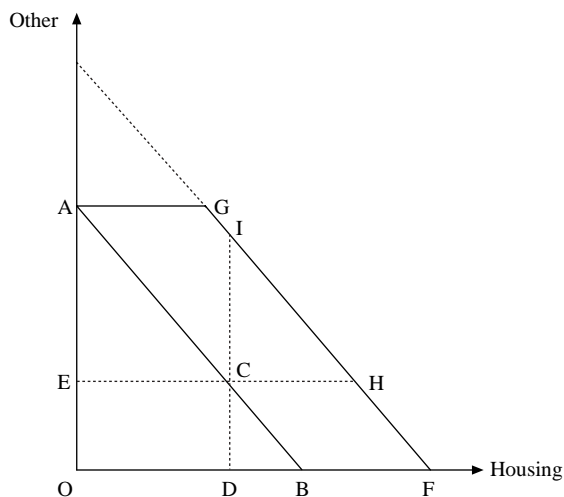
⁶ See Renaud (1997, pp. 3-4).

⁷ See Gonzales Arrieta (1999) for a detailed explanation of the economic rationale of direct housing subsidies.

⁸ According to Hicks's Composite Commodity Theorem, a group of goods whose relative prices do not vary may be treated as one commodity.

FIGURE 3

Impact of a direct housing subsidy on real income



directly related to the development of the mortgage market.⁹ In the first place, these subsidies help to expand the potential market of mortgage borrowers, by reducing the amount of indebtedness needed to make up the price of the housing being purchased. They therefore allow recipient families, with no increase in their income, to obtain mortgage loans that meet their capacity to pay. In addition, the lower indebtedness made possible by these subsidies may stimulate the formal financial system to increase the volume of housing loans to the low-income sectors, and may also

offer a better-quality loan portfolio: the borrowers are assuming obligations that will be easier to pay back, given their level of income, since the coverage of the mortgage guarantee will yield a surplus over the debt (equivalent to the amount of the subsidy).

Secondly, direct housing subsidies, as part of the above-mentioned tripartite scheme to facilitate access to housing, may stimulate the formation of family savings channelled through the formal financial system, if they are designed to reward the amount saved and the duration, steadiness and regularity of the prior saving process. This is true when regular prior saving is a requirement for granting such subsidies. In turn, the formation of prior savings through the financial system may help to expand the base of potential borrowers, incorporating groups that are traditionally rejected because of their inability to demonstrate a steady income.

Thirdly, direct housing subsidies, unlike interest rate subsidies, strengthen rather than distort the operation of the housing finance market. They complement, rather than displace, the mortgage loan on market terms; hence, for segments with some indebtedness capacity, the counterpart of a direct housing subsidy would be a mortgage transaction on the same terms. The validity of a subsidy mechanism of this type is therefore perfectly consistent with a housing resource mobilization scheme with positive real interest rates, both for savings and for loans, that stimulates both the flow of financial resources to the sector and the capitalization of financial intermediaries.

III

Strengthening of mortgage instruments: policy recommendations

1. General overview in Latin America

The validity and effectiveness of mortgage instruments are based on two premises: on the one hand, the

possibility of mobilizing long-term resources for housing finance and, on the other, the possibility of designing mortgage products that help families with indebtedness capacity gain access to housing.

Clearly, the mobilization of long-term resources for housing finance systems is a pending task in most Latin American countries. Countries like Brazil, with its former Housing Finance System (SFH); Colombia, with its now abolished system based on the constant unit of purchasing power (UPAC); Costa Rica, with its

⁹ Direct housing subsidies have other important advantages, especially in terms of equity—they allow for better targeting and progressivity—and in terms of encouraging the efforts and capabilities of the beneficiaries to choose their housing solution. See Gonzales Arrieta (1999, pp. 142-143).

National Housing Finance System (SFNV); and the Dominican Republic, with the Dominican Savings and Loan System for Housing, to name only a few, primarily support long-term mortgage loans with resources, largely short-term, from the financial markets. The SFH in Brazil uses the so-called *cadernetas de poupança*, an instrument for raising savings deposits on call whose real growth, since 1981, has tended to be lower than non-monetary financial assets; moreover, these deposits have been very volatile, and a rigid scheme prevails for investing resources raised by this means. In Costa Rica, one of the main weaknesses of mutual-type savings and loan institutions, which are part of the SFNV, is the maturities mismatch between funding—mainly short-term family savings—and long-term lending. This traditional system of financing long-term loans with short-term savings is potentially vulnerable, because of the risk of mismatching maturities and rates.

Other countries rely on compulsory savings—for example, the *Fondo de Garantía por Tiempo de Servicios* [Unemployment Insurance Fund] (FGTS) in Brazil, or the payroll deductions in the *Instituto del Fondo Nacional de Vivienda para los Trabajadores* [National Workers' Housing Fund Institute] (INFONAVIT) and other funds in Mexico—or on the setting up of State-provided funds intermediated by the financial system, such as the *Banco Ecuatoriano de la Vivienda* [Ecuadorian Housing Bank] (BEV), the former *Fondo de Operación y Financiamiento Bancario a la Vivienda* [Bank Operation and Finance Fund for Housing] (FOVI) in Mexico, whose functions are now performed by the *Sociedad Hipotecaria Federal* [Federal Mortgage Company] (SHF),¹⁰ or the *Fondo Mivivienda*, the State housing programme in Peru. In addition to the constraints these mechanisms may impose on the amount of available resources, dependence on this type of resources often makes it difficult for lending institutions to sustain themselves. In Brazil, since FGTS deposits largely depend on variables such as employment level, purchasing power of wages and participation in formal employment, there has been an increased decapitalization of the Fund and some destabilization of housing credit in times of poor macroeconomic performance. In Peru, it is clear that the initial investment of the *Fondo Mivivienda*, including its loan repayments and profitability, will be

insufficient to meet the sustained needs for housing finance.¹¹

Since housing finance and access to housing are only available through long-term loans to creditworthy families, the financial engineering of mortgage origination requires a transformation of maturities. Accordingly, linkages must be created between the housing finance market and the capital market, offering housing finance systems, in principle, the possibility of making resources available in amounts and terms that financial intermediation alone cannot provide. The development of a secondary mortgage market is the vehicle by which this linkage is established between the housing finance system and the capital market.

In Latin America a number of legal, institutional and operational initiatives are being taken to link housing finance systems with capital markets in order to attract long-term resources for housing. Where long-term resources (savings) and institutional investors exist, as they do in many countries to a greater or lesser extent, one way of achieving this goal is through mortgage securitization. To cite some examples, in Brazil the establishment of the Real Estate Finance System (SFI) clearly incorporates this idea; in Colombia the new law regulating sector development includes instruments to establish such linkages; in Mexico some legal reforms and the creation of the *Sociedad Hipotecaria Federal* [Federal Mortgage Company] (SHF) seek to create favourable conditions for securitization; and in Ecuador and Peru there is a legal framework and institutional setting to allow for securitization.

A crucial prerequisite for the development of secondary mortgage markets is the existence of sound primary markets to form the basis for the design of products to facilitate access to the capital market; also, it is required that the latter have long-term resources available. Experience in this area, however, shows that this process is only beginning—today only six countries in the region (Argentina, Brazil, Chile, Colombia, Mexico and Panama) have issued mortgage-backed securities—in part because of weaknesses in the primary mortgage markets themselves but also because of a series of difficulties, particularly the recent financial crises that have downgraded mortgage credit

¹⁰ Note that the ability of SHF to grant loans may not be extended beyond 12 October 2009.

¹¹ In line with this reality, the *Fondo Mivivienda* has been working on the design of a guarantee scheme and other products to stimulate resource mobilization from other sources, including the capital market.

portfolios and created uncertainty for long-term financial investments. Mortgage securitization is not the only way, however, to establish linkages between the housing finance and capital markets. For many years Chile has been setting up these linkages through the use of mortgage securities, an instrument that dominates the Chilean mortgage market and is highly liquid, in addition to fully backing the assets and liabilities of the issuing institutions. In Chile, securitization is being used to create additional linkages with the capital market, an action that helps, in particular, to mitigate the risks of other instruments, such as endorsable mortgage credits and housing leasing contracts.

As noted above, there is a clear trend towards mobilizing the general saving of the economy for housing finance, that is, not only family savings in financial institutions but also the savings of institutional investors who participate in the capital markets. In order to continue competing in the financial market and start doing so in the capital market, the housing finance system must use instruments (such as deposits, mortgages and bonds) isolated from subsidy components. The need for housing finance systems to grant mortgage loans on market terms, without subsidies, is closely related to the possibilities for these systems to establish linkages with the capital markets, in order to broaden their fund-raising and improve risk management. Likewise, in order to strengthen the capacity of a housing finance system to attract more family savings through the financial system, these savings must earn a positive real rate of return, which not only prevents their depreciation over time, but also makes this option preferable to others. Such a condition would be incompatible with an arrangement whereby the institutions that attract family savings granted loans that included a subsidy, if the point is to ensure that housing finance instruments are self-sustainable in the long run.

In the light of the foregoing, in addition to providing long-term resources to the primary mortgage market, the criterion of profitability must prevail in order to ensure the emergence and permanence of mortgage credit. Amortization schemes must be designed to ensure the recovery of loans in real terms. This aim is important not only to rule out hidden subsidies, but also to prevent the decapitalization of intermediaries and to make it possible for portfolio recovery to be the primary source of resources for housing finance systems. In this context, various indexation models have been implemented in Latin America, in particular to counteract the adverse effects

of inflation. To list some examples, Chile, Colombia and Mexico use an inflation-based scheme for indexed loans, while in Ecuador and Peru, mortgages are fully or primarily dollarized. On the other hand, Costa Rica and the Dominican Republic grant housing loans in local currency at variable rates.

While it is true that inflation is currently not a major economic problem in the region, any long-term financial instrument, such as a mortgage loan, will have better possibilities for success if it is associated with an indexation scheme that protects it against the risks of inflation and devaluation; in other words, that helps to "insure" it. Moreover, countries with a long tradition in the use of this scheme, such as Chile, are not even remotely considering the possibility of giving up indexation, despite a sustained period of price stability. Of course, no indexation system is a guarantee in the face of runaway inflation or devaluation; in fact, many of these schemes have failed in such situations. As for indexation, it has yet to be determined how to guard against or compensate for possible borrower default when wages fail to keep up with inflation (if indexation is inflation-based) or devaluation (if loans are dollarized).

The above-mentioned conditions, aimed at ensuring the profitability and self-sustainability of housing finance systems, should provide access to housing through a combination of prior saving and long-term mortgage loans. This does not necessarily mean, however, that all segments of the population, in particularly low-income groups, will have full access to the opportunities created by the operation of a housing finance system in such conditions. Therefore, in order to develop sound housing finance systems in developing societies with relatively low incomes and large segments with scant purchasing power, such as those prevailing in Latin America,¹² it is essential to establish a clear separation between subsidies and financing. Attempts to use a housing finance mechanism that includes a subsidy (for example, on loan interest rates) in order to help low-income segments gain access to housing have generally not achieved the anticipated results and, on the contrary, have

¹² ECLAC (2001) notes that 10% of higher-income households in Latin American and Caribbean countries earn, out of total income, an average of 19 times more than is earned by 40% of lower-income households. Moreover, between two thirds and three quarters of the population, depending on the country, earn a lower per capita income than the overall average. Thus, in the 1990s the region had the most unequal distribution of income in the world.

undermined the self-sustainability of the housing finance system.

Accordingly, another pending task is to determine how to harmonize profitability criteria, which favour the development of a self-sustainable housing finance system, with the criterion of borrowers' access to housing and protection of their ability to pay. The available mortgage instruments in the housing finance markets of a number of countries are usually accessible to the relatively higher income strata but rarely help promote access for those with a limited capacity to pay. SHF loans in Brazil, where resources from short-term savings are used, are granted to upper-middle-income families (earning more than US\$ 1,000 a month). In Chile, where endorsable mortgage certificates are actively used for financing higher-priced housing, the average value of accumulated loans under this instrument, operated by endorsable mortgage loan administrators, was US\$ 37,000. About 37% of total loans granted by the Housing Finance Programme (PROFIVI) in Mexico, formerly administered by FOVI and now by SHF, go to households with ranges of monthly income between US\$ 780 and US\$ 1,300, and 35% to those earning between US\$ 1,300 and US\$ 1,950. The average loan amount from the *Fondo Mivivienda* in Peru is about US\$ 18,000, which means that these funds are basically reaching families with monthly incomes of US\$ 530 to US\$ 585.

In public policy in Latin America there is, in fact, a fairly widespread tendency to recognize that a combination of saving and a mortgage loan (on market terms) is insufficient to meet the housing needs of large segments of the population, since for some time now nearly all the countries of the region have had direct housing subsidy schemes that represent a cornerstone of public policy and are designed to make up for the housing deficit in the low-income sectors.

2. The role of the State in the creation of a mortgage market

State participation is crucial to this pending task. For many years the State has been actively involved in the housing sector, seeking to help the low-income sectors; however, this State participation has often displaced the private sector and, ultimately, has failed to reach the target population. More recently, in Latin America there has been a tendency for the State to withdraw from the direct building and financing of housing, and to begin playing a basically regulatory role as well as promoting private initiative. Some experiences, such

as those of Chile, Costa Rica, Ecuador and Mexico, bear witness to this change of focus and seem to indicate a move in the right direction. But these same experiences also reveal certain shortcomings: for example, in schemes of this nature it has not always been possible to attract private-sector participation in the granting of small mortgage loans. This means that in low-income societies, where broad sectors of the population have little purchasing power, the State is necessary not only to act as a regulator but also to help provide these sectors with greater access to housing. To ensure that this participation does not displace private initiative but rather reinforces the self-sustainability of housing finance systems, various instruments must be considered.

In general, in the case of low-income sectors, opportunities for access to housing should be based on a combination of up to three elements: (i) prior saving of the buyers, or some indication of their own effort, not necessarily monetary in nature, in the case of the lowest-income strata; (ii) a direct, non-reimbursable State subsidy, in support of housing demand; and (iii) a long-term mortgage loan on market terms as a supplement to help the more creditworthy strata. Obviously, while a combination of savings and a mortgage loan should be enough for families with sufficient capacity to pay to have access to housing, in the poorest sectors, with no capacity to pay, access to housing should fundamentally depend on State support in the form of a direct subsidy (for example, basic or partly self-built housing), with perhaps the addition of some component of saving or family effort.

From this standpoint, the direct housing subsidy mechanism should be used as leverage to convert the potential demand for housing into actual demand, without introducing distortions in the operation of the housing finance market; to that end, the portion of the housing market that lacks sufficient capacity to pay and needs a State subsidy must be differentiated from the portion having the capacity to pay, which can be reached by private intermediaries through market mechanisms. Furthermore, as already noted, the direct housing subsidy may contribute to the growth of the potential market of mortgage borrowers by reducing the amount of indebtedness needed to make up the price of the dwelling; the exception is the case of the poorest population, which can be offered a housing solution by combining prior saving with a State subsidy. A review of the experience in the region clearly shows that this mechanism is an integral part of the housing policies of a growing number of countries.

Of course, the award of a direct housing subsidy is not enough to guarantee that private financial institutions will give supplementary mortgage loans to the beneficiary population or, more generally, to the lowest income strata. Moreover, the lack of mortgage credit to complement the State subsidy has undermined the effectiveness of the latter instrument, since it raises the proportion of subsidies that are granted but not paid out. In this context, the Latin American experience also sheds light on other promising channels of State intervention, provided that the purpose is not to distort the operation of the housing finance market. One of these, for example, is the mortgage loan scheme with preferential interest rates, as used by mortgage banks in Panama.

This mechanism works as follows: lenders originate mortgages at market interest rates, but qualify potential borrowers at preferential interest rates (i.e., below market rates) in order to give more families access to these loans. To cover the difference between the two rates, the Government grants the lenders tax credits that are tradable on a secondary market. Mortgages are originated at the referential rate, calculated and published by the National Banking Commission and based on the average mortgage rate offered by the five banks with the largest mortgage portfolios in the system. The mechanism is applied to mortgage loans of up to US\$ 62,500 in two tranches: the first is for housing worth up to US\$ 25,000, for which the Government guarantees the lender a 5% reimbursement (in tax credits); the second tranche includes housing priced between US\$ 25,000 and US\$ 62,500, in which case the Government grants a 4% reimbursement. The financial intermediary applies to the Government for reimbursement at the end of the year, depending on the value of the mortgages granted. The borrower accordingly pays a preferential rate, defined as the difference between the referential (market) rate and the rate to be reimbursed by the Government (4 or 5%, depending on the case). Employers may deduct the monthly payments from the borrowers' pay and then remit the payments to the lending institutions; this will help improve debt repayment, especially in the case of relatively small mortgage loans.

Note that, in this case, there is no borrower subsidy at the expense of the decapitalization of the lending institution, as has been (and still is) the usual practice in many countries. Actually, the institution grants mortgages at market rates, since the State covers the difference in rates with tradable tax credits.

Although the scheme is less progressive than the direct housing subsidy—since the bigger the loan, the bigger the subsidy—it has proved to be effective not only in stimulating mortgage loan activity in Panama, but also in creating a mortgage stock that is fully securitizable and attractive to the capital market. In other words, a product has been created in the primary mortgage market for the establishment of linkages with the capital market, in order to channel long-term resources to housing finance. In fact, in Panama a high proportion of the underlying assets in the issue of mortgage-backed securities is represented by loans originated under the Act on Preferential Interest Rates.

