

CEPAL

REVIEW

NUMBER 65
AUGUST 1998
SANTIAGO, CHILE

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Notes and explanation of symbols
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., 1970/1971.
(-)	Use of a hyphen between years, e.g., 1971-1973, indicates reference to the complete number of calendar years involved, including the beginning and end years.

References to "tons" mean metric tons, and to "dollars", United States dollars, unless otherwise stated. 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 submission of an article assumes an undertaking by the author not to submit it simultaneously to other periodical publications.

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—Papers should not be longer than 10 000 words, including the summary, notes and bibliography, if applicable, but shorter articles will also be considered.

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—Footnotes should be kept to the minimum, as should the number of tables and figures, which should not duplicate information given in the text.

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—Authors will receive a one-year courtesy subscription to the *Review*, plus 30 offprints of their article, both in Spanish and in English, at the time of publication in each language.

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Income distribution, *poverty and social expenditure* *in Latin America*

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Great social inequality has long been a frustrating feature of Latin American economic development. Not in vain has Latin America been described as the region of the world with the highest levels of inequality of income distribution. Although the prevailing levels of poverty are lower than those typical of other parts of the developing world, they are still extremely high and, taking the region as a whole, are higher now than they were before the debt crisis. These are the conditions now confronting the new elements which have changed the economic and social dynamics of the region. Special mention may be made of four of these elements: the structural reforms embarked upon in all the countries, the accompanying process of globalization, the resumption of economic growth, and the new reforms initiated in the area of social expenditure and social services as part of the "second generation" reforms. This article puts forward some hypotheses about the effects of these new events on poverty and inequality and analyzes their implications for social policy.

I

Poverty, inequality and their determinants

The "lost decade" was a period of marked deterioration in terms of poverty in Latin America. The region suffered a setback in this respect, and in 1990 its levels of poverty were even higher than those existing in the early 1970s. In the 1990s, in contrast, the recovery of economic growth has given rise to a substantial improvement in these indicators, although the regional average is still above the levels prevailing before the crisis. Thus, whereas in 1980 35% of households were in a state of poverty, that proportion stood at 41% in 1990, and in 1994 the figure was still as high as 39% (figure 1). The 1980s was also a period of deterioration in terms of income distribution. The expectations that the renewal of economic growth would reverse the latter trend have not come true, so that the levels of inequality today are still above the already high levels which existed before the debt crisis (IDB, 1997; ECLAC, 1997).

These global tendencies conceal heterogeneous patterns in the different countries of the region, of course. According to the existing comparative studies, there is only one such country –Uruguay– where the levels of both poverty and equity have improved compared with those observed at the beginning of the 1980s. In several other countries –Brazil, Panama and, according to some studies, Colombia– the levels

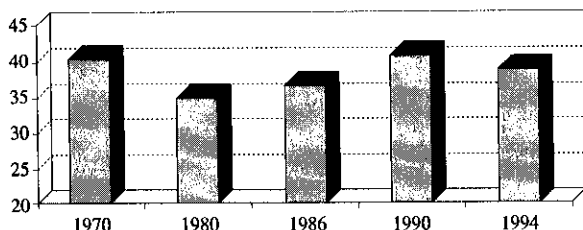
of poverty have gone down, but the indicators of equity have not improved. The Chilean case is more complex: poverty has gone down markedly compared with the levels of the mid-1980s and even, perhaps, compared with those of the beginning of that decade (for which no estimates exist), but it has nevertheless barely recovered the levels of the early 1970s,¹ while inequality of income distribution is greater than it was then and has been reluctant to go down even during the recent period of sharp reduction in poverty.

The attempts to explain these tendencies have given rise to a major controversy on the effects of macroeconomic behaviour, of structural reforms and of globalization on the social indicators. Since the pioneering essay by Morley (1994), several studies have confirmed that poverty tends to go down with economic growth, which would therefore explain the favourable behaviour displayed by this variable in response to the higher growth rates that have accompanied the reform process. In contrast, however, there is a growing group of studies which indicate that economic liberalization and globalization have tended to cause a deterioration in income distribution.

One of the authors who has been asserting this most forcibly in recent years is Albert Berry. This author has shown in various studies that there is evidence over the last quarter of a century that the application of economic liberalization measures has been associated with deterioration (sometimes serious) in income distribution (see, for example, Berry, 1997). According to Berry, this information is taken from the experiences of Argentina, Chile, Colombia, the Dominican Republic, Mexico and Uruguay, whereas Costa Rica is an exception to this rule. The comparative study by Robbins (1996) also shows that trade

FIGURE 1

Latin America: Percentage of households in a state of poverty



□ This paper was presented at the First Conference of the Americas, held by the Organization of American States in Washington on 6 March 1998.