Another form of State intervention is the allocation of subsidies to financial institutions to cover the proportionately higher fixed costs they incur in granting and administering small mortgages. Although this mechanism should theoretically promote a greater availability of small mortgages for creditworthy families, it has only been applied in Chile, and for a short time. It is one of the innovations being applied under the new Chilean housing policy since early 2002, with a view to stimulating greater participation by private lenders in mortgage loans to supplement direct housing subsidies and also to relieve the State of the task of granting and administering small loans, in which it has a poor record. Low-income Chilean families have had limited access to the housing credit options offered in the market.¹³ In this situation, the State has acted, in practice, as an active mortgage lender for low-income segments that qualify for the Basic Housing Program of the Ministry of Housing and Urban Development (MINVU). Authors such as Pardo (1998) and Rojas (1999) found that the State's performance in this area was considered highly unsatisfactory. It is estimated that even after many renegotiations, more than 60% of the Ministry's mortgage portfolio includes more than three overdue payments, and default represents virtually three quarters of hidden subsidies.¹⁴

Furthermore, Latin American experience shows that State guarantees aimed at partially covering the credit risk involved in home mortgages may stimulate the participation of private-sector financial institutions. This type of guarantee is generally linked to State housing funds. In Mexico, SHF gives financial

¹³ See Rojas and Greene (1995, pp. 31-49).

¹⁴ See (Almarza (2000, pp. 237-257). Note that in Chile, beginning in 2002, an incentive policy has been applied to reduce past due indebtedness, which has had considerable success.

intermediaries a guarantee against borrower default; if the borrower fails to pay, SHF covers the first loss for up to 25% of the unpaid debt, for which it charges a premium. Likewise, financial intermediaries operating with the *Fondo Mivivienda* in Peru receive credit risk coverage amounting to one third of the loan, being in addition a subordinated coverage (that is, the bank recovers its first two thirds, and the *Fondo Mivivienda* recovers the remaining third). Accordingly, as is being done in some countries, the possibility of establishing mortgage insurance in the region more widely should be explored, to protect lenders against potential losses as a result of default, on the one hand, and to enable borrowers to obtain mortgage loans with a lower down payment, on the other.

The proper management of inflation-indexed mortgages, or in some countries dollarized mortgages, given the intrinsic long-term horizon of mortgage loans, entails the requirement of ensuring adequate protection of the borrower's capacity to pay throughout the term of the loan. Thus it will also be important for the State to establish some kind of mechanism to compensate for any borrower's inability to pay resulting from the lag of wages behind inflation, where the latter is the indexation factor, or devaluation, where the loans are dollarized.

Since 1999, a type of mortgage has been used in Mexico with a guarantee against systemic risk that covers a possible sudden or permanent collapse in the minimum real wage, enabling borrowers to pay, in minimum wage terms, a mortgage denominated in investment units (UDI).¹⁵ The instrument devised to ensure that loan payments increase only in proportion to the minimum wage, even though the loan is denominated in investment units, is a swap, currently offered by SHF (formerly offered by FOVI) through the financial intermediaries. The cost of coverage is shared between the borrower and the Federal Government: the former pays a premium of 71 base points, which is combined with a bank line of credit backed by the Federal Government, creating a fund to cover temporary shortages of funds and guard against deep recessions.¹⁶ This fund is designed to withstand a real deterioration in wages of 25% for up to 30 years. If the deterioration is greater, SHF will have losses; if less, the fund will see a profit. This is a practical example

that combines State participation with the beneficiaries' commitment to sharing the cost of this type of insurance, adding a premium to the interest rate paid by the borrower.

Another step the State could take in order to promote the operation of a deeper mortgage market would be to act as a second-tier bank. Latin American experience reveals the ineffectiveness of the State as a direct lender: available funds have not reached the neediest population, and the coverage of these loans has not been very successful. On the other hand, the institutional schemes of second-tier banks, which exist in a number of countries in the region (Costa Rica, Ecuador, Mexico and Peru, among others), may be more efficient instruments for procuring resources for loan originators and stimulating the formation and consolidation of a housing finance market.

In Costa Rica, the Banco Hipotecario de la Vivienda (BANHVI) is a publicly-owned financial institution which acts as the leading agency for the National Housing Finance System (SFNV) as a second-tier bank. The strategy used in setting up SFNV was to combine a subsidy with an increased ability to purchase mortgages on the part of BANHVI, so that the financial intermediaries could commit themselves to substantial financing operations, thereby mitigating potential problems of liquidity and mismatch of maturities. In the first years of SFNV, the mortgage discount capacity of BANHVI not only represented one of the biggest sources of funds for savings and loan associations, but also accounted for a good part of the strength of the system.¹⁷ In the 1990s, however, funds became more scarce, and for nearly a decade BANHVI has virtually discontinued the use of this mechanism, making it more difficult to stimulate loan activity, especially for creditworthy sectors already receiving the subsidy.

For its part, the Banco Ecuatoriano de la Vivienda [Ecuadorian Housing Bank] (BEV) was restructured in 1998 and converted into a second-tier bank, geared to supporting the building and financing of housing by refinancing the mortgage portfolios of private-sector financial institutions, but no longer having a direct relationship with the final beneficiaries. After performing these functions for some years, BEV, as a second-tier bank, must now face the challenge of expanding its rediscount operations and reducing costs

¹⁵ The investment unit (UDI) is a unit of account whose value is estimated by the Bank of Mexico (the country's central bank) and is adjusted daily according to inflation.

¹⁶ See Zepeda (2000, pp. 30-35).

¹⁷ From 1989 to 1992, BANHVI completed an annual average of more than 7,000 mortgage rediscount operations. See Zawadzki (1994, p. 40).

in order to become a source of funding capable of increasing the supply of mortgage credit.

In Mexico, SHF handles several credit products, acting as second-tier mortgage lender. These include lines of credit to financial intermediaries for housing purchase, although this scheme will expire in a few years. After the “tequila crisis” in 1994-1995, the so-called *sociedades financieras de objeto limitado* (SOFOL), or specialized financial institutions, began to play an important role as mortgage institutions; today they channel nearly 96% of the funds granted by SHF, and also handle markets that previously had no access to mortgage loans from private financial intermediaries.¹⁸ Note that, under the law creating it, SHF will retain the authority to grant loans only until 12 October 2009, after which it may influence the market only through the granting of guarantees. One function that SHF can perform (which its predecessor, FOVI, could not) is to help the SOFOLES finance themselves directly, through bank lines of credit or through the securities market, backed by a guarantee of timely payment granted by SHF.

This role as a second-tier lender entails, for example, the extension of lines of credit, including the contracting of external credits, a mortgage rediscount mechanism and the issue of mortgage securities in the capital market. Through this mechanism, it is generally possible to make a certain amount of funds available to the mortgage market on more favourable terms—in respect of maturities and cost—not only providing incentive to the participation of private lenders but also, in principle, reaching segments of the population with a more limited capacity to pay.

In addition to the above-mentioned ways of arranging for the State to act as a second-tier bank, as being practised to a greater or lesser extent in a number of countries in the region, the trend towards the creation of secondary mortgage markets—which is crucial, as we have seen, for ensuring the transformation of maturities required for housing finance—also expands State participation as a catalyst of the housing finance market. Many years ago, for example, the State played an important role in Chile as a market maker in the negotiation of mortgage securities. In the case of mortgage-backed securities, the State’s actions may be crucial in promoting standardization in the primary mortgage market on the basis of incentives to encourage originators and other participating agents to meet

certain standards that will help to create a stock of securitizable mortgages. For example, since 1998 the Central Bank of the Argentine Republic has been encouraging the financial intermediaries to use a standardized contract to originate mortgages, while in Mexico, SHF, acting as guarantee provider, is promoting standardization of both documents and procedures for originating and collecting mortgage loans.

The provision of State guarantees supporting the issue of mortgage-backed securities and bonds, especially those including mortgages for low-income borrowers, may help to improve the creditworthiness of these instruments. In Colombia, this is the purpose of Titularizadora Colombiana, a secondary mortgage market institution; in Mexico, a prime role is assigned to SHF as an insurance provider for mortgage-backed issues; and in Peru, the fundamental law of the *Fondo Mivivienda* was amended to permit it to guarantee mortgage-related securities issued or managed by financial institutions or securitization companies.

Since the housing deficit in the low-income sectors is often qualitative in nature, these sectors accord high priority to improving existing housing. Housing finance needs are thus related to smaller loans on shorter terms, which do not necessarily have a mortgage as collateral. Accordingly, it may be helpful to promote micro-finance options that can be used to meet this type of credit needs. In the Dominican Republic, for example, some initiatives for granting micro-credits have emerged, administered by savings and loan associations, to improve housing in low-income neighbourhoods. In addition, the Banco Nacional de Fomento de la Vivienda y la Producción [National Housing and Industrial Development Bank] (BNV) has established a micro-finance fund to improve and expand housing, whose funds will be channelled through non-governmental organizations that promote micro-credit, and through grassroots groups. The soundness of the financing will be based on managed, ongoing supervision, rather than on the existence of real guarantees; finance programmes will be offered to improve and repair housing, and hence small loans will be provided (US\$ 1,500 to US\$ 2,000 on average). Managed and cooperative self-construction housing schemes will also be promoted, operating on market terms, so that the existing resources in the formal sector can be applied in the informal sector. Although experiences of this type are still in the early stages in the Dominican Republic, and in general in the region, the financial product described has an enormous market potential; moreover, because these are short- and

¹⁸ See Obregón (2001, pp. 49-56).

medium-term loans, there may be a better correspondence between the traditional modalities for raising and lending funds, and because there has been prior investment in a housing, the debt ratio is more favourable, if the property serves as collateral.

Finally, with the continuing aim of making housing loans more accessible to the low-income population, it is important to design products to stimulate prior saving for housing through the financial system in order to expand the base of potential borrowers by incorporating groups that are traditionally rejected because of their inability to demonstrate a steady income. In Chile, for example, the requirement of prior saving in order to qualify for a State subsidy

has been a powerful tool in creating a significant volume of financial savings in small amounts. In Mexico, through regular savings plans, a financial history can be built that will allow the families involved to demonstrate their credit eligibility and, at the same time, make a down payment on the loan that will later be approved. More recently, in Peru, similar savings programmes have been set up as a prerequisite for applying for direct subsidy programs and supplementary loans. These programmes not only help to identify but also to “qualify” borrowers. In this way, a wide segment of the self-employed population, which represents a significant portion of the potential demand for housing, may be attracted to the mortgage market.

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Spatial segregation, employment and poverty in Montevideo

Rubén Kaztman and Alejandro Retamoso

This article looks at two processes that are affecting the characteristics of poverty in the city of Montevideo: the weakening of lower-skilled workers' attachments to the labour market and the growing concentration of such workers in neighbourhoods with a high density of poverty. While far from conclusive, the results suggest the advisability of further research into the relationship between changes in the social morphology of cities and the segmentation of their labour markets. If further research confirms both a tendency towards growing polarization in the spatial distribution of social classes in cities and the presence of feedback mechanisms reinforcing the social isolation of residents in the most disadvantaged neighbourhoods, it will be safe to say that these processes, if not effectively countered, will irreversibly widen the already excessive inequalities that affect large Latin American cities.

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I

Introduction: employment, spatial concentration and the entrenchment of urban poverty

Among Latin American cities, Montevideo has been distinguished by its relatively low levels of inequality and poverty. This record was badly tarnished during the period of military government, but for a decade after 1985, when democracy was restored, the social structure of the city moved back towards what it had been in the past. In particular, the percentage of households below the poverty line declined continuously (figure 1).

In the mid-1990s, however, this trend was reversed. From then until 2001 the poverty indices rose slightly, and then the financial crisis of 2002 triggered a sharp increase. The result was that by 2003 about a fifth of households in the Uruguayan capital were poor.

The current rise in poverty has been associated with a significant change in its characteristics. There has been a marked weakening of the attachments that the less skilled are able to forge with the labour market, as manifested by high unemployment, insecure and substandard working conditions and low pay, while the gap between such workers and the higher-skilled has widened in all these respects (Kaztman, 2002; Amarante, Arim and Vigorito, 2004). Since these tendencies derive from key aspects of the new accumulation pattern, they indicate that poor households will find it increasingly difficult to move out of poverty.

Numerous studies carried out in Uruguay show that most of the variations in the levels and composition of poverty are due to changes in the labour market.¹ Without ignoring the strength of this causal relationship, the results of a number of recent research projects suggest that it would be wise to broaden the framework of interpretation to include the profound changes affecting the social fabric of the city. These changes, while less visible than those in the labour market, are weakening the mechanisms that can be

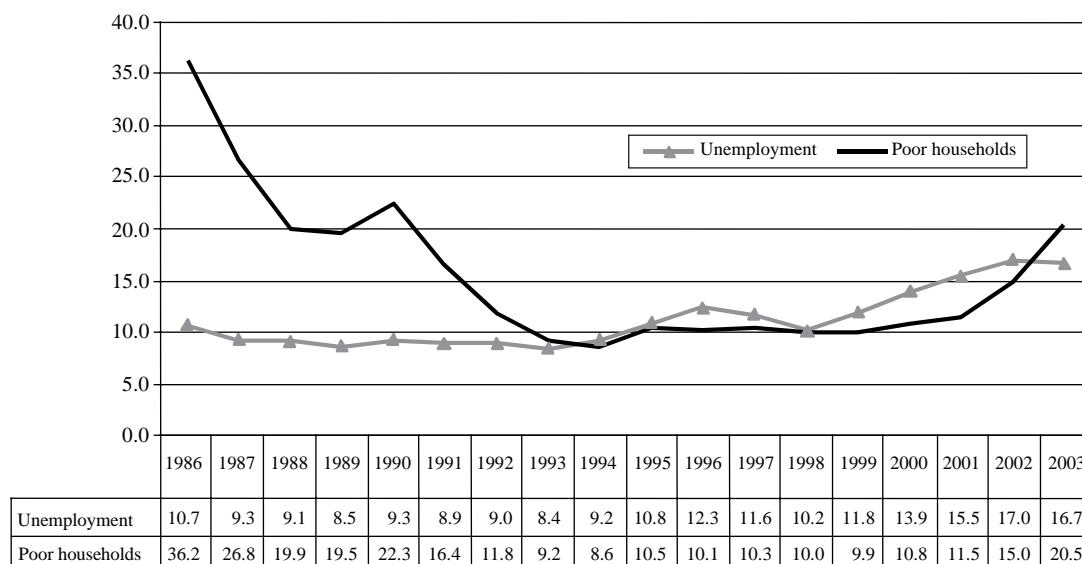
credited with enabling many households to escape from poverty over the course of the twentieth century. The changes referred to are growing segmentation in the quality of the services (health, education, housing) available to the different social classes, and the increasing concentration of poor households in urban areas.

The latter phenomenon is attracting the attention of the social sciences in the region. Building on a tradition initiated by a seminal article of Park's (1926), there is a growing interest in systematic exploration of the ways urban poverty is hardened and perpetuated by spatial concentration.² This "residential segregation" approach, which has given rise to a large number of academic studies, attaches great importance to the effect that the social environment of residential areas has on the prospects of poor households and individuals improving their living conditions. Neighbourhoods are seen as ecological contexts that intervene between people and the most important sources of physical, social and human assets in the market, the State and the community. This takes place in two main ways. Firstly, through a progressive narrowing of the spheres of interaction with other social classes, and secondly, through a widening of the differences between poor neighbourhoods and the other parts of a city, in terms of the quality of services and institutions. According to this approach, living in neighbourhoods with a high concentration of poverty creates large additional disadvantages on top of those that, in production structures that are increasingly organized around knowledge, derive from the low relative skills of residents.

¹ The outcome of the 1989 plebiscite on the index-linking of pensions also had a major impact on the poverty trend. The plebiscite resulted in the passing of a constitutional amendment index-linking payments to retirees to quarterly wage increases, application of which has resulted in large rises in pensions.

² As well as making very valuable contributions to the measurement of residential segregation in the Latin American countries, a recent paper by Rodríguez and Arriagada (2004) provides a detailed review of studies dealing with this issue in Latin America and identifies the most promising lines of research for future progress in this area. Jencks and Mayer (1990) and Sampson, Morenoff and Gannon-Rowley (2002) offer an exhaustive review of the United States literature dealing with neighbourhood effects on different types of behaviour.

FIGURE 1

Montevideo: Unemployment and percentage of households below the poverty line, 1986-2003

Source: Prepared by the authors using data from the Uruguayan National Institute of Statistics (INE).

While it is too soon to reach firm conclusions, the results of the studies undertaken using this approach are enough to show that by considering labour market changes in conjunction with the spatial segregation of social classes, a better understanding can be reached both of the changes that are occurring in the nature of urban poverty and of some central aspects of inequity in urban social structures.

The following sections of this article will look at the evidence now available on the tendency towards spatial concentration of the poor in Montevideo. It will touch on the results of studies dealing with employment and, in particular, with changes in the situation of the least skilled in the labour market. It will analyse the relationship between the two phenomena,

emphasizing the less studied and less well known side of this, namely neighbourhood effects on residents' labour market attachments. Lastly, it will draw some conclusions about the role that segregation may be playing in the prospects for achieving higher levels of equity in the social structure of the city.

Since the concern of this study is to examine and discuss long-term structural processes, we have sought to avoid periods clearly affected by particular crisis situations like the one that Uruguay underwent in the closing years of the last century and, particularly, the one that was triggered in early 2002. For this reason, the body of evidence that will be used to test the consistency of the conceptual framework adopted will be limited to the final decade of the twentieth century.

II

Spatial segregation in Montevideo

The tables that follow draw on various indices to show the changes affecting the spatial distribution of social classes in Montevideo between the 1980s and the 1990s. Table 1 reveals a significant increase in homogeneity in

the social composition of neighbourhoods, something that is reflected in the Duncan indices of residential segregation and dissimilarity for households as classified by different social status and living condition

variables.³ A rising geographical concentration of people with similar living conditions is observed in indicators of household income, educational level, employment and occupational status of household heads. These results are consistent with other measurements (Kaztman, 1999; Pellegrino, Macadar and others, 2002).