¹ Although there are problems of comparability of the figures, ECLAC (1990) estimated that the proportion of poor households in Chile was 38.1% in 1987, compared with 17% in 1970, and the percentage of poor persons was 44.4% compared with 20% in those same years. Subsequent revisions slightly raised the 1987 estimates to 39.1% and 45.1% respectively. The most recent calculations, corresponding to 1996, indicate that the percentages of poor households and poor persons have gone down to 19.7% and 23.3%, respectively.

openness processes have had unfavourable effects on equity in a number of countries of the region.

Recent ECLAC studies (see, for example, ECLAC, 1997) indicate that the main adverse pressures on income distribution in the present decade come from the increase in the disparity between the wages of the more highly skilled workers and those of the less skilled operatives, against a background of scant generation of skilled jobs and greater intrasectoral and intersectoral inequality in the product per person employed. Thus, there was an almost generalized increase in the wage gap in the countries of the region in the first half of the 1990s (figure 2). The studies in question, like those of the ILO (see ILO, 1997), indicate that in the region employment has grown less than the economically active population and, in particular, the new jobs have been concentrated in the informal sector. According to the ILO's estimates, eight out of every ten jobs created in the 1990s correspond to low-quality jobs in the informal sector.

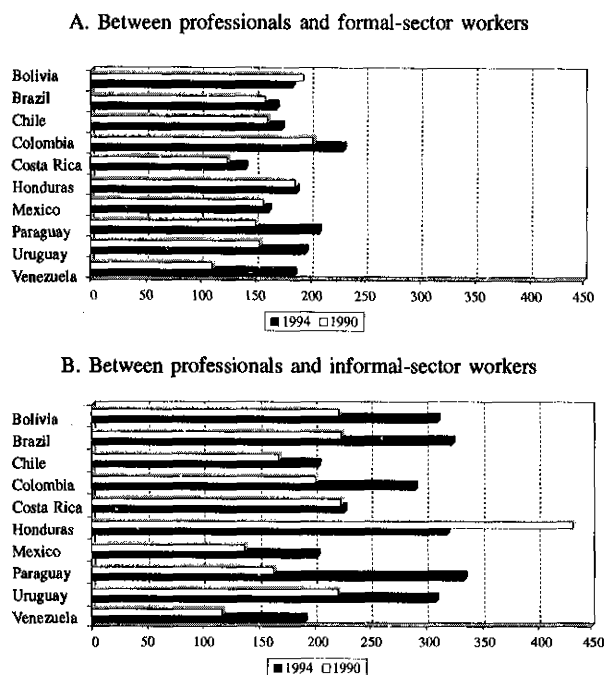
The growing inequality in wages according to levels of skills of the labour force has not only been a feature of production restructuring processes in the region, for a recent report (UNCTAD, 1997) indicates that it may be an almost universal phenomenon, since it has affected a number of industrialized countries and some rapidly growing economies in the Asia-Pacific region and has given rise to particularly severe pressure on the middle classes of many countries.

There are various possible explanations for these trends. The most interesting is that of Rodrik (1997), according to which globalization heightens the asymmetrical relations between the factors that can cross national frontiers most easily—capital and highly skilled labour—and those that cannot do this—less skilled labour. The possibility of relocating production activities means that the demand for labour is more elastic in all countries, thus reducing workers' bargaining capacity and increasing the instability of their income when there are upsets in demand.

Other authors have suggested different explanations. According to Berry (1997), there are important economies of scale in international trade and finance which are reflected in the greater participation in those activities of the biggest firms in each sector, which are also those that make the most intensive use of capital and/or more highly skilled labour. This would explain why a relative increase in the activities most closely associated with international trade could

FIGURE 2

Latin America: Differences in labour remuneration, 1990 and 1994



Source: ECLAC, 1997.

be reflected in greater inequality. It has also been suggested that the greater transfers of technology generated by trade itself, including technology transmitted through imports of machinery and equipment, can cause developing countries which are in the midst of internationalization processes to adopt skilled-labour-intensive technologies designed to serve the needs of the industrialized countries (Robbins, 1996).

In the case of Latin America, there may be further explanations complementary to this phenomenon. One of them is that the trade liberalization process took place after a decade of declining social expenditure. The bias in labour demand towards more highly skilled labour therefore came up against an inelastic supply of such workers. Moreover, during the liberalization process itself there were no clear efforts to link up the demand and supply of skills. Another possible explanation is that some elements of macroeconomic policy accompanying the reform process, especially the tendency towards currency revaluation and the opening up of the capital account, generated growth patterns in which exports displayed less dynamism than imports and the tradeable goods sectors showed less dynamism than the

sectors producing non-tradeable goods and services, thus giving rise to skews in the demand for labour which were reflected in the relative behaviour of wages.² Macroeconomic management has also been marked by severe "stop and go" cycles which, together with fluctuations in capital flows, have kept growth rates highly volatile, thus making it more difficult to generate more stable jobs.

The foregoing considerations are in no way intended to show that the economic reforms are responsible for the present levels of social inequality in the region: far from it. As we noted at the beginning of this article, inequality in Latin America has very deep roots. It is associated in particular with the great

inequality in the distribution of human capital and wealth.³ Furthermore, in many countries the import substitution stage was marked by a deterioration in income distribution, and the experience of the 1980s may be considered as convincing proof of the social costs associated both with macroeconomic imbalances (for example, the regressive effects of the destabilization of general price levels) and with the initial impact of the adjustment processes designed to correct this. At the same time, however, it would appear that although economic liberalization and globalization have had positive effects on growth they have increased the challenge to secure greater equity rather than reducing it.

II

Public social expenditure and equity

As may be gathered from the previous section, one of the great challenges in Latin America is to show that the new development model is compatible with the gradual correction of the great existing social inequalities. If this objective is not achieved, there could be a deterioration of the political bases of the reforms, which have been solid so far largely because the return to macroeconomic stability has been perceived by the population at large as a positive development. An equally serious danger is that social tensions might arise which could affect governance and erode the bases for the political consensus which have made it possible to strengthen democracy in the region: undoubtedly one of the great achievements of recent years.

International experience bears witness to surprising results as regards the handling of the social risks involved in globalization. The study by Rodrik (1997) referred to earlier shows that in the past greater openness of the economy has been compensated by greater social protection of the population

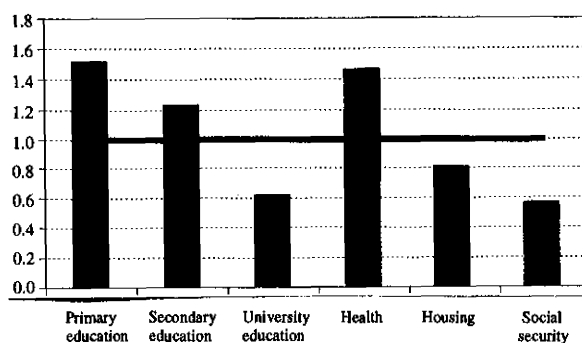
on the part of the State, which has been reflected in a positive relation between the degree of openness and the size of the State sector. According to this author, this appraisal holds good both for the members of the Organization for Economic Cooperation and Development (OECD) and for a broad sample of 115 countries. This would appear to show that the distributive tension generated by economic openness processes has been dealt with so far by offsetting economic liberalization with greater State protection through more active social policy.

Social expenditure is undoubtedly the most important component through which the State can affect income distribution. There is a great deal of evidence that social expenditure has a significant effect on secondary income distribution. Moreover, in the long term greater investment in human capital makes it possible to affect one of the structural determinants of income distribution. The existing studies show that greater allocation of resources to education, which makes it possible to improve the distribution of human capital in a society, can have effects on income distribution which are much greater than those estimated in short-term income distribution incidence studies (see, for example, IDB, 1997, pp. 82-83). On a cautionary note, it should be emphasized that there is

² As a result of the trade openness process in itself and/or the incentives generated by macroeconomic policies, the linkages between the export sectors and the domestic economies have also been weakened, and the effect of this on the generation of employment should also be explored. It should be emphasized, however, that as a result of the great increase in intraregional trade, part of these lower national linkages have been compensated by increased regional linkages.

³ See, in this respect, the interesting study by Birdsall and Londoño, 1997.

FIGURE 3
Latin America (10 countries): Targeting of social expenditure on the poor^a



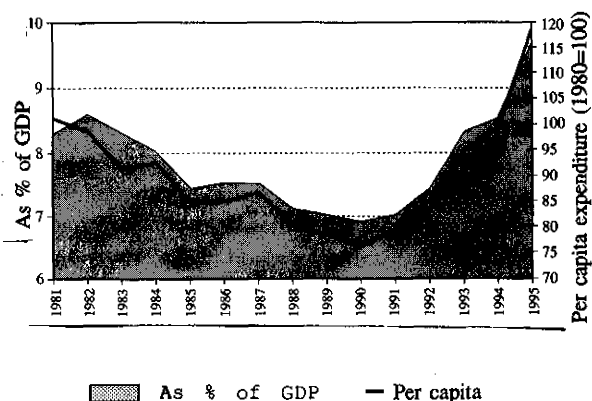
Source: ECLAC, 1998.