Although poverty was reduced significantly in all areas of Montevideo during the 1980s and 1990s, during that period the tendency for low-income families to concentrate in the poorest neighbourhoods was greatly accentuated. Thus, as table 2 shows, in the three most deprived zones (or groups of neighbourhoods) in the city, concentration rose from 65% of the city's poor residents to 78%, and from 78% of its indigent residents to 84%. At the same time, these neighbourhoods, which are on the outskirts of the city, also increased their share of the total population.

The conclusion that can be drawn from table 3 is that the neighbourhoods which displayed higher demographic growth were those with a lower initial density, and that this development was mainly due to movements from the central to the peripheral areas of the city. Here, attention should be drawn to the large increase in informal settlements which, while they started to emerge with the economic crises of the 1970s and 1980s, really began to expand with the return of democracy in 1985.

The picture is completed by the data of table 4, which show that the neighbourhoods gaining population were the very ones that displayed the most disadvantageous social characteristics, i.e., a high density of needy households and a large incidence of risk factors. At the same time, there were also population shifts among the middle and higher classes towards the neighbourhoods in the east of the city. As the physical distance between the classes thus increased, Montevideo began to display a level of spatial segregation already familiar to other large Latin American cities.

³ The Duncan dissimilarity index is a synthetic indicator of the relationship between the composition of territorial subunits (social, workforce, racial, etc.) and the social composition of the larger territorial unit (city or urban conglomeration). If the two differ in composition then residential segregation exists, since the distribution of social groups among the territorial subunits is out of line with their representation in the city or larger conglomeration as a whole. The measurement ranges from 0 (zero segregation) to 100 (total segregation where no subunit has a mixed composition). However, the residential segregation index used in this study indicates the proportion of the total variance accounted for by the variance between territorial subunits.

1. What is new about today's urban residential segregation?

Despite the tendencies referred to, it could be argued that in the history of Montevideo during the twentieth century there were always clear differences in the location of social classes within the city. At least three possible objections can be made to this argument, and they relate to both the quantitative and the qualitative dimensions of the phenomenon.

The first objection stresses differences in the extent of the phenomenon and the implications that its intensification has for homogeneity in the social composition of neighbourhoods. In other words, without denying that spatial segregation already existed in the city, the point made is that this segregation is now much more marked than formerly.

The second objection is based on the fact that residents in the uniformly poor neighbourhoods of the city are now less integrated with the rest of urban society than in the recent past, when their attachments to the labour market were stronger, more stable and better protected and they more closely resembled what Castel called "the salaried society". In Montevideo, in fact, neighbourhoods with a high density of industrial workers were quite homogeneous in their composition. But that was a "virtuous" homogeneity in which there was a harmony between neighbourhood life and the world of the factory, as manifested by a local sociability and institutional density that strengthened the bonds of solidarity forged in both. In the new types of poor neighbourhood, by contrast, the greater fragility of occupational attachments and the greater density of need resulting from this are restricting both the formation of reciprocity networks and the opportunities for creating and maintaining home-grown neighbourhood institutions, all of which tends to weaken the social fabric of the community.

The third objection has to do with disparities in the frame of reference that residents of poor neighbourhoods use to evaluate their situation. The makeshift households that were established on the outskirts of the city in the 1950s were the result of population movements from the countryside or small towns. Many migrants underwent this change in the expectation of improving their quality of life, both through the symbolic conquest of urban citizenship and actual access to a far greater variety of consumption and services than were available in their places of origin, and through the employment opportunities offered at that time by the growth of domestic markets,

TABLE 1

Montevideo: Residential segregation index (RSI) and neighbourhood dissimilarity index

Variable	Indicator	1986-1987-1988	1996-1997-1998	Relative variation (%)
Per capita household income	RSI	16.36	21.94	34
Per capita household earnings	RSI	14.49	18.43	27
Average education of over-26s, by household	RSI	21.69	26.02	20
Households with head in high-status employment	Dissimilarity	32%	35%	10
Unemployment	Dissimilarity	9%	13%	39
Own-account without premises (non-professionals)	Dissimilarity	13%	17%	28

Source: Cervini and Gallo (2001), based on the Continuous Household Survey (ECH) carried out by the National Institute of Statistics (INE).

TABLE 2

Montevideo, groups of neighbourhoods: Incidence of poverty in the population and contribution to total poverty, indigence and population

Groups of neighbourhoods ^a	Incidence of poverty in the population of each neighbourhood ^b		Contribution of groups of neighbourhoods to total poverty in Montevideo ^b		Contribution of groups of neighbourhoods to total indigence in Montevideo ^b		Contribution of groups of neighbourhoods to total population in Montevideo ^c	
	1986-88	1995-97	1986-88	1995-97	1986-88	1995-97	1985	1996
<i>Total</i>	<i>34.5</i>	<i>15.8</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>
1 (No. = 3)	66.7	45.0	9.4	14.2	14.1	21.4	4.8	6.5
2 (No. = 12)	58.4	31.6	25.7	33.2	33.3	36.4	15.9	17.4
3 (No. = 14)	45.7	20.4	30.5	30.8	30.4	25.9	23.2	23.6
4 (No. = 15)	29.1	9.7	20.2	13.2	14.4	7.9	22.3	20.6
5 (No. = 7)	23.1	6.7	6.8	4.5	3.7	2.8	10.4	9.8
6 (No. = 6)	14.7	4.0	5.3	3.1	3.2	3.9	12.8	11.7
7 (No. = 3)	8.4	1.6	1.8	0.8	0.5	1.0	7.7	7.4
8 (No. = 2)	4.5	1.3	0.4	0.2	0.5	0.7	3.0	3.0
Neighbourhoods in groups 1, 2 and 3	52.5	27.2	65.5	78.2	77.7	83.7	43.9	47.5

Source: Cervini and Gallo (2001), based on the INE Continuous Household Survey.

^a Neighbourhoods grouped using the cluster multivariate method on the basis of household per capita income, the proportion of adults completing secondary education and the percentage of people with Ministry of Public Health medical coverage.

^b Prepared by the authors using data from the INE Continuous Household Survey.

^c Prepared by the authors using INE (1998) data.

TABLE 3

Montevideo: Neighbourhood structures in 1996, by population changes between the 1985 and 1996 censuses and average population density in each neighbourhood^a

Type of neighbourhood by population change between censuses (1985-1996)	Average population density of neighbourhood			
	Low	Medium	High	Total
Losing population	9.1	20.0	75.0	33.9
Stable	9.1	60.0	20.0	29.0
Gaining population	81.8	20.0	5.0	37.1
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>
<i>Total neighbourhoods</i>	<i>22</i>	<i>20</i>	<i>20</i>	<i>62</i>

Source: Prepared by the authors using INE (1998) data.

^a Rates of change between 1985 and 1996 censuses: neighbourhoods losing population, below -4%; stable neighbourhoods, between -4% and +3%; neighbourhoods gaining population, over +3%. Gross population density in 1996: density is considered low up to 6,000 inhabs./km², medium from 6,000 to 10,000 inhabs./km² and high over 10,000 inhabs./km².

TABLE 4

Montevideo: Percentage breakdown of neighbourhoods by population changes between censuses,^a social composition and risk situations index, 1996

Neighbourhoods	Losing population	Stable	Gaining population	Total
<i>Social composition of neighbourhood</i>				
Low	4.8	22.2	69.6	33.9
Medium	38.1	38.9	21.7	32.3
High	57.1	38.9	8.7	33.9
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>
<i>Social risk index of neighbourhood</i>				
Low	57.1	38.9	4.3	32.3
Medium	33.3	44.4	26.1	33.9
High	9.5	16.7	69.6	33.9
<i>Total</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>	<i>100.0</i>
No.	21	18	23	62

Source: Prepared by the authors on the basis of Kaztman (1999), using data from the seventh General Population Census (INE, 1998).

^a Rates of change between the 1985 and 1996 censuses are used to distinguish between neighbourhoods that are losing population (below -4%), stable (between -4% and +3%) and gaining population (over +3%). The social composition of neighbourhoods is measured using the percentage of high-status occupations (professionals, managers, technical workers, etc.), and the risk index is calculated as the standardized sum of risk indicators (teenage motherhood, educational deficiency and young people not studying, working or seeking work).

whose ability to absorb labour, stimulated by import substitution and the expansion of the State apparatus, kept open important avenues of social mobility.

The little information available about the formation of poor neighbourhoods since the 1980s yields a different picture. First, the population concerned has mainly been urban in origin, moving from other parts of the city of Montevideo itself.⁴ In other words, if the formation of marginal settlements in the mid-twentieth century was driven by the strong pull of cities, since the 1980s it is mainly expulsion processes that have been at work. Secondly, if what characterized the situation confronting the urban poor in the 1950s was the widening of channels of mobility, the most prominent feature of today's situation is the narrowing of those channels. Thirdly, the increasing

⁴ Even in 1984 most residents of these settlements (93.5%) had been born in urban areas, three quarters of them in Montevideo itself (Cecilio, 1996).

territorial concentration of the poor has been paralleled by the movement of the upper-middle and upper classes to exclusive neighbourhoods, some of which have adopted the gated community model (Álvarez, 2004). As the same author stresses, however, the phenomenon of exclusive neighbourhoods is far smaller in scale in Montevideo than in other large cities of the Southern Cone, such as São Paulo (Caldeira, 2000) and Buenos Aires (Svampa, 2002). In fact, according to Álvarez, in 2003 there were only 10 gated communities in Greater Montevideo, housing 315 families.⁵ In other words, without seeking to deny the contribution of the new exclusive neighbourhoods to the recent tendency towards urban fragmentation, it can be said that this contribution has been much slighter in Montevideo than in other South American cities. Lastly, the heterogeneity that still exists in some lower or lower-middle class neighbourhoods has been affected by the departure of better-off families seeking to avoid the risks associated with rising tensions and insecurity in these areas.⁶ All these movements have contributed to the fragmentation of the urban social fabric as a whole.

In sum, the processes currently giving rise to the spatial concentration of poverty in Montevideo are more likely than those of the past to generate situations of isolation between classes and of vulnerability to social exclusion.

2. Why has the social composition of poor neighbourhoods in Montevideo become more homogeneous?

Historically, many cities that have experienced significant spatial concentration of poverty have previously displayed considerable increases in urban density and in the social mobility of their populations. These two processes, accentuated by an expansion of transport and communications that facilitates the separation of the home and workplace, are usually associated with a widening of land price differentials between the different areas of the city, and with the development of a real-estate logic that distributes the

⁵ As compared to 434 gated communities inhabited by 13,500 families in Greater Buenos Aires in 2000, according to Svampa (2002).

⁶ Interviews carried out as part of a study examining the resources available to low-income urban families for dealing with critical situations (Zaffaroni, 1999) document cases where households have moved away from particular neighbourhoods to "flee" what they perceive as grave conditions of insecurity.

population around the urban space in accordance with income.

Despite the evidence of a significant rise in the spatial concentration of the poor, Montevideo has not displayed either of these characteristics. When developments there since the mid-twentieth century are compared with those in other cities of the region, it is striking how little its population has grown. Nonetheless, a number of studies —Lombardi (1989), Retamoso (1999), Kaztman, Corbo and others (2003)— have shown that beneath the apparent calm of the city's demographic dynamic there have been massive population movements, particularly in the last 20 years, most of them from the centre of the city to its outskirts.⁷ Again, there is no evidence for significant upward social mobility. What little information is available on this seems rather to indicate an alternation between periods of immobility in the social structure and periods of downward mobility for large segments of the middle classes.

In the view of the authors, the likeliest explanation for the increased spatial concentration of the poor in Montevideo involves at least three factors: insufficient demand for low-skilled labour, liberalization of the rental market, and the retrenchment of public housing policies at a time when social spending is increasingly absorbed by pension payments.⁸ The combination of

these forces has driven many families to seek solutions for their housing problems on the cheapest urban land, or simply to occupy land and build makeshift dwellings on it.

Concerning the demand for low-skilled labour, it can be argued that general constraints on labour absorption capacity are nothing new in Uruguay. Even by the closing stages of the import substitution period, what was termed the “dynamic insufficiency of the economy” was something to which specialists in these subjects were pointing with concern. Thus, the new feature introduced by the recent widening of the country's competitiveness frontiers and the rapid shift towards technology use has been a worsening both of dynamic insufficiencies already existing in the market and of the gap between the employment situations of the skilled and unskilled.

In these circumstances, the deregulation of rents has placed a growing proportion of the unskilled in a situation where they are unable to pay their rent or find people prepared to stand surety for their letting contracts, which in any case are not certain to be honoured. As early as 1994, a study warned that irregular settlements were expanding strongly and that a significant proportion of their inhabitants came from “houses or apartments”, which led the authors to surmise that land occupation came to be seen as an option when it proved impossible to carry on living in homes in the “formal” market, a situation that appeared to be particularly prevalent in the case of young, recently formed households (Cecilio, 1996).

In sum, given existing housing policies, different ground rents and the forms taken by real-estate speculation, the processes referred to have produced a progressive shift of poor families to the cheapest neighbourhoods in the city or, in the case of settlements, to cost-free land occupation. In relation to this, the literature on the subject in Uruguay is united in asserting that the most important single factor behind the current level of residential segregation in Montevideo has been the pauperization and occupational instability affecting a large number of wage earners.

⁷ “In the midst of this polarization there are, however, counter-currents in the location of the most vulnerable households. The empirical studies by Mazzei and Veiga (1985a, 1985b and 1986) in the mid-1980s found that some informal settlements were not distributed in rings around the city but tended to be enclaves close to the places where work was available. These enclaves are either located close to rich neighbourhoods, or use poor-quality housing in city centre areas (Portes, 1989). The determining factor that these two types of residential location have in common is their proximity to places where work is created. However, the survival of location patterns oriented by service-related work opportunities is threatened by a property development logic which, driven by changes in urban land prices, is tending to displace the poorest from higher-density areas and from the vicinity of residential areas” (Kaztman, 1999).

⁸ The general attitude of the political system towards land occupation must also be regarded as one of the factors giving rise to the rapid growth of irregular settlements in Montevideo.

III

Employment trends

As in other cities, the new poverty in Montevideo largely derives from what is now regarded as one of the dominant features of modern labour markets, the weakness of their attachments with the low-skilled. During the import substitution period, these attachments were solid enough for a significant proportion of workers, particularly those who entered what were then emerging industries, to be able to plan their lives, construct their identities and build reasonable expectations of social mobility around their work.⁹

These prospects and plans are usually unviable now. Some figures encapsulate the changes in the labour market that support this statement. Between 1970 and 1999, the State almost halved (from 28% to 16%) its presence in that market. Something similar happened with industry, which employed 32% of the workforce in 1970 but only 16% in 2002. At the same time, the female economically active population (EAP) greatly increased, raising its participation rate from 27.5% to 52.5% over those 30 years in a context of poor job creation, thus contributing to higher unemployment, poorer working conditions and lower wages. Beginning in 1980, well-capitalized businesses came to the fore in trade and services, displacing significant numbers of semi-formal small business owners who had been the backbone of a substantial self-employed middle class. From the second half of the 1990s onward, there was also a rise in the number of recurrent short-term crises.

The processes summarized here led to higher joblessness and increasingly to the unstable, substandard and unproductive employment that characterizes the

informal sector, the result being an ever-widening gap between less and more highly skilled workers (Katzman, Corbo and others, 2003; UNDP, 2001).¹⁰

These characteristics of employment are the single most important factor not only behind the persistence of poverty in the current generation, but also behind the reinforcement of the mechanisms that reproduce it between generations. This is because adults who do not have the capabilities and skills needed to stay clear of unstable, substandard employment will hardly be in a position to transfer to their children the physical, human and social capital these will need to develop fully in post-industrial societies.

Given their strong impact on the characteristics of the urban poor, it is worth looking a little more closely at industrial developments in Montevideo. The city has not only shared in the general decline of industry across the country, but has been losing its supremacy. Whereas in 1960 it was responsible for 78% of gross industrial output, by the early 1990s the figure was 60% (Becker, Jager and Raza, 2001). This twofold process—general industrial decline and the loss of supremacy—has severely affected the employment capacity of factories that, sited in different areas of the capital, used to recruit mainly in their immediate neighbourhoods. This pattern of recruitment favoured the formation of dense networks of relationships between families, local residents and work colleagues.¹¹ With the decline of the import substitution model, many industries closed their doors, stable jobs like those in the public sector became scarcer and Montevideo lost some of its former industrial supremacy.

⁹ Much of the social integration that used to be the rule in Uruguay was based on the nature of the so-called import substitution model, which was the result of an alliance extending to about 80% of the population and resting on an anti-Schumpeterian triangle between the State, the protected industrial bourgeoisie and their workers.

¹⁰ It could be retorted that the employment crisis, and the resultant increase in uncertainty as regards well-being, have affected all social

strata. It is unquestionably true, though, that those who have accrued more human capital are better placed than the rest to take advantage of the opportunities offered by a production structure that is increasingly knowledge-based and is incorporating technological innovations with greater and greater rapidity.

¹¹ The stability of factory employment also encouraged workers to set up home near their workplaces.

IV

Residential and occupational segregation

In any attempt to identify relationships between contextual characteristics (segregated neighbourhoods) and individual ones (employment situation, poor working conditions) it is advisable to keep a critical eye on the direction of causality, without losing sight of the possibility of movement in the opposite direction, where the supposed causes are affected by the supposed consequences. In the case of the relationships between a person's employment situation and the location of his or her home, the line of causality most often examined is that posited by the assumption that those with the greatest problems in the labour market are most likely to take up residence in the poorest neighbourhoods. Because this association is so reasonable, it cannot be surprising if the concentration of low-skilled populations in certain neighbourhoods is usually interpreted rather as a consequence than as a cause of what happens to people in the labour market.

The evidence provided by studies looking at the rapid growth of irregular settlements on the outskirts of the city of Montevideo backs up this interpretation. These studies report that the inability to pay rents, find surety for letting contracts or, in some cases, pay the taxes on small properties are the most important single reasons for the mass displacement of young families from relatively central areas of the city to more outlying ones. This displacement, which increases the territorial concentration of poverty, is compounded by rising homogenization in the social composition of outlying neighbourhoods due to the growing employment difficulties faced by established residents of these areas.

But even admitting that employment opportunities are a major cause both of displacements towards neighbourhoods where the poor are concentrated and of the "new" impoverishment of their existing residents, it must also be recognized that, once people are established or remain in these areas of more concentrated and homogeneous poverty, any attachments they have to the labour market will be affected by factors and processes characteristic of surroundings where there is a high density of need. The effects of the context of residence will show themselves more clearly in the generations that are socialized in these areas, for whom the neighbourhood influence clearly precedes their efforts to enter the labour market.

The tables that follow show the distribution of certain substantive indicators of instability (the

unemployment rate), informal working (own-account work) and substandard working conditions (lack of health coverage) affecting residents of different census blocks in Montevideo in accordance with their social composition. Given that the census does not ask about household income, the operational definition of the social composition of census blocks was based on the average educational level of the households living in them.¹² The data are from the 1996 population and housing census, and thus cover the entire economically active population of the city.

Table 5 shows the unemployment rate, used in this case as a proxy variable for instability of employment, for the Montevideo census blocks classified into three categories by the percentage of low-education households. The information is broken down by residents' age, sex and years of education.

The table shows that the behaviour of unemployment has a systematic inverse relationship with the average education levels used to characterize the social composition of census blocks, and that this holds true irrespective of the sex, age and education of individuals.¹³

Similar considerations arise from tables 6 and 7. The purpose of these is to estimate the distribution between neighbourhoods of informal activity (using own-account working as a proxy) and of substandard working conditions (the lack of legally mandated health protection). Controlling by individuals' education level offers a way, albeit an imperfect one, of testing the causal effect that context may have on individuals. Regardless of how they are ultimately interpreted,

¹² This indicator was constructed in two stages. In the first, a calculation was made for each census block of the percentage of households with a low educational level, this classification being applied to households where the average number of years' schooling of members aged over 18 did not exceed the equivalent of incomplete primary education (less than six years of education). In the second stage, once the city's 1,032 census blocks had been ranked by the percentage of households with a low level of education, the distribution was divided into deciles. The deciles were then grouped into three categories. The "low education context" includes the 30% of deciles with the highest percentage of low-education households, the "medium education context" covers the four intermediate deciles, and the "high education context" covers the 30% of deciles with the fewest low-education households.

¹³ Note that the intervals between the years of individual education are small enough to minimize the possibility of the dependent variable being affected by variations within each interval.

TABLE 5

Montevideo: Unemployment rate by educational context of census block and by residents' age, sex and education, 1996

Age and education		Educational context of census block								
		Low			Medium			High		
Age	Education	Male	Female	Total	Male	Female	Total	Male	Female	Total
15 to 29	Incomplete primary	22.8	39.0	27.0	22.2	33.4	25.6	17.6	24.1	19.7
	Complete primary	21.6	33.7	25.3	23.5	32.3	26.2	19.1	26.9	21.6
	7 and 8 years	19.6	29.9	23.5	20.2	26.6	22.7	17.5	21.5	19.0
	9 and 10 years	17.2	24.3	20.3	16.0	22.6	19.0	15.2	19.4	17.1
	11 years	15.6	20.9	18.2	13.4	20.5	16.8	13.8	17.3	15.5
	12 years plus	12.9	16.3	14.8	13.6	15.6	14.8	12.7	16.1	14.6
	<i>Total</i>		<i>19.6</i>	<i>27.7</i>	<i>22.7</i>	<i>18.1</i>	<i>22.4</i>	<i>20.0</i>	<i>14.7</i>	<i>17.8</i>	16.2
30 plus	Incomplete primary	13.0	16.0	14.1	10.6	13.6	11.8	7.5	9.8	8.5
	Complete primary	11.2	16.9	13.4	10.1	14.3	11.8	7.2	10.0	8.4
	7 and 8 years	11.0	16.0	13.1	9.2	14.3	11.4	6.4	10.1	8.0
	9 and 10 years	8.5	14.0	10.9	7.1	11.3	9.0	5.1	8.8	6.8
	11 years	8.6	11.9	10.1	6.2	9.0	7.6	4.8	7.0	6.0
	12 years plus	7.2	8.4	7.7	4.6	5.2	4.9	2.4	4.2	3.3
	<i>Total</i>		<i>10.7</i>	<i>15.0</i>	<i>12.4</i>	<i>8.0</i>	<i>10.8</i>	<i>9.3</i>	<i>4.3</i>	<i>6.6</i>	5.4
Total	Incomplete primary	15.1	19.4	16.5	12.0	15.1	13.2	8.2	10.5	9.2
	Complete primary	15.0	21.9	17.5	13.7	17.6	15.2	9.7	12.3	10.8
	7 and 8 years	15.2	22.4	18.0	14.0	19.1	16.0	10.8	13.7	11.9
	9 and 10 years	11.9	18.2	14.7	10.1	15.1	12.4	8.3	12.1	10.0
	11 years	11.5	16.0	13.6	8.7	12.9	10.8	7.7	9.9	8.8
	12 years plus	9.0	11.5	10.2	7.1	8.6	7.9	5.1	7.9	6.5
	<i>Total</i>		<i>14.0</i>	<i>19.4</i>	<i>16.1</i>	<i>11.1</i>	<i>14.3</i>	<i>12.5</i>	<i>7.2</i>	<i>9.8</i>	8.5

Source: Prepared by the authors using unpublished data from the *Activos y estructura de oportunidades* project (Kaztman, 1999).

however, the results raise questions like the following: what are the mechanisms that operate so that, for example, people who have completed 11 years of schooling (the only one of the education categories in the table to cover just a single year), whether they are younger or older (and, in the case of unemployment, whether they are men or women), and who live in neighbourhoods whose social composition indicates a high concentration of need, display higher rates of unemployment, higher percentages of own-account working and lower health coverage than people with the same level of schooling who live in different neighbourhoods?

As has just been said, the explanation for these associations is not simple, particularly where the direction of causality is concerned. On the one hand it can be argued that, irrespective of the level of education they have attained, people who are more likely to be unemployed will tend to congregate in the poorest neighbourhoods. The empirical patterns observed will then be interpreted as a selection process implicit in the relationship between the poverty of the neighbourhood and its residents' attachments to the

labour market. According to this view, the most disadvantaged neighbourhoods are the receptacle for the "losers" of the system, those who for one reason or another do not manage to establish a stable, protected and remunerative link with the world of work and who, not having the resources to meet the costs of living in other parts of the city, are forced to move with their families to marginal areas. If this is so, the differences found between the residents of different neighbourhoods should be attributed not to the influence of contexts that socialize or limit opportunities in a differentiated way for those living in them, but simply to the territorial aggregation of those who share experiences of failure in the world of work.

On the other hand, the opposite argument can be made, i.e., that the direction of causality runs from the characteristics of the neighbourhood to its residents' employment situation. Here, it is worth bringing in some empirical information that can show the way to a more accurate interpretation of the relative importance of the two possible lines of causality linking territory and employment. The data in table 8 are given with this end in view.

TABLE 6

Montevideo: Percentage of own-account workers, by educational context of worker's census block and worker's years of education,^a 1996

Worker's education	Educational context of census block			
	Low	Medium	High	Total
Less than 6 years	24.8	23.4	20.5	23.8
6 years	18.9	18.0	16.9	18.3
7 and 8 years	15.5	14.6	12.8	14.6
9 and 10 years	13.5	11.7	8.9	11.2
11 years	10.8	8.6	6.5	8.0
12 years or more	8.5	5.1	3.0	4.1
<i>Total</i>	<i>17.0</i>	<i>12.6</i>	<i>7.1</i>	<i>11.9</i>

Source: Prepared by the authors using unpublished data from the *Activos y estructura de oportunidades* project (Kaztman, 1999).

^a Excludes managers, professionals and technical workers.

TABLE 7

Montevideo: Percentage of private-sector employees lacking medical cover or attended by the Ministry of Public Health,^a by educational context of census block and employee's years of education, 1996

Worker's education	Educational context of census block			
	Low	Medium	High	Total
Less than 6 years	37.5	25.4	18.3	31.0
6 years	34.6	23.7	18.0	28.1
7 and 8 years	27.5	19.1	14.3	21.2
9 and 10 years	18.8	11.1	7.5	11.9
11 years	13.4	7.9	4.9	7.6
12 years or more	11.3	5.7	3.6	5.0
<i>Total</i>	<i>27.6</i>	<i>14.7</i>	<i>7.4</i>	<i>16.2</i>

Source: Prepared by the authors using unpublished data from the *Activos y estructura de oportunidades* project (Kaztman, 1999).

^a Under current legislation, private-sector employees acquire the right to medical care in group medical assistance institutions (IAMC). For employees not to receive such care and to be lacking in medical coverage or attended by the Ministry of Public Health (MSP) suggests they may not be registered in the social security system.

The table shows the situation of young people aged 15 to 19 who are still living in their households of origin and are unaffiliated with institutions like workplaces and educational establishments, crucial to the transition to the adult world. These are young people who are not working, studying or seeking work. For our purposes, what is interesting about this indicator is that the ages of the people concerned make it reasonable to assume that they include a large proportion of adolescents and young people who were born or have been socialized in the neighbourhoods

TABLE 8

Montevideo: Percentage of males aged 15 to 19 still living with their parents who are not studying, working or seeking work, by educational context of census block and household educational level, 1996

Educational level of household	Educational context of census block			
	Low	Medium	High	Total
Up to 6 years	28.2	24.9	19.1	26.3
Over 6 and up to 9	26.2	23.3	16.1	23.1
Over 9	21.9	18.1	12.5	15.5
<i>Total</i>	<i>26.8</i>	<i>22.0</i>	<i>13.8</i>	<i>21.4</i>

Source: Prepared by the authors using unpublished data from the *Activos y estructura de oportunidades* project (Kaztman, 1999).

where they live, and that it was not they themselves who decided to take up residence in those areas. Thus, if it could be shown that these age groups displayed patterns similar to those described above, the line of causality whereby the characteristics of the place of residence are attributed to the problems of labour market participation would look weaker. The table takes account of the parents' educational level, given that this variable has proved to be one of the most powerful predictors of institutional disaffiliation among adolescents and young people (ECLAC, 1997; MEMFOD, 2002).

As in the previous cases, the results show a statistically significant negative relationship between the average socio-economic level of the neighbourhood where young people live and the incidence of institutional disaffiliation, regardless of the parents' educational level. Consideration should also be given here, however, to the possibility that the same configuration of resources as led to the parents taking up residence in poor neighbourhoods might have affected the children through family socialization. If this were the case, we would once again be faced with a spurious relationship between environment and behaviour, with the difference that on this occasion the family would be the intervening factor. This argument is lent credence by the fact that the educational level of parents actually does influence the institutional disaffiliation of their children. On the other hand, it is contradicted by the fact that, when the differences explained by one and the other variable are compared, it transpires that the social composition of the neighbourhood appears to have a greater effect than the educational level of the family in explaining the variations in the disaffiliation of young people.

With this empirical background, we can now turn to the mechanisms that might be activated in

neighbourhoods with a high concentration of poverty and that could be affecting the type of attachments established by their residents with the labour market.

1. Which are the factors associated with the social composition of neighbourhoods that might be impeding the access of residents to the labour market?

Before analysing the different mechanisms associated with living conditions in neighbourhoods with a high concentration of poverty (which will be helpful in exploring their effects on employment), brief consideration should be given to a basic question that arises when we seek to explain people's behaviour by the characteristics of the neighbourhoods they live in: which are the factors that determine whether people are more or less susceptible to the influences of the social environment in the place where they live? An initial approach to answering this is to separate the conditions deriving from global and analytical characteristics of the neighbourhood from those deriving from the characteristics of individuals living there.

Concerning the former, neighbourhoods have all sorts of attributes that are likely to affect residents. The most general one is physical proximity. When compared to other social networks that could operate as sources of recognition, sociability and identity formation—such as those constructed in the workplace, educational institutions and the associations and institutions in which residents participate—what characterizes the social network of the neighbourhood is that it is the one closest to people's private lives. Saraví (2004) exemplifies this very well when he says that “the neighbourhood [is] the first public encounter upon emerging from the private space”.

While physical proximity makes it easier for the neighbourhood social network to influence people, the direction of this influence will vary depending on other characteristics. The following seem to be the most significant. First, the level of security and the general tone of the neighbourhood are important. With respect to the effects of these on the formation of residents' attitudes and expectations, Saraví (2004) says that “...the prevailing climate—of security or insecurity, violence or friendliness, mutual recognition or indifference—will mould the characteristics of the interactions and relationships that are constructed in local public spaces”. A second significant factor is the social status of the neighbourhood. City dwellers usually have a clear image of where their neighbourhood stands in the general

ranking of prestige among the different parts of the city. While the residents of some areas may be more sensitive than others to criteria such as the level of social disorder, the most general standard for this ranking is the average socio-economic level of the households living there. For the inhabitants of a neighbourhood, this image will weigh more or less heavily in the decisions they make about where to live, their openness to the influences of their immediate social environment and the importance they assign to their association with the neighbourhood in shaping their identities, depending on how much scope they have for choice. A third factor that helps explain the influence of a neighbourhood on the habits, behaviour and expectations of residents is its socioinstitutional fabric. The denser this fabric is, the more likely it will be that local standards will have a real influence in regulating the behaviour of residents.

As for individual characteristics, the differences in people's receptiveness to the influences of their neighbourhood environment will depend, among other factors, on their “free valencies”. The narrower the spheres available to them for satisfying their need for recognition, identity and belonging, the more susceptible they will be to the influences of the neighbourhood social fabric and the readier to change or adopt habits and expectations as a result of interactions with other residents. This being so, neighbourhood influences on behaviour might be expected to be greater among those sectors of the urban population that are most vulnerable to social exclusion, precisely because the process of exclusion entails a progressive reduction of other sources of belonging, recognition and identity outside the neighbourhood.

These brief observations on some of the aspects that might help determine the influence of local surroundings on behaviour call into question any supposition that neighbourhoods may have a uniform impact on individuals. A great number of case studies are still needed to create and hone the conceptual frameworks which will help us to understand differentials in the susceptibility of residents to their neighbourhoods. With these caveats, we shall now proceed to analyse the mechanisms involved.

2. Mechanisms that mediate between neighbourhood contexts and individual behaviour

There are a number of mechanisms, some of which have already been extensively examined in the specialist literature, that mediate between aspects of a

neighbourhood and the behaviour of its residents. Although the mechanisms discussed below do not coincide with those identified by Small and Newman (2001), in presenting them we shall use the distinction drawn by those authors between instrumental mechanisms and socialization mechanisms.

a) *Instrumental mechanisms*

Instrumental mechanisms are the different channels through which neighbourhood conditions can constrain individual action. In this category we include the following: distance to workplaces and the costs in time and money associated with transport, local employment opportunities, the scope for accumulating social capital that is useful for finding work, the difficulty of mobilizing the family workforce because of insecure surroundings, and the reaction of potential employers to the idea of recruiting residents of these neighbourhoods.

If concentrations of poor households arise in neighbourhoods on the outskirts of cities, the extent to which transport is a problem for residents will depend on how much it costs as a proportion of their income. Case studies dealing with poor young people in Montevideo have found that these costs, as well as placing severe constraints on job-seeking, heavily influence people's decisions as to whether or not to accept jobs that are very poorly paid once the cost of travel has been deducted. It must be remembered here that the pronounced shift towards personal services in urban demand for unskilled workers has mainly occurred in those neighbourhoods where the most well-to-do population lives, and which have the highest property values and rentals in the city. Because the low-skilled therefore have difficulty in finding places to live near their potential workplace, transport costs and journey times affect their employment prospects.¹⁴ In fact, it is possible to find pockets of poverty around the upper-middle and upper class areas of Montevideo, undoubtedly as the result of elaborate strategies by lower-income households to match their housing to their work.

A second mechanism, whose impact varies with the concentration of poverty in a neighbourhood, is provided by small industrial or repair workshops and

businesses offering services of various kinds. In poor neighbourhoods where a relatively high proportion of workers had stable jobs, adolescents and youths used to benefit from the presence of these enterprises, which offered a major resource for obtaining their first work experience as assistants, apprentices or helpers in different tasks. It should be noted that, in these cases, the realization that there were potentially gainful work opportunities in the neighbourhood gave families a further reason to invest in building up local social capital, as they could realistically expect this capital to materialize in the form of actual jobs.

One consequence of the loss of industrial dynamism, the liberalization of imports of cheap household electrical goods of all kinds and the growing presence of large investors in the supermarket business was the gradual disappearance of many of these small businesses and workshops. What can now be seen, both in the old working-class areas and in the neighbourhoods that are forming on the outskirts of the city, are, firstly, individuals selling all kinds of second-hand items or home-made foodstuffs, a trade that is often concentrated in markets situated at different points around these neighbourhoods, and secondly, family microenterprises with minimal infrastructure that operate inside homes or as extensions to these. In these circumstances, only a few businesses are formal and dynamic enough to need more labour than can be mobilized within the home in the form of unpaid family workers.

Concerning the prospects of obtaining a return on social capital by finding work, the increase in spatial segregation has had another negative consequence. This is because construction of the other type of social capital —“weak links”, in Granovetter's (1985) terminology— that the poor usually rely on as a vital source of useful information and contacts in their efforts to enter the world of work is being increasingly obstructed by the growing physical separation from other social classes and the narrowing of the spheres of interaction with them that this segregation has entailed.¹⁵

¹⁴ Suárez (2004). According to this author, “many of those interviewed said that they stuck to doing odd jobs in their own neighbourhood or nearby, because ‘it costs money to go out looking for work’; ‘you can't pay the bus fare every day to go after work’ ...”.

¹⁵ During the period when public-sector employment was expanding, there were networks of social capital based on political patronage that penetrated deeply into the poor neighbourhoods of Montevideo, expanding their residents' opportunities for finding work. As their room for manoeuvre was diminished by the growing pressure to put the fiscal accounts in order, the politicians who operated these networks were gradually deprived of the resources they needed to sustain them. See Rama (1971) and Luna (2004) for an analysis of the processes seen when political patronage flourished in Uruguay and again when it went into decline (or changed its nature).

The constraints that public insecurity places on the ability of the workforce to travel from home are a fourth instrumental mechanism. Fear of assault, robbery and the exposure of children to unwanted influences paralyse household resources that could be used to generate income and moulds survival strategies. The effects of a climate of insecurity can be seen in people's choice of occupations, the constraints on the times at which they will travel through public spaces that residents have ceased to control, and the need to allocate human resources from the family to looking after household property or children who cannot be left alone and have to be accompanied to their places of study or recreation.

Lastly, the increased physical and social distance between the populations of poor neighbourhoods and the rest of the city also alters the way the social classes regard one another. These alterations result from a combination of two processes. Firstly, as the opportunities for social interaction between the classes diminish, those classes that are part of the mainstream of urban society gradually lose their ability to "put themselves in the other's place" (empathy). This tends to raise their tolerance threshold for both inequality and the various manifestations of wretchedness on the streets of the city. Secondly, the high density of need in poor neighbourhoods creates fractures in their social fabric through which marginal subcultures can germinate. The resultant disorder affects the public image of these neighbourhoods. Those where patterns of behaviour are perceived by the rest of urban society as being more exotic and dangerous are written off as "no-go areas". The combination of the two processes helps to create stigmas. These stereotyped images can come to count for a great deal in the collective identification of those who, exposed to similar experiences of discrimination, gradually discover a painful community of problems and destinies with their neighbours. What is important for our purposes is that these images, which place a negative stamp on certain areas of the city, also colour the judgement of employers when they recruit unskilled labour. In turn, the realization that inhabitants of these areas are rejected as potential candidates for employment because of where they live leads many young job-seekers to conceal their place of residence.

b) *Socialization mechanisms*

These mechanisms, which include things like the existence of role models in the neighbourhood, the efficiency of community standards and the presence of

marginal subcultures, are closely interrelated. Where labour market attachments are concerned, the most important consequence of their operation is the degree to which people are exposed to signals, images and habits that justify and reinforce discouragement, cast doubt over the prospects of escaping from poverty through work, or call into question mental content consistent with the formation of a culture of work.

A first factor here is the absence in the immediate social environment of role models who can convey the work-related expectations, habits and types of behaviour that predominate in the social and economic mainstream of the city. Such models are living proof that it is possible to escape from poverty and improve family welfare by making use of the opportunities available within the legal framework that regulates the world of work.¹⁶ Regular contact with such people can help raise expectations of future well-being, encourage discipline and a work ethic and, in particular, strengthen the conviction that continuing investments in education and training will eventually be rewarded by significant achievements. Of course, there are so many instances of downward mobility in the poor neighbourhoods of Montevideo that the conditions are not favourable for contacts of this type.

Two other, closely interrelated factors militate against the formation of a culture of work. One is the inefficiency of the standards governing relations among residents, a key aspect of community social capital. The pressures placed on households by the needs of day-to-day survival, and the dearth and instability of the bare resources needed to sustain reciprocity networks or community-based institutions, conspire against the generation and maintenance of general patterns of community life. The other factor, which tends to arise as a corollary, is the presence of marginal subcultures. Neighbourhoods with high concentrations of poverty experience a latent but perpetual struggle between the two options. There are those who try to resist social disaffiliation and those, already discouraged, who are willing to break with normal standards and explore non-legitimate ways of improving their living conditions. By lending support to those who take this route, marginal subcultures make work less attractive as a means of achieving welfare goals.

¹⁶ The "role model" function can also be fulfilled by residents who achieve economic success illegally, something that is common in neighbourhoods where there is organized criminal activity such as drug dealing and the selling of parts from stolen and dismantled cars, or semi-criminal activity such as small-scale merchandise smuggling.

Box

The issue of the costs entailed for poor households by a climate of insecurity in their neighbourhoods has been largely neglected in the literature, so that it is worth giving a few examples of what it means in practice for those affected. A woman interviewed in a disadvantaged neighbourhood in Greater Buenos Aires, speaking of the occupation she works in, says (Suárez, 2004):

“Those are the kinds of work I can do... With children it’s hard to do anything else. They need me at home... if you’re not there, heaven knows what they’ll get up to... Before I got married I worked in a hotel in Once, but now I can’t be out all day.”

Similar problems are brought up by people living in poor areas of Montevideo (Zaffaroni, 1999):

- *“When I go to work I have to leave the little ones shut in all afternoon, I can’t leave them here on their own. Kids go around on drugs. If we have to go out, I go or Julio goes, we can’t go out together. If you leave the place empty, you won’t even have any windows by the time you get back.”*
- *“They give the children milk in the snack bar, but I can’t let them go on their own, I’d rather do them their milk here.”*
- *“Where we lived was one of the worst places. That’s why we had to leave a house that was ready to live in and a working shop.”*
- *“You can’t leave your son on a street corner with other boys, because they’ll be taking cocaine or sniffing glue there.”*
- A woman says that after a burglary: *“We just stopped going out after that, and it’s been almost two years. Unless we’ve got someone to mind the place. Otherwise we don’t go out.”*
- *“They’re thieves. You can’t go out for two hours without everything being stolen.”*

Source: Suárez (2004) and Zaffaroni (1999).

V

Final considerations

This article has aimed to set forth a range of reflections and empirical information concerning two processes that are affecting the characteristics of poverty in the city of Montevideo: the weakening of less-skilled workers’ attachments to the urban labour market and the increasing concentration of these workers and their families in neighbourhoods with a high density of poverty. While far from conclusive, the results of this exercise suggest that it would be worth looking more thoroughly into the relationship between changes in the social morphology of the city on the one hand and the segmentation of its labour market on the other, considering the possibility of spurious findings, examining in detail the relative importance of each causal direction (from the context to the individual and from the individual to the context) and seeking to lay

bare in all their complexity the mechanisms that operate between contexts and any effects they might have on individuals. As can be seen, this points the way to a whole research programme.

What is the justification for such a programme? The main argument for it is that, if the tendency towards an ever more polarized spatial distribution of the social classes in cities is confirmed, and if it can be shown that there are feedback mechanisms in the most disadvantaged neighbourhoods that compound the social isolation of their residents, then it will be safe to say that these are processes which, if not effectively counteracted, will lead ineluctably to the reproduction and amplification of what are already extremely marked inequalities in the large cities of the region. Any intervention strategy designed to foster integration

on the basis of equity, the construction of citizenship and reinforcement of the social fabric will need to neutralize these processes, and will therefore need to have diagnoses available to it that can help towards an understanding of the nature of this perverse relationship between territory and work.¹⁷

It should be added that, to judge by the changes in the production structure of the city, any future recovery in labour absorption capacity will have a marked bias in favour of the best-skilled, and that differences in income and working conditions will continue to widen in their favour. The effects of socialization and instrumental mechanisms in the neighbourhoods where very needy households are increasingly concentrated can be expected to reinforce the tendencies referred to.

To simplify the exposition, this analysis has given a perhaps excessively linear and deterministic character to the factors driving social exclusion among the least skilled urban workers. In fact, the relative strength of the forces for exclusion and inclusion is determined by a whole range of possibilities. But the conflicts between these forces are present, openly or otherwise, in every neighbourhood. There are those who resist social disaffiliation and those who give themselves up to it, making do with a "second class citizenship". The argument of this essay is that, in Montevideo in recent years, the balance of this conflict has shifted towards the latter outcome.

Concerning work, this pessimistic view is supported by the conclusion that the residents of poor segregated neighbourhoods will only be able to capitalize on the opportunities created by any recovery if economic growth is much more vigorous than in the past. Indeed, there is no reason to think that sufficiently strong demand for labour cannot neutralize the mechanisms analysed, giving back hope to those who have lost it and, among those who never had much of it, making the attainment of decent living conditions by their own efforts seem a reasonable prospect. If this should happen, it seems reasonable to expect that in each segregated neighbourhood positive employment

signals will gradually strengthen the position of those who are holding out against disaffiliation and weaken the arguments of the discouraged and disaffected.

The question, then, is rather how realistic a scenario of this kind is in the short and medium term. If the assessment sets out from current employment trends in the major cities of Latin America, it has to be said that these (other than in Mexico, which shares a border with the world's most dynamic labour market) still have relatively high unemployment rates, particularly among lower-skilled workers. As in Montevideo, this can be put down to weak and unstable economic growth and to the fact that this growth is heavily dependent for its dynamism on production activities of increasing technological density. In these circumstances, it is hard to see on what basis we can build expectations of major improvements in unemployment rates, in the indices of occupational instability and insecurity, and in the pay differences between skilled and unskilled workers, at least in the short and medium term. Accordingly, there is no reason to expect that mechanisms like those described will be neutralized either.

If attention is turned to the occupational opportunities for the coming generations, the fundamental problem is how to raise the qualification levels of children from poor homes and narrow the education gaps between the urban classes. A large number of studies have given indications of the effects on children's school performance of mechanisms similar to those discussed here in very needy neighbourhoods. The type of changes needed to neutralize these effects and give such children and adolescents hope for the future demand improvements in the coverage and quality of the educational system strong enough to enhance its ability to absorb and retain these young people, whose primary socialization takes place in such unsatisfactory surroundings.

As regards urban planning, there is a need for measures to reverse or check the process of residential segregation, keeping in mind that the economic and political costs of these measures rise exponentially as marginal subcultures crystallize. Consolidation of these subcultures usually takes place in parallel with the undermining both of the world of work as the core of urban adult identity formation, and of expectations of social advancement and real integration into the economic and social mainstream of society. Here as in other areas of social policy, prevention is the best cure.

¹⁷ Similar explorations ought to be undertaken with regard to the mechanisms affecting access to services that are a source of assets in the form of physical, human and social capital, such as education, health care, housing infrastructure, public security, political activity and places of recreation, and that tend to be activated in tandem with the processes leading to the spatial segregation of the urban poor.

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Intergenerational social mobility in urban Mexico

Fernando Cortés and Agustín Escobar Latapí

This article assesses changes in absolute and relative opportunities of access to the upper strata of the urban social and occupational structure in Mexico, drawing on data from the largest retrospective social mobility survey carried out in the country, which covers all the largest cities and some medium-sized ones. It analyses intergenerational mobility in three periods: before 1982, from 1982 to 1988, and from 1988 to 1994. The results show a striking decline in opportunities of access to the stratum of professionals, managers and executives and large employers. This decline has not been linear but has affected first and foremost those from the lowest strata, then those from privileged strata, while leaving the intermediate strata of the socio-occupational structure virtually unaffected. The article also analyses the evolution of absolute and relative opportunities by gender.

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I

Introduction

Since they originated in the early twentieth century, social mobility studies¹ have been exploring the links between social mobility systems and economic systems. The nature of these links was examined in the pioneering social mobility studies in the United States (Sorokin, 1927), and then in the rest of the industrialized Western world (Lipset and Zetterberg, 1959). Since the 1970s, most works dealing with the subject have been based on the so-called “FJH hypothesis” (FJH standing for Featherman, Jones and Hauser),² which states that social mobility systems in Western industrial societies are fluid and homogeneous to a high degree.

The debate has given rise to a fundamental disagreement between liberal sociologists and materialists. The former argue that, particularly since market reform, the market-based industrial and post-industrial economic structure necessarily involves a fairly constant expansion of social mobility opportunities, i.e., an equalling out of opportunity (Featherman, Jones and Hauser, 1975). The latter hold a variety of positions, but are at one in arguing that no such tendency exists (Goldthorpe, 1987; Erikson and Goldthorpe, 1992; Haller, 1990). In these analyses, then, the idea of a close relationship between the economic system and the social mobility system is central.

These ideas can be explored in Latin America, which has moved from the domestic market-oriented accumulation model that was responsible for the region’s urbanization, growth and development to a model that, broadly speaking, has resulted in a decline

in economic growth and the ability of the State to cope with the new international conditions, and in heightened economic and social inequality. In Mexico, there have been numerous studies into the effects of this shift on poverty levels and the inequality of income distribution (Boltvinik and Hernández Laos, 1999; Cortés, 2000; Rubalcava, 1999). Population and job creation trends are also known (CONAPO, 1999 and 2000; Tuirán, 2000; Escobar, 2000a). What has been virtually ignored until now is the relationship between economic reform and the degree of equity in the social mobility system.

Given the lower growth and large economic fluctuations that have been seen, it is essential for this analysis to be conducted with a methodology that can measure structural mobility, which is the outcome of population changes, economic growth and job creation in each occupational stratum.

The present analysis is conducted in two stages. First, it establishes the general level of incorporation of individuals into each social class or stratum, i.e., absolute opportunities for mobility, which are strongly influenced by the level of economic and demographic growth. Second, it uses the analysis of relative opportunities to establish the level of inequality in competition conditions, controlling for economic and demographic developments. This is what may properly be called “endogenous” analysis of the social mobility system. In the debate, changes in participation levels or in occupational distribution are often confused with changes in inequality conditions in the competition to attain the highest socio-occupational positions. For example, there are now more women than formerly in the labour market, both in high positions and generally, but this does not in itself mean that the social mobility system has “opened up”; in other words, the fact that more women are reaching high positions does not allow any inferences at all to be drawn about the conditions and barriers they encounter on the way, since far more women are now competing than before. Thus, there is a need for a specific analysis to show the evolution of inequality in the competition between women of different classes and between women and men, i.e., an analysis of relative opportunities by class and gender.

□ The material analysed here is taken from the project “Género, edad, familia y trabajo: la reestructuración de la sociedad urbana en México”, directed by Agustín Escobar and financed by the Ford Foundation, the National Council for Science and Technology (CONACYT) and the Centre for Research and Higher Learning in Social Anthropology (CIESAS). M. González de la Rocha, R.M. Rubalcava and B. García provided generous and helpful comments on a number of preliminary versions.

¹ In this, as in most other studies on the subject, occupational mobility is equated with social mobility, owing to the close relationship between the two. Mexico is no exception. See below for the relationship between schooling, income and occupational stratum.

² See Featherman, Jones and Hauser (1975) and Erikson and Goldthorpe (1992).

This is the aim of the present study, which explores the way mobility systems have become more or less open as Mexican cities have moved from import substitution industrialization (ISI) to a period of crisis, adjustment and uncertainty (transition phase) followed finally (up to the present) by a third period which we call the “restructuring” period. For our purposes, and in this text, analysis of the social mobility system at the “genotype” level is defined as the analysis of relative opportunities for social mobility by class and gender and, more specifically, as the analysis of odds and of odds ratios, respectively, in all social groups in relation to the highest class in the occupational structure.

The analysis is based on a random sample of households and individuals in six Mexican cities (Mexico City, Guadalajara, Monterrey, Mérida, Veracruz and Córdoba-Orizaba), conducted between July and September 1994, which was a core component of the “Género, edad, familia y trabajo” study. Although it has its limitations, it is the broadest survey of social mobility to have been conducted in Mexico and, in view of its coverage, we believe that it reflects the general conditions of the urban social structure.

Social mobility systems were studied in Mexico during the 1960s and early 1970s. In these studies, the analysis of social mobility was related to the rapid urbanization of Mexico and the unequal participation of the population in the labour and employment modernization process that took place then: the expansion of the State machinery and social services, and of service functions in companies (Balán, Browning and Jelin, 1973; Muñoz, De Oliveira and Stern, 1977; Contreras, 1978).

The main contributions of these studies to our subject are as follows: i) they establish the inequality in individual attainments by class of origin; ii) they highlight the importance for attainment levels of migratory origin and “exposure” to the urban environment, and iii) they allow a distinction to be drawn between structural social mobility and circular mobility.

They have four limitations, however: i) they deal with just one city, Mexico City or Monterrey, and are not comparable between themselves; ii) they deal only with men; iii) they do not provide an analysis of changes in the social mobility system as such, i.e., in the “endogenous” or inequality characteristics of social

mobility, and iv) they do not systematically reflect the heterogeneity of occupations, strata and social classes.

These limitations determine the main challenges to be met by research into social mobility today. The greatest challenge, however, will be to determine how and by how much the basic components of social mobility have changed, so that we have available a medium-term historical diagnosis of the increasing or decreasing openness of stratification and mobility systems in our countries. This is essential, given the depth of economic and institutional change in the societies of Latin America.

The weight of Mexico City and other large cities in the country has diminished, and it is medium-sized cities that are now the most dynamic. For this reason the analysis, while it cannot neglect the largest cities, also needs to include medium-sized ones; this would mean, in principle, that the findings could be treated as applicable to the urban system as a whole.

Women need to be included. Given the doubling of women’s participation rates, economic restructuring (which may affect men more than women) and the growth in households headed by women (Payne and Abbott, 1990), it is unacceptable for class or social stratum to be determined predominantly by the employment of male heads of households.

The analysis presented below seeks to overcome these limitations. Its main contribution is to establish levels of change in absolute and relative opportunities for social mobility as one economic phase succeeds another, and the interaction between the growing participation of women in employment, on the one hand, and the general conditions of the mobility system, on the other.³

³ Many problems still remain to be addressed in future studies, however. Two may be mentioned here: the economic reforms have not reduced, but entrenched, the structural heterogeneity of employment in Latin America, where a sector of modern private- and public-sector employment governed by bureaucratic rules exists side by side with ever-growing numbers of people in informal occupations (or the black economy) or in own-account work. Should social mobility analyses create at least two mobility systems, each identified with an employment sector? How should this diversity be recognized? Is there enough movement between these sectors for it to be possible to speak of a single system? Is one of the two a “trap” for those entering it, or are these both “open” sectors, meaning that they can be taken together as a single system? Another challenge for analysis is the growing scale of occupational and social exclusion in Latin America, transcending occupation-centred analysis.

II

Aims and hypotheses of the analysis

The purpose of this analysis is to measure changes in opportunities of access to higher-level occupations in Mexican cities. The first axis in this measurement is social class,⁴ and for this a specific stratification has been designed. The second axis is time. The analysis looks at the careers of individuals who began working before 1982, between 1982 and 1988, and between 1988 and 1994, and contrasts the relative opportunities of individuals from different social classes in the import substitution industrialization period, in the transition years from 1982 to 1988, and in the subsequent economic restructuring. A further variable is brought in, namely gender, to establish whether women are now competing under the same conditions of inequality (of gender and class) as before 1982.

Empirical analysis of these phenomena is vital, since opposing forces were acting on mobility systems during these periods. When growth in modern and non-manual occupations stagnates generally, some privileged groups can bring into play mechanisms that restrict entry to them, so that the system will tend to close up and inequality of access to intensify. Conversely, when recruiting for such positions the private sector and State will prefer people who demand less in the way of wages and security, which may lead to greater openness (and a corresponding diminution of privilege). Social institutions that create a degree of equity (staple food subsidies, free education, universal health services) are also undergoing restructuring, although it cannot be said that their influence is clearly diminishing in Mexico. Price subsidies for food and utility services have been dismantled. Public education services have expanded their coverage. "Open" health services have done the same but the best-developed system, the employment-linked health services provided by the Mexican Social Security Institute (IMSS), now covers a smaller proportion of the workforce than before, as informal employment has increased. In other words, so long as these systems

work, they will tend to promote equity and open up the social mobility system; but if they go into crisis, this system may tend to close up. Lastly, the rapid growth of "targeted" social health and education programmes will also need to be evaluated for their effects on the equity of social mobility, although their effects are not yet observable.⁵

Households partially offset the decline in real wages by increasing the participation of women and young people in the workforce (González de la Rocha and Escobar, 1986; González de la Rocha, 1988; De Oliveira, 1988; Selby, Murphy and Lorenzen, 1990; De Barbieri, 1989; Cortés and Rubalcava, 1991; Tuirán, 1993; González de la Rocha, 1994, pp. 136 to 139; Escobar and González de la Rocha, 1995; Hernández-Licona, 1997, pp. 547-560). At 39%, women's participation in employment is now about double what it was in 1979 (García and De Oliveira, 1994; INEGI, 2002). If this intensification of employment is accompanied by a reduction in years of education among poor women and young people, then greater inequality could result. But if the increase is distributed equally among all social classes, there might be no change.

Besides the interplay of opposing forces, changes in the nature of the labour market are likely to be found in the periods examined. We shall deal only with two. First, it is possible that what is meant by reaching the "top" of the occupational hierarchy may have changed. In other words, it may have happened that the ever-increasing power of employers has resulted in these higher positions being "downgraded" in relation to lower ones, so that access to them is less remunerative than before, at least in one sector of employment (the public sector, for example). Reyes Heróles (1983) noticed the beginnings of a process of this type as early as the

⁴ We are aware of the ambiguity of the term "social class" when used to refer to social conglomerates united by educational and income levels and their position in the social scale, rather than production relationships. For this reason, the term "social stratum" will be used in some cases. It should be noted, though, that the two terms are used synonymously in this text.

⁵ In Mexico, the Progresá programme (now the Oportunidades programme) began operating in 1997 in deprived rural communities and only included poor urban areas in 2001 and 2002. This programme makes cash payments to poor families (4,240,000 beneficiary families in 2002), on condition that they send their children to school and comply with health programmes (Escobar, 2000b and 2000c). Given that this support is targeted on poor households, the impact of the programme should consist in: i) a rapid rise in educational levels among the poorest, and ii) a diminution of inequality in school achievement between the poor and the non-poor.

second half of the 1970s, when the income gap between manual and non-manual employment narrowed perceptibly. Solís (2002) made the same observation in a recent analysis of occupational mobility and income in Monterrey. Secondly, it may have happened that stagnation in the non-manual and higher occupations has resulted in a more extended career structure, i.e., in a multiplication of the intermediate stages between the beginning and culmination of a career. This may mean that careers commence at a lower level, although some of those setting out from lower positions than earlier

cohorts may also reach the highest positions, only later in their careers.

To sum up, in periods when the economic model is changing there are a wide range of forces acting in different directions upon the social and employment structure, and some of these forces alter the nature of this stratification. But given the right sources and methods, this need not prevent us from ascertaining the direction and significance of economic change in terms of greater or lesser openness in the social employment structure.

III

Methodology and model of analysis

As has already been stated, this study seeks to ascertain only how and to what extent patterns of labour mobility have changed, for both men and women, in the phases through which the Mexican economy has passed during the last five decades. The aim is to find out whether there have been changes in mobility patterns by class and gender and, if so, what the direction of these changes has been.

With this aim in mind, one of the main elements in the “Género, edad, familia y trabajo” project is analysed. These are the results of a wide-ranging questionnaire conducted with a random sample of 11,800 households in six Mexican cities (Mexico City, Guadalajara, Monterrey, Mérida, Veracruz and Córdoba-Orizaba), which was answered by 25,000 people aged over 18. It included questions on the migratory, educational, occupational and family history of both the respondent (also called “ego”) and the person who was the breadwinner⁶ when the respondent was 14. Between July and September 1994, the questionnaire was appended to the National Urban Employment Survey (ENEU) conducted each quarter by the National Institute of Statistics, Geography and Information (INEGI) in 44 Mexican cities. Given the nature of the research, particular care was taken to

avoid the pro-male biases that characterize traditional social mobility surveys. Details of the design and results can be found in Escobar (1996).

Six occupational strata were used to analyse social mobility. Ranked from top to bottom, they are as follows:

- (I) Professionals, managers and executives and employers of more than five workers.
- (II) Technical and white-collar workers.
- (III) Small employers and non-professional own-account workers.
- (IV) Skilled workers in industry and formal workers in services.
- (V) Unskilled workers in industry and informal workers in services.
- (VI) *Ejidatarios* (holders of shares in common lands), small rural landowners and labourers.⁷

Table 1 shows that an informant’s average income by occupational stratum declines systematically from the top to the bottom of the ranking.⁸

The monthly income of professionals, managers and executives and employers of more than five workers (stratum I) is 3.25 that of technical and white-collar workers (stratum II) and 3.3 times the average; from the second stratum downward the decline is

⁶ By “breadwinner” (*responsable económico*) is meant the person who made the main contribution to the respondent’s subsistence when the latter was 14. In over 80% of cases this is the father; it is the mother in less than 10%; the balance is made up of other adults and the actual respondent. The breadwinner, male or female, is regarded as the respondent’s predecessor for the purpose of assessing the respondent’s social mobility.

⁷ In this urban sample, few respondents belonged to this agricultural employment stratum; the calculations include it, however, because it is very significant as the breadwinner’s occupation ($N = 2.255$) and the inequality encountered is significant and consistent with other studies.

⁸ All the tables in this article are based on material obtained from the survey carried out for the “Género, edad, familia y trabajo: reestructuración de la sociedad urbana en México” project.

TABLE 1

Mexico (6 cities): Occupational stratum and average income of survey respondents

Stratum	Monthly income from main occupation (in 1994 dollars)
I	1 403.1
II	430.6
III	404.3
IV	274.8
V	245.0
VI	201.8
<i>Total</i>	<i>427.6</i>

Source: Modules appended to the National Urban Employment Survey (ENEU), July-September 1994.

regular and even. The polarization revealed by the table reflects the unequal distribution of income in Mexico.

At the same time, educational levels fall systematically down the occupational scale.

The unemployed are not included in this analysis. They lack the attributes needed to place them in the stratification; besides, it would be wrong to assign the same place to an unemployed professional as to an unemployed farmer. Their social strata remain different even though they are both unemployed, because they belong to social groups normally defined by their previous occupations. However, analysis of movements into and out of unemployment and their impact on subsequent occupational attainment, among both men and women, is of growing importance in Latin America (Cerrutti, 2000a and 2000b).

The following points should be made about this table: i) there is a clear gap in educational levels between those in the top stratum (I) and the rest, the distribution in this group being concentrated in full and postgraduate higher education; ii) technical and white-collar workers are characterized by the predominance of secondary and higher educational levels, and iii) the lower levels of education predominate from the third stratum downward.

This paper looks at mobility between the occupational stratum of the informant's first job and that of the breadwinner in the household when the informant was 14, i.e., intergenerational mobility up to the first employment of men and women from all urban social classes.

In measuring social mobility it must be remembered that in a sample of people whose ages range from 18 to over 97, a distinction has to be drawn between changes in occupational stratification resulting from the

spectrum of opportunities made available by the economic structure, i.e., what is commonly termed structural mobility, and changes influenced by an individual's class of origin. For example, it is well documented that the growth of services in the Mexican economy in the 1970s increased employment opportunities for women; consequently, some of their social mobility was due to this widening of the opportunities provided to them by changes in the economic structure. Thus, we need a method that can measure inequality in the attainments of different people and not just their absolute mobility, whether upward or downward.

The Mexican economy is usually viewed as having passed through three periods in the last five decades, namely: the stabilizing development period, which ended with the 1982 crisis, although its problems began in the early 1970s and manifested themselves dramatically in the 1976 crisis; the transition period, when the policy approaches of the import substitution-based development period coexisted with those of the third period; and the last phase, that of structural change, whose commencement is dated to 1988 and which might be characterized by the formula "more market and less State" (Cortés, 2000).

If each of these three periods is characterized by economic structures that are qualitatively different, patterns of urban occupational mobility should display significant alterations. For example, it is known that one of the characteristic features of the import substitution model (phase I) was strong growth in typically middle-class jobs; meanwhile, the keynote of structural change (phase III), at least up until the early twenty-first century, has been rising poverty and greater social polarization worldwide (World Bank, 2000; UNRISD, 2000, pp. 11-13). Mexico has been no exception (Hernández Laos, 2001, pp. 56-67 and 98-119).

Taking account of the three phases through which the Mexican economy is considered to have passed during the second half of the twentieth century, the sample was divided into three by the age of respondents: up to 26; 27 to 35; and 36 and over. These three categories place the breadwinner either in the same period as the respondent, or in the one immediately preceding, as table 3 shows (it must be remembered that the information on the breadwinner relates to the year when the respondent was 14, and it can be used for analysis between and within periods). In theory, the study provides information on social mobility within each phase, leaving structural mobility constant; this control will only be partial, however, as

TABLE 2

Mexico (six cities): Occupational strata and education levels^a
(Percentages and cases)

Stratum	No schooling	Incomplete primary	Complete primary	Incomplete secondary	Complete second.	Incom. upper.	Complete. upper	Incom. higher	Complete higher	Postgr.	No data	Total	Total cases
I	0.0	0.6	2.0	0.6	4.8	1.2	3.0	5.2	71.7	10.9	0.0	100.0	1 280
II	0.9	3.9	10.3	5.3	37.6	6.7	11.6	8.1	15.1	0.7	0.0	100.0	5 657
III	9.3	18.9	26.4	6.5	19.7	3.4	4.6	3.5	7.0	0.9	0.0	100.0	3 251
IV	3.7	14.6	30.0	9.6	28.4	6.2	4.9	1.5	1.1	0.0	0.0	100.0	3 567
V	6.3	18.3	29.8	8.2	26.2	4.3	4.3	1.8	0.8	0.0	0.0	100.0	2 367
VI	4.0	22.0	26.0	10.0	24.0	0.0	0.0	10.0	4.0	0.0	0.0	100.0	50
<i>Total</i>	<i>3.9</i>	<i>11.2</i>	<i>20.1</i>	<i>6.5</i>	<i>27.6</i>	<i>5.1</i>	<i>6.9</i>	<i>4.6</i>	<i>12.7</i>	<i>1.3</i>	<i>0.0</i>	<i>100.0</i>	<i>16 172</i>

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

^a In Mexico the primary level includes six years of basic schooling, the secondary level three years more, and the upper (*medio superior*) level a further three. "Higher" is equivalent to university.

TABLE 3

**Mexico (six cities): Economic period^a
of first employment of respondents
and of those who were their breadwinners
at age 14, by age group**

Age group	Respondent	Predecessor (respondent's father or breadwinner) ^b
18 to 26	III, II	III, II
27 to 35	II, I	I
36 and over	I	I

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

^a Period I, stabilizing development, 1982 and earlier; period II, transition, between 1983 and 1987, and period III, structural change, between 1988 and 1994.

^b The "father or breadwinner" category refers to the father (if he lived with the respondent) or, in his absence, whoever made the main financial contribution to the domestic unit where the respondent lived at the age of 14. Among those entering the labour market in period I, this was the father in 80% of cases. Among those entering it later, it was the father in 91% of cases.

adjoining intervals overlap.⁹ This imprecision in the empirical cut-off points needs to be dealt with for accurate results to be obtained.

For the purposes of the present study, all members of the first age group are classified as belonging to economic period III (structural change), those in the second age group are assigned to period II, and those

⁹ The classification is not based on the date of first employment but on age in each of the periods. Thus, for example, the young cohort was aged between 12 and 20 when the restructuring period began in 1988, so that the great bulk of these people began their careers after that time.

in the third group to period I. This classification of age groups in the historical periods was used to produce the transition matrices that can be found in the appendix. The calculations provide information about the proportion of "successors" ending up in each of the six strata, given the strata of their "predecessors". These data are quite informative when there have been no changes in the opportunity structure, or when change has been gradual and the observation time short, or when the economic structure has not undergone significant changes during the period analysed. None of these situations holds for Mexico in the second half of the twentieth century, so the likelihood of mobility in the country depends not just on the stratum of the breadwinner, but on structural changes as well.

It has already been noted that dividing the observations into three subsets defined by respondent age only partially measures the effect of structural mobility since, as was seen in table 3, these combine some of the periods through which the Mexican economy has passed. Mobility studies usually control for structural mobility by calculating the odds ratio (R),¹⁰ odds being the quotient between the probability of moving and not moving between strata *i* and *j*.

¹⁰ The idea is that, in principle, structural mobility should provide more opportunities at all ages, so that the odds should increase proportionately; i.e., the odds of all age groups should increase. Suppose that during a particular period, for example, for every child of professionals descending four remained in class I, while for every two children of office workers only one reached this class, and the odds doubled in both cases because of a change in the production structure, i.e., increased to eight and two, respectively. In this example both odds rise, but the ratio between them stays constant. This statistical artifice annuls the effect of the structural factor, since the incidence on the probability of the numerator is cancelled out by that operating on the denominator.

Now, given the social class of origin, as measured by the occupation of the breadwinner when the respondent was 14, it is possible to find out which is the modal class of destination, i.e., the most probable. In the language of descriptive statistics, this category is a central tendency indicator, and there is one for each line of the transition matrix. If it is known that the predecessor was situated

in stratum i , the mode indicates the most likely destination for the respondent in the occupational hierarchy. Following the rules of elementary statistics, the transition probabilities, the odds and their ratios, which can be regarded as central tendency measures, were supplemented by entropy, which is a dispersion measure for non-metric variables (Theil, 1972).

IV

The results

1. Changes in general intergenerational mobility to first employment

This article only analyses intergenerational social mobility between the respondent's first job and the occupation of his or her father or breadwinner when he or she was 14. Naturally, most of those surveyed were in different jobs or occupations by the time of the interviews. Nonetheless, the decision to confine the study to mobility at the time of first employment allows a partial estimate to be reached of the effects of differing career length between young and old. In this way, we were able to contrast fairly comparable points in the careers of all the individuals analysed, irrespective of age.

Table 4 shows the mobility opportunities associated with the six social strata during the import substitution industrialization ("ISI") period, the transition ("mixed") period and the economic restructuring ("restructuring") period. The odds given in the body of the table indicate the opportunities for individuals in the sample to reach stratum I, depending on their stratum of origin and their cohort.¹¹

The three series of odds show, as was to be expected, that opportunities for entering stratum I decrease as we descend from the top to the bottom of the stratification. Social mobility prospects do not change significantly in the first two periods, but in

the third they decline sharply at all social levels. These results show that economic restructuring in Mexico, at least in its early stages, reduced opportunities for occupational mobility by comparison with the options made available by the previous economic model.

To form an idea of the degree to which absolute opportunities for labour mobility had diminished, we established for each stratum the ratio between the odds in the import substitution and transition periods in relation to those in the restructuring period; this yields a single, simple number that gives an idea of the effect the change in model has had on mobility for the different social classes.

As table 5 shows, the decline in opportunities is greater among those from the two lowest classes, although it is also substantial among the higher classes. Economic restructuring diminished opportunities for social mobility among all strata, but this effect was far more marked in the lowest classes. It should be noted that the reduction in opportunities left employers of up to five workers and non-professionals virtually unaffected. This is an interesting finding that could guide future research into the informal sector, and it is worth asking whether it is related in any way to the marked growth of this sector in the last two decades. The central characteristics revealed by the table show that the tendency is not linear by social stratum of origin (it is more like a "U"). Furthermore, the fact that the greatest decline is found among the most deprived sections of society indicates an increase in the inequality of opportunity.

In this analysis, as was explained in the previous section, we have included a dispersion measure for those leaving each social stratum of origin, called

¹¹ The definition of odds is $M_{ij} = \frac{P_{ij}}{1 - P_{ij}}$ $i, j = 1, 2, 3, 4, 5, 6$,

where P_{ij} symbolizes the probability of a person having a stratum j job, given that the breadwinner was in stratum i when the respondent was 14.

TABLE 4

Mexico (six cities): Absolute opportunities for moving into stratum I

Social stratum of predecessor		ISI ^a	Transition	Restructuring
I	Professionals, managers and executives, employers of more than 5 workers	0.218	0.230	0.084
II	Technical and white-collar workers	0.051	0.051	0.026
III	Small employers and non-professional own-account workers	0.021	0.020	0.016
IV	Skilled workers in industry and formal workers in services	0.014	0.011	0.006
V	Unskilled workers in industry and informal workers in services	0.013	0.015	0.004
VI	<i>Ejidatarios</i> , small rural landowners and labourers	0.011	0.010	0.002

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

^a Import substitution industrialization.

TABLE 5

Mexico (six cities): Absolute opportunities for moving into stratum I, taking the restructuring period as the base

Social stratum of predecessor		ISI	Transition	Restructuring
I	Professionals, managers and executives, employers of more than 5 workers	2.591	2.744	1.000
II	Technical and white-collar workers	1.985	2.000	1.000
III	Small employers and non-professional own-account workers	1.324	1.262	1.000
IV	Skilled workers in industry and formal workers in services	2.349	1.932	1.000
V	Unskilled workers in industry and informal workers in services	3.021	3.626	1.000
VI	<i>Ejidatarios</i> , small rural landowners and labourers	4.936	4.502	1.000

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

entropy.¹² This measurement is the only one in our analysis that does not relate to attainment of the highest social stratum, but to the dispersion of those from a given category among all destination positions. In table 6 we present the results of the standardized entropy calculation. The values of this measure range between 0 and 1; the entropic index of a stratum tends to zero when all successors end up in one and the same stratum (albeit not necessarily that of the predecessor); when this happens, the transition matrix has to be examined to identify which that destination was. If the origin has no influence whatever on the destination, the index will have the value 1; in this case all destinations are equally likely to be reached from the starting point of a given stratum.

¹² For the particular case being analysed, entropy H is defined as:

$$H_i = \sum_{j=1}^{j=6} P_{ij} \ln \frac{1}{P_{ij}} \quad i = 1, 2, 3, 4, 5, 6.$$

The entropy is normalized by limiting its range to the interval 0 to 1 (H_N); for this H_i is divided by the maximum theoretical value (H_M), which in this case is equal to $\ln 6$. Consequently, H_N responds to the following expression: $H_{iN} = \frac{H_i}{H_M} \quad i = 1, 2, 3, 4, 5, 6.$

The information contained in table 6 supplements that of the earlier tables; these confined themselves to showing what happens to social mobility whose destination is the top of the stratification, whereas this one synthesizes the opportunities for mobility from any origin to any destination.

The data in this table yield the conclusion that during the transition years, as compared with the import substitution industrialization stage, the social mobility options of the first four strata (I to IV) diminished and those of unskilled manual, itinerant and "other" workers increased. Conversely, when we compare the restructuring period with the ISI period it transpires that social mobility fell for all social classes without exception.

Against the background delineated so far (social mobility in the ISI period, changes in mobility that varied by stratum during the transition period and a clear general reduction in mobility opportunities during restructuring, accompanied in particular by a lessening of opportunities to reach the top), it must now be asked which was the class whose members bore the brunt of the changes. Asking this is equivalent to focusing the inquiry on social mobility opportunities, taking changes

TABLE 6

Mexico (six cities): Standardized entropic index of absolute opportunities for mobility

Social stratum of predecessor		ISI	Transition	Restructuring
I	Professionals, managers and executives, employers of more than 5 workers	0.770	0.686	0.692
II	Technical and white-collar workers	0.733	0.666	0.685
III	Small employers and non-professional own-account workers	0.914	0.848	0.810
IV	Skilled workers in industry and formal workers in services	0.833	0.774	0.762
V	Unskilled workers in industry and informal workers in itinerant services	0.749	0.761	0.733
VI	<i>Ejidatarios</i> , small rural landowners and labourers	0.837	0.849	0.795

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

TABLE 7

Mexico (six cities): Relative opportunities for reaching stratum I

Social stratum of predecessor		ISI	Transition	Restructuring
I	Professionals, managers and executives, employers of more than 5 workers	1.000	1.000	1.000
II	Technical and white-collar workers	0.233	0.222	0.305
III	Small employers and non-professional own-account workers	0.096	0.086	0.187
IV	Skilled workers in industry and formal workers in services	0.063	0.049	0.069
V	Unskilled workers in industry and informal workers in services	0.058	0.066	0.050
VI	<i>Ejidatarios</i> , small rural landowners and labourers	0.050	0.043	0.026

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

of period into account; this analysis will yield what is usually called the “genotype” of the social mobility system.

The odds ratio¹³ can be used to study mobility controlling for the effects upon it of structural mobility, i.e., that portion of the changes of stratum that arises from alterations in the economic structure. This is what we call relative opportunity analysis, i.e., the analysis of competition conditions in the social mobility system, irrespective of economic and demographic fluctuations.

Table 7 shows the evolution of relative opportunities for people from different strata, irrespective of the absolute level of movement into class I, and allows these opportunities to be analysed between any pair of social classes, although the reference variable is always the opportunity ratio of those from stratum I. Focusing on the economic restructuring phase, as compared with the import substitution phase, it transpires that the disproportion between the opportunities of the lowest classes and

those of people from the highest class increases; this outcome was to be expected since, as was seen earlier, the situation worsened most in the lowest classes.

The odds ratios of the second and third strata increased significantly in the restructuring phase by comparison with the ISI phase. Thus, technical and white-collar workers, along with employers of up to five workers and non-professionals, who did not escape the general decline in mobility opportunities, did see a relative improvement in their prospects of reaching the pinnacle of the occupational structure. As can be seen, the ratio of stratum III almost doubled, because opportunities diminished less there than in stratum I, and the stratum II ratio rose significantly.

Thus, changes in relative opportunities for reaching stratum I between the ISI and restructuring phases can be divided into three: relative inequality of opportunity declines among those from the first three social classes, holds fairly steady for class IV and increases in classes V and VI, particularly the latter. Thus, rising up from farming to stratum I becomes practically impossible: during the ISI period, inequality was 1 over 0.05, or 20 times; during the restructuring period, the ratio was 1 over 0.026, or approximately 40 times; this indicates that those from stratum I have 40 times as much opportunity to reach that stratum as

¹³ The odds ratio is defined as $R_{i1} = \frac{M_{i1}}{M_{11}} = \frac{\frac{P_{i1}}{1-P_{i1}}}{\frac{P_{11}}{1-P_{11}}}$ $i=1, 2, 3, 4, 5, 6$.

those from an agricultural background or, in other words, that the relative opportunities of the latter have halved.

2. Intergenerational mobility by gender

The research done in Mexico shows a significant and steady rise in female participation in the workforce. The question, then, is what kinds of employment women end up obtaining in a context of greater rigidity in social mobility.

The rise in female employment could be due both to a strategy by households to cope with the successive crises through which the country has passed since the 1980s (González de la Rocha and Escobar Latapí, 1986) and to a cost-cutting strategy on the part of businesses, if we consider that women are usually paid less than men for doing the same jobs with the same qualifications (Pacheco and Parker, 1996). If this were the case, we should observe barriers to the social advancement of women. At the same time, research has shown that the increase in educational levels among women (García and De Oliveira, 1994) has been one of the forces driving this growth. Assuming a relationship between years of education and social stratum, these processes should translate into social advancement. What effects have these changes in workforce participation had on social mobility by gender?

Table 8 shows the odds of reaching stratum I for people from all strata, by cohort and sex. The odds in

the panel where the information on women is displayed indicate that women from households whose breadwinner was in any of the three upper strata (I to III) experienced a significant rise in their opportunities for social mobility in the transition period, as compared to the ISI period. However, this increase was uneven: the odds rose by a factor of 8.4 for women from stratum I, by 3.1 for those from stratum II and by just 1.6 for those from stratum III. In the social layers at the base of the pyramid there were no significant changes during the period. Women from domestic units headed by skilled and unskilled manual workers, and those from rural households, experienced no significant change in their almost non-existent opportunities for reaching the pinnacle of society.

The economic restructuring years were accompanied by a significant reduction in the social mobility options of women from strata I, III and IV, while in the bottom two there were once again no significant alterations. Only the daughters of technical and white-collar workers (II) kept the same odds as in the transition years. More in-depth studies will be needed to understand this behaviour.

The shift from the ISI model to the transition model was accompanied by an increase in the opportunities for women from the higher classes to reach stratum I (or remain there), and the shift from transition to restructuring was marked by a significant decline in the odds, with the exception of the daughters of technical and white-collar workers already referred to. Since the growth was greater than the reduction,

TABLE 8

Mexico (six cities): Absolute opportunities for moving into stratum I, by gender

Social stratum of predecessor		ISI	Transition	Restructuring
Men	I Professionals, managers and executives, employers of more than 5 workers	0.332	0.231	0.071
	II Technical and white-collar workers	0.071	0.071	0.023
	III Small employers and non-professional own-account workers	0.020	0.008	0.016
	IV Skilled workers in industry and formal workers in services	0.014	0.015	0.007
	V Unskilled workers in industry and informal workers in services	0.021	0.021	0.007
	VI <i>Ejidatarios</i> , small rural landowners and labourers	0.013	0.011	0.000
Women	I Professionals, managers and executives, employers of more than 5 workers	0.026	0.218	0.102
	II Technical and white-collar workers	0.009	0.028	0.029
	III Small employers and non-professional own-account workers	0.023	0.038	0.015
	IV Skilled workers in industry and formal workers in services	0.010	0.008	0.002
	V Unskilled workers in industry and informal workers in services	0.000	0.005	0.000
	VI <i>Ejidatarias</i> , small rural landowners and labourers	0.006	0.007	0.006

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

women in strata I and II improved their mobility options over the three periods.

Women descended from small employers and technical workers, whose options expanded significantly in the transition period, saw them contract severely when economic restructuring took place, so that they ended the period with a large reduction in the odds of their rising up to the highest class. Those from stratum V saw virtually no change, while those from IV saw their already meagre options diminish further.

The transition did not alter social mobility opportunities for men, except for those with predecessors in strata I and III, whose odds fell by 30% and 60%, respectively. Once the new economic model was consolidated, mobility options declined markedly in all strata except that of small employers and non-professional own-account workers, for whom the decline was small. Does this have some link with the expansion of the informal sector?

Owing to the movements described for men and women, it transpires that opportunities for reaching stratum I have altered in ways that differ greatly by gender. Whereas tables 4 to 7, which appear in the previous section, only showed insignificant changes between the first and second phases, table 8 shows that for men the situation worsened in an almost linear fashion, while for women in the higher classes the situation improved very significantly from the first period to the second and then worsened markedly from the second to the third. The “stability” in social mobility opportunities between the ISI period and the transition period that is observed in tables 4 to 7 is made up of a worsening of opportunities for men and an improvement for women. From the second period to the third, the situation worsened for both sexes.

Table 9 compares the mobility opportunities of the first two phases with those of the restructuring phase. For men from stratum I the fall is almost linear and for those from stratum II there is a decline followed by a slight recovery, while for the rest there is greater stability from the first to the second phase and a marked reduction in the third.

In any event, the overall result for men is a loss, while the situation for women has been far more variable. All in all, opportunities for women from the first two strata have increased very significantly. Those from strata III and IV have experienced a loss of opportunities, and those whose predecessors were in agriculture have seen virtually no change.

The gender-specific entropic index adds to the analysis of the previous section, which did not distinguish this variable. The dispersion of men in the

destination strata is quite high, indicating that males of any social status have “similar” probabilities of ending up in any stratum. Furthermore, entropy changes are small, meaning that options for moving between the different strata seem to be independent of the period being passed through by Mexican society at the time.

During the transition years, women’s opportunities for social mobility diminished by comparison with the previous phase in all strata, except among those from households headed by itinerant and unskilled manual workers. When the restructuring period was over the mobility prospects of women diminished again in all classes except the highest one. Women in strata I and V escaped this tendency, ending up with higher entropy in the restructuring phase than in the ISI stage. Overall, table 10 indicates that inequality by origin is probably lower among young men and higher among young women.

Table 11 shows the odds ratios of movement into stratum I by origin and gender, i.e., the inequality of opportunities of access to stratum I within each gender category.

The increase in the odds ratios of men in the restructuring period as compared to the ISI stage shows that, despite the reduction in opportunities for rising socially into stratum I, there has been a reduction in relative inequality by stratum of origin in the male distribution, except for those from agricultural backgrounds. The opposite is true of women: those from strata I and II are in a very different situation from the rest.

Lastly, table 12 analyses the evolution of gender inequality, i.e., the male odds ratios for advancement to stratum I compared to the odds for women.¹⁴

A value higher than 1 indicates that men have the advantage over women. The table shows that over the period analysed there is a clear tendency for the male advantage to disappear in the two upper strata. In the ISI years the odds of upper stratum men were almost 13 times as high as those of women in the same class, but they tended to equal out during the transition and shifted modestly but perceptibly in favour of women when the new economic model began to operate. A similar, albeit less drastic movement is seen in the stratum of technical and white-collar workers, since during the transition men still had the advantage over women.

$${}^{14} R_{ilm} = \frac{M_{ilm}}{M_{ilw}} = \frac{\frac{P_{ilm}}{1 - P_{ilm}}}{\frac{P_{ilw}}{1 - P_{ilw}}}, \text{ where } m = \text{men and } w = \text{women.}$$

TABLE 9

Mexico (six cities): Absolute opportunities for moving into stratum I, by gender, taking the restructuring period as the base

Social stratum of predecessor			ISI	Transition	Restructuring
Men	I	Professionals, managers and executives, employers of more than 5 workers	4.642	3.231	1.000
	II	Technical and white-collar workers	3.033	3.052	1.000
	III	Small employers and non-professional own-account workers	1.203	0.518	1.000
	IV	Skilled workers in industry and formal workers in services	2.015	2.110	1.000
	V	Unskilled workers in industry and informal workers in services	3.092	3.071	1.000
	VI	Others (agriculture)	Indeterminate	Indeterminate	1.000
Women	I	Professionals, managers and executives, employers of more than 5 workers	0.254	2.148	1.000
	II	Technical and white-collar workers	0.303	0.979	1.000
	III	Small employers and non-professional own-account workers	1.559	2.533	1.000
	IV	Skilled workers in industry and formal workers in services	5.287	4.216	1.000
	V	Unskilled workers in industry and informal workers in services	Indeterminate	Indeterminate	1.000
	VI	<i>Ejidatarias</i> , small rural landowners and labourers	0.978	1.181	1.000

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

TABLE 10

Mexico (six cities): Normalized entropic index of absolute opportunities for social mobility, by gender

Social stratum of predecessor			ISI	Transition	Restructuring
Men	I	Professionals, managers and executives, employers of more than 5 workers	0.753	0.749	0.784
	II	Technical and white-collar workers	0.765	0.799	0.791
	III	Small employers and non-professional own-account workers	0.916	0.858	0.848
	IV	Skilled workers in industry and formal workers in services	0.723	0.818	0.793
	V	Unskilled workers in industry and informal workers in services	0.760	0.734	0.753
	VI	<i>Ejidatarios</i> , small rural landowners and labourers	0.741	0.829	0.792
Women	I	Professionals, managers and executives, employers of more than 5 workers	0.414	0.396	0.491
	II	Technical and white-collar workers	0.603	0.431	0.382
	III	Small employers and non-professional own-account workers	0.849	0.764	0.698
	IV	Skilled workers in industry and formal workers in services	0.753	0.622	0.607
	V	Unskilled workers in industry and informal workers in services	0.606	0.690	0.641
	VI	<i>Ejidatarias</i> , small rural landowners and labourers	0.859	0.782	0.678

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

TABLE 11

Mexico: Relative opportunities for reaching stratum I, by gender

Social stratum of predecessor			ISI	Transition	Restructuring
Men	I	Professionals, managers and executives, employers of more than 5 workers	1.000	1.000	1.000
	II	Technical and white-collar workers	0.213	0.308	0.326
	III	Small employers and non-professional own-account workers	0.059	0.037	0.228
	IV	Skilled workers in industry and formal workers in services	0.043	0.065	0.100
	V	Unskilled workers in industry and informal workers in services	0.064	0.091	0.096
	VI	<i>Ejidatarios</i> , small rural landowners and labourers	0.039	0.049	0.000
Women	I	Professionals, managers and executives, employers of more than 5 workers	1.000	1.000	1.000
	II	Technical and white-collar workers	0.341	0.130	0.286
	III	Small employers and non-professional own-account workers	0.895	0.172	0.146
	IV	Skilled workers in industry and formal workers in services	0.383	0.036	0.018
	V	Unskilled workers in industry and informal workers in services	0.000	0.023	0.000
	VI	<i>Ejidatarias</i> , small rural landowners and labourers	0.215	0.031	0.056

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

TABLE 12

Mexico (six cities): Male/female opportunity ratios

Social stratum of predecessor		ISI	Transition	Restructuring
I	Professionals, managers and executives, employers of more than 5 workers	12.822	1.057	0.702
II	Technical and white-collar workers	8.006	2.493	0.800
III	Small employers and non-professional own-account workers	0.848	0.225	1.099
IV	Skilled workers in industry and formal workers in services	1.452	1.906	3.810
V	Unskilled workers in industry and informal workers in services	Indeterminate	4.111	Indeterminate
VI	<i>Ejidatarios</i> , small rural landowners and labourers	2.345	1.688	0.000

Source: Prepared by the authors using data from CIESAS/INEGI (1996).

Men whose predecessors were small employers or non-professional own-account workers (stratum III), or skilled workers in industry and formal workers in services (stratum IV), have greater opportunities to attain the top stratum than women in those same occupational categories. There is a difference between these two strata, however, since men from stratum IV systematically improved their advantage over the three periods, having

started with a modest advantage during the ISI years, while those from III were at a disadvantage to women during the import substitution years, and even more so during the transition, but drew level with them under the new model. Thus, the male advantage disappeared and a female one was created in strata I and II, and masculine privilege was strengthened in stratum IV, while opportunities for social mobility were evened out in III.

V

Conclusions

This paper sets out to study the changes that have occurred: i) in opportunities for occupational attainment; ii) in the inequality of such attainment, and iii) in the interaction between the growing participation of women in employment and changes in occupational opportunities between and within the genders. We hope it will contribute to the debate about structural change in Mexican and Latin American society during the period of stabilizing development, the crisis that followed and the introduction of the model based on freer trade and liberalization of the domestic economy.

The strategy followed was to take the attainments of class or stratum I (professionals, managers and executives and large employers) as a reference point. This was decided upon to avoid reaching erroneous conclusions about occupational attainments by gender (Portocarero, 1989) and to obviate the need to bring in analyses of the restratification process in Mexican society (Rubalcava, 1999). Since the 1960s, and still now, the occupations comprised in class I have stood high above the rest in every sense, for both men and women.

Among the findings, we would stress, firstly, a considerable decline from 1988 onward in the opportunities of all occupational strata for rising to

class I or remaining there. That year, in our judgement, marked the boundary between the old import substitution model and the new model. The only exception to this pattern is found among those from class III (small employers and non-professional own-account workers), where the decline is much less marked. It should be noted that the market position of members of that class shielded them, at least in part, from the consequences of the policies that reduced wages and incomes in Mexico in the early 1980s.

The decline in opportunities or probabilities of attainment is not directly related to economic growth. While growth in the economy and formal employment has been very low since 1982, attainment probabilities began to fall in 1988. This, in our opinion, indicates that the change in the mobility system is closely related to the accumulation model and not merely to economic growth.

In the second place, this decline has been greater among those from the urban and agricultural working classes than in the remaining strata. The relative decline in attainment opportunities displays three tendencies: diminishing in the first three strata, holding steady in the fourth, and increasing among those from the fifth and sixth strata. This finding is a first indicator of

growing inequality and, in particular, of a strengthening of the barrier separating the attainments of the higher and intermediate classes from those of workers, low-level services workers and farm workers in general.

Thirdly, the analysis of the entropic indices showed that the dispersion of individuals from each class through the occupational structure was constantly declining; i.e., there was greater occupational fluidity in society in the years when the old stabilizing development model applied than in the years during which the new model has applied. This finding, combined with the previous one, allows us to state that, as well as intensifying inequality, the Mexican occupational mobility system has become more rigid. In other words, the occupation of the respondent's father or breadwinner has become a more robust predictor of the respondent's own occupational destination. This indicates that the role of the social institutions that contribute to greater equity in the competition for occupational positions (consumption subsidies for the lower classes, social education, health and urban services) is becoming weaker and weaker within the social mobility system in Mexico.

This is true of people working in urban employment generally in the Mexican cities covered by the data and, we believe, in urban Mexico as a whole. But the inclusion of the gender variable in the analysis allows it to be shown that the results are a composite of difference tendencies for men and women.

While the opportunities for male attainment fall continuously from the first period to the second and from this to the third, for women there is found to be: i) a substantial improvement in opportunities from the first period to the second and ii) a decline that is large, but smaller than for men, from the second to the third. Thus, the apparent stability of opportunities between the first two periods is actually composed of a worsening for men and an improvement for women, while from the second to the third the tendency is similar for both, although it differs in degree. This behaviour must be related to the continuing expansion of educational and occupational opportunities for women since the 1970s. However, the strength of this phenomenon during the transition period (1982-1988), when modern services were no longer growing, also suggests it is possible that employers adopted a strategy in those years of recruiting women to senior positions, possibly because women are paid less and are less well-placed to negotiate with employers than men. But this is a hypothesis which will have to be explored in another study. The final outcome, in any event, points to reduced inequality in opportunities for attainment by

gender. This diminution, however, is not linear from top to bottom of the occupational structure.

The detailed analysis of developments in social mobility opportunities within the gender groups, however, shows that all in all, while opportunities for reaching the top of the stratification have diminished for men in all social classes, for women the situation is more involved. Opportunities for attainment among the female descendants of predecessors situated at the top of the occupational stratification increased during the economic restructuring years in relation to the prospects they had while the old economic model was in place; but among women from the lower classes the opposite movement was seen, i.e., there was a marked decline in their opportunities over the same period. The composition of the two movements meant that inequality between women by class of origin increased. This creates a striking difference between the genders, since men from the higher classes have seen the advantage gap between them and men from the lower strata narrow, reducing inequality by class of origin.

These tendencies are manifested in entropic indices that are higher for men than for women, while over time these indices show a rising trend (less determined by class of origin) for men and a falling one (more determined by class of origin) for women. These patterns suggest the conclusion that the occupational structure tends to be more fluid for men than for women and that this fluidity is increasing in the case of the former and tending to diminish in the case of the latter.

The interplay of these movements has meant that inequality in opportunities for achievement is now greater among women than among men. It may be suggested that this finding is related to the greater rapidity of changes in fertility and family size in the higher classes, and to a greater perception that women have to perform a role as workers for most of their adult life, i.e., that they need to "have a career", so that their parents tend to invest more in their education. But once again, this is a hypothesis that will need to be explored later.

The above analysis supports the idea that, in the years which other analysts have shown to be a time of large, sudden changes, Mexico has undergone a profound transformation affecting not only incomes (Rubalcava, 1999), poverty and inequality (Cortés, 2000), but also the underlying ways in which society distributes opportunities among the population. This analysis ought to be updated at later dates, taking advantage of the availability of databases such as the Retrospective Demographic Survey conducted in the country in 2000 and 2001.

Notwithstanding the above results, it should be noted that our analysis has certain limitations. One important one, with a number of consequences, is that as the labour market evolves, so may the relationship observed between the outset and the maximum attainment of people's careers. The market has become more rigid, and differences of education could, on the one hand, help many men originally from class I to return to that class, even if their first job was in a different one. For the same reason, it may become less likely that people from low classes will succeed in reaching stratum I with time. In other words, the analysis could mask a growing inequality among men. Similarly, our analysis finds that equality in occupational opportunities by gender has increased. But hitherto men's careers have shown more of an upward tendency than women's. We will not know for some time whether men will maintain this advantage over women or whether, conversely, their careers will become more alike, which would reinforce the equalizing tendency found in this study. Third, it is

clear that, up to the time when this analysis was carried out, the occupations represented in class I have been "winning" ones, i.e., have virtually guaranteed a position at the top of the income (decile I) and occupational structure. But increasing education in the population at large, and the downgrading of many professions, could make it necessary to draw finer distinctions within class I to separate those who are really attaining success by entering that stratum and those (middle-ranking managers and executives, for example) who are losing a considerable part of their income and status. Lastly, class or stratum I in our distribution does not include large employers, and class or stratum VI does not properly represent rural labourers, owing to the limitations of the occupational and household surveys conducted in cities (Cortés, 2002). This means that developments in the inequality of opportunity cannot be calculated for this stratum. In any event, though, we hope that the foregoing results will spur on new research projects to answer these new questions.

APPENDIX

Mexico (six cities): Results matrixIntergenerational mobility: First occupation, by predecessor's occupation, period and gender^{a-b-c}

Period of occupations	Gender			First job: those in work only						Total
				I	II	III	IV	V	VI	
Restructuring (after 1987))	Male	Predecessor's (breadwinner's) occupation	I	11	83	9	32	24	6	165
			II	12	210	30	142	116	18	528
			III	13	198	67	178	289	65	810
			IV	6	196	63	275	275	32	847
			V	3	110	27	95	192	13	440
			VI		68	3	72	52	81	276
		<i>Total</i>		45	865	199	794	948	215	3 066
	Female	Predecessor's (breadwinner's) occupation	I	12	98	6	10	4		130
			II	10	294	6	26	16	2	354
			III	8	272	17	89	149	12	547
			IV	1	322	12	107	83	10	535
			V		145	7	54	72	3	281
VI			1	75	2	10	65	24	177	
	<i>Total</i>		32	1 206	50	296	389	51	2 024	
Mixed (1982-1987)	Male	Predecessor's (breadwinner's) occupation	I	24	61	15	15	8	5	128
			II	23	166	23	61	64	10	347
			III	7	218	67	186	263	95	836
			IV	9	155	48	206	163	26	607
			V	7	86	12	75	142	17	339
			VI	4	98	19	50	85	101	357
		<i>Total</i>		74	784	184	593	725	254	2 614
	Female	Predecessor's (breadwinner's) occupation	I	19	80	1	3	1	2	106
			II	8	232	6	23	17	3	289
			III	20	281	46	83	108	14	552
			IV	3	213	12	65	90		383
			V	1	79	8	31	73	4	196
VI			1	62	9	14	40	24	150	
	<i>Total</i>		52	947	82	219	329	47	1 676	

(continued overleaf)

(continued)

Period of occupations	Gender			First job: those in work only						Total
				I	II	III	IV	V	VI	
ISI (until 1982)	Male	Predecessor's (breadwinner's) occupation	I	64	101	9	39	26	18	257
			II	34	273	17	82	82	28	516
			III	31	361	202	238	382	397	1 611
			IV	11	157	53	254	241	60	776
			V	9	66	35	80	207	36	433
			VI	12	129	42	119	164	467	933
	<i>Total</i>	<i>161</i>	<i>1 087</i>	<i>358</i>	<i>812</i>	<i>1 102</i>	<i>1 006</i>	<i>4 526</i>		
	Female	Predecessor's (breadwinner's) occupation	I	3	96	4	9	7		119
			II	2	150	23	31	21	2	229
			III	19	310	104	148	215	44	840
			IV	4	150	45	96	109	4	408
			V		69	19	27	172	2	289
			VI	2	100	39	67	104	50	362
<i>Total</i>			<i>30</i>	<i>875</i>	<i>234</i>	<i>378</i>	<i>628</i>	<i>102</i>	<i>2 247</i>	

^a Occupational strata:

I: Professionals, managers and executives and employers of more than five workers.

II: Technical and white-collar workers.

III: Small employers and non-professional own-account workers.

IV: Skilled workers in industry and formal workers in services.

V: Unskilled workers in industry and informal workers in services.

VI: *Ejidatarios*, small rural landowners and labourers.

^b The figures in this table are unweighted. Expansion factors are available.

^c The total sample is 9/13 of the sample of the National Urban Employment Survey for these cities.

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Preliminary Overview of the Economies of Latin America and the Caribbean, 2004, LC/G.2265-P/I. United Nations publication, Sales No. E.04.II.G.147, ECLAC, Santiago, Chile, February 2005.

The Latin American and Caribbean economy grew by 5.5% in 2004, outstripping the most optimistic forecasts, while the region's per capita GDP is estimated to have risen by about 4%. In 2005, GDP growth is projected to come in at about 4%; this would yield a per capita GDP almost 5% higher than the 1997 figure, around which the region fluctuated until last year.

The region's strong economic performance was closely tied to developments in the international economy. World economic activity picked up speed in 2004, resulting in estimated global GDP growth of just under 4% (versus 2.7% in 2003), while the expansion of world trade may have exceeded 9% (versus 5.8% in 2003). The United States and China were the engines of the world economic expansion, which contributed to the commodity price rises that have benefited many countries in the region, especially in South America.

The strong growth in world trade meant a continuation of the recovery in the region's terms of trade, which had already improved by 1.3% in 2003. In 2004 this process accelerated, with an improvement of 5.6% resulting from a 10.5% increase in export prices and a smaller (4.7%) rise in import prices. Commodity price trends were a key determinant of this outcome, especially in the case of oil and metals.

One of the distinguishing characteristics of the current recovery that makes it stand out from other events in the region's economic history is that, for the second year in a row, GDP growth has been coupled with a surplus on the balance-of-payments current account; moreover, both of these aggregates are on the rise. A second distinctive trait, related to the first, is that the sharp increase in GDP has occurred at a time when the region is registering capital outflows. In 2004 the net capital flow received by the region diminished markedly; by contrast with what happened in the past, though, sovereign risk premiums also fell.

These features of the growth cycle that began in the second half of 2003 and consolidated in 2004 are largely due to the fact that demand was led by exports, followed by investment. Consumption, meanwhile, grew more slowly than GDP and imports grew by 2.6 times as much as output. Nonetheless, gross capital formation as a share of GDP (18.9%) is still below the average for the 1990s.

The weakening of the real exchange rate since the beginning of the current decade has been an incentive to expand the supply of internationally tradable goods, replacing imports and increasing exports. Since 2003, and particularly in 2004, favourable external conditions have started to have a positive influence on the terms of trade.

Where macroeconomic policy was concerned, there were two important developments. On the one hand, central banks cut interest

rates, following risk premiums down and helping to reactivate the economy. Flexible monetary policy also helped support the nominal exchange rate.

On the other hand, the maintenance of a high public-sector saving rate did not aid economic expansion, having at best a neutral effect, but it did help sustain the relative prices of tradable goods and give flexibility to monetary policy. The macroeconomic performance seen in 2004 resulted in a significant improvement in the fiscal accounts of the Latin American and Caribbean countries.

The exchange-rate policies applied in the region, in a context that was almost wholly free of constraints, were able to keep real exchange rates fairly stable. This task was not without its difficulties, given high commodity prices and the increase in the volumes exported, particularly in South America.

Where the labour market is concerned, job creation was strong as a result of greater demand for labour. Regionally, in the absence of labour supply pressures, increased employment translated into a drop in the unemployment rate from 10.7% in 2003 to 10% in 2004. This positive result was mainly due to events in countries that are recovering from deep crises, but there is no sign as yet of an across-the-board improvement in the region's labour indicators. It may be supposed that the drop in unemployment, combined with a modest upturn in wages, contributed to the decline in poverty from the 44.3% estimated for 2003 to 42.9% in 2004.

The inflation rate, meanwhile, continued to show a downward tendency, falling to a regional average of 7.7% in the 12 months to November, as compared to 8.5% in 2003 and 12.1% in 2002.

In 2005, Latin America and the Caribbean are expected to continue the expansion that began two years ago, although at a somewhat slower rate. A regional average of 4% should be attained with positive rates in all countries and with fewer deviations from that value. The outlook is not free of risks, however, particularly given that the international economy is suffering from imbalances that could give rise to higher interest rates and lower world growth. In any case, the America region needs to take this opportunity to modify its position in the global economy, raise aggregate productivity and improve income distribution.

Economic Survey of Latin America and the Caribbean, 2003-2004, LC/G.2255-P/I. United Nations publication, Sales No. E.04.II.G.2, ECLAC, Santiago, Chile, September 2004.

This year's *Economic Survey of Latin America and the Caribbean* is the fifty-sixth in the series. It is divided into two parts. The first analyses the main features of the regional economy, while the second examines the situation in the individual countries. For ease of data processing, a summary statistical annex is supplemented by detailed information on CD-ROM.

The first part deals with the performance of the region's economy and begins with an introduction that summarizes the main trends of recent times and the challenges for economic policymakers. The following chapters are devoted to the international situation and the external sector, macroeconomic (fiscal, exchange-rate and monetary) policy and regional trends in the level of economic activity, inflation, employment and wages. To strengthen the analytical orientation of the *Economic Survey*, this part has been supplemented by two contributions that look more closely at key elements of the region's economic performance in relation to its short-term prospects. The chapter on economic policy includes a section on the sustainability of public debt, a major issue for many countries in the region and one that has become increasingly

important in recent years. The first part concludes with a chapter that offers a comparative analysis of the region's economic growth from a medium-term perspective.

The second part provides overviews of macroeconomic policies and trends in the Latin American and Caribbean countries in 2003 and the first half of 2004. These country notes include tables for the main economic indicators.

The statistical annex presents 25 regional tables, while the CD-ROM contains about 400 tables which provide ready access to the information for recent years.

Other publications

Etnicidad y ciudadanía en América Latina, Libros de la CEPAL, No. 79, LC/G.2239-P. United Nations publication, Sales No. S.04.II.G.113, ECLAC, Santiago, Chile, November 2004.

The construction of indigenous citizenship in Latin America is an issue of growing importance both on the political agenda and in academia. This book provides an up-to-date account of both the academic debate and the political evolution of indigenous citizenship in the region. Consequently, it centres on the idea of "indigenous conflict", the keys to which are considered to be the concepts of ethnicity, identity and collective action.

The author argues that indigenous citizenship is a process constructed by the actors themselves in their sociohistorical contexts,

in an environment where the State has had a permanent presence as the main organizing force in national societies. For this reason, the construction of indigenous citizenship is basically a struggle for recognition of specific rights within the framework of these States and operates through the politicization of identities, i.e., through a dynamic whereby cultural identity becomes a focus of political action, negotiation with the State and public visibility for the indigenous actor in society. This dynamic is generally known as "ethnicity".

The main reason for citizen development processes of this kind is that globalization, as well as transforming the State, the market and civil society, has produced deep changes in the collective action of indigenous peoples, especially when it comes to the interactions between the community, the national level and the international level. As a result of this, the political strategies of indigenous movements and organizations are structured in different ways, but are expressed and symbolized through shared codes that give them a unity of discourse.

The book consists of an introduction and seven chapters, which develop different theoretical concepts and present: a descriptive analysis of indigenous peoples; a general framework for the development of indigenous demands and human rights; an analysis and interpretation of indigenous demands; a review of the development of indigenous collective action in four of the region's countries, and a concluding debate on the new citizenship proposals now being put forward by States and intellectuals in response to indigenous demands.



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