^a The data presented refer to the average index of targeting of ten countries for which information is available. In the case of some sectors of expenditure, the information does not cover all these countries.

also evidence that a big effort in the field of education will tend to be reflected in decreasing returns on the investment in education, so that its redistributive consequences (although not its consequences for growth) may be somewhat overestimated. Important effects could also possibly be achieved if efforts were directed towards improving asset distribution (an area which has been very little explored and warrants greater attention), including the redistribution of assets without giving rise to distortions in economic activity (as in the case of institutional improvements to channel credit to small-scale or micro-enterprises without altering the credit market, or the new agrarian reform schemes which make active use of the land market).

The available data for Latin America on secondary income distribution indicate that in absolute terms the higher-income sectors derive more benefit from social expenditure. As a proportion of the income of each stratum, however, the subsidies channeled through such expenditure are greater for the poorest sectors of the population. This global pattern is the result of the very different distributive impacts of the different types of expenditure. The degree of targeting on the poor (i.e., the proportion of expenditure directed towards the poor compared with the proportion of the population which is in a state of poverty) is high in the case of expenditure on health, primary education and, to a lesser extent, secondary education (figure 3). In contrast, expenditure on social security and higher education displays a

FIGURE 4
Latin America: Social expenditure, 1981-1995



Source: ECLAC, 1998.

generally regressive tendency. Expenditure on housing is in an intermediate position, since it benefits in particular the middle strata of the income distribution table.

These results indicate that there is a good deal of room for improving income distribution through social expenditure, but there is also considerable room for improving the targeting of the latter, as noted in a recent ECLAC study. The way such expenditure is financed is of course highly relevant in this connection: financing from direct taxes tends to be more progressive than financing from indirect taxes and—equally important—an unsuitable form of financing which translates into higher inflation can wipe out the favourable effects in terms of redistribution (ECLAC, 1998, chap. VI).

The evolution of social expenditure in Latin America, according to that same study (see also ECLAC, 1997), is summarized in figure 4. The 1980s was marked by a collapse in social investment. Because of the dual effect of the smaller proportion of GDP devoted to social expenditure and the reduction in per capita income, real per capita social expenditure went down by 24%. In the 1990s, both these factors evolved positively, so that in 1995 per capita social expenditure was already 18% higher than the real levels registered before the crisis. This positive state of affairs must be qualified, however, in two different respects. Firstly, there continue to be big disparities between the countries of the region as regards the degree of priority given to social expenditure, so that

in many of them social expenditure is still unsatisfactory in quantitative terms. Secondly, a very high proportion of the increase in social expenditure—especially in the countries where such expenditure is highest—has been directed to social security (and, more specifically, to pension payments), which is the component displaying the least progressive form of distribution. This means that the increase in expenditure on human capital has actually been smaller than the figures in question would appear to indicate. In the case of education, real per capita expenditure in 1995 had only recovered its 1980 level for the region as a whole and was still below that level in a considerable number of individual countries.

III

Social policy and second-generation reforms

The efforts to increase and target social expenditure in the region must be complemented with a substantial reorganization of the sector in order to make the supply of social services more efficient and efficacious. This is one of the central issues in the so-called second-generation reforms, the basic purpose of which is to improve the efficiency of the markets and introduce microeconomic rationality criteria in the supply of those services where this has previously been lacking.

The debates on social services have been aimed at bringing competition into their supply (creation of quasi-markets), introducing the participation of private agents, and making changes in the forms of State support (changing from the traditional supply subsidies to demand subsidies). At the same time, and in a complementary manner, the supply of those services still provided by the State has been decentralized, new systems of public management designed to get results have been created, effective autonomy has been given to the public bodies responsible for providing services, and citizen participation mechanisms have been established for the control of public management. All the components in this reorganization—but especially the first-named—are designed to deal with the “government flaws” which became evident in the past in the supply of social services and are reflected in inefficiency and low quality of services provided by the State.

As may be gathered from the foregoing considerations, there is a good deal of room for combining economic liberalization policies with a more active social policy, as indeed the traditional international patterns seem to reflect. This calls for the reorientation of public expenditure towards the social sector and its targeting so as to maximize its favourable distributive effects. Some countries are also in a position to make an additional increase in social expenditure, thanks to higher tax income. Indeed, this is what the Chilean government did in the early 1990s, without thereby adversely affecting real investment or economic growth. In such a case, the net distributive impact will depend on the manner of financing.

Experience shows that the private sector responds dynamically to the incentives given to it. It also shows, however, that the participation of that sector is likewise subject to “market flaws”: both those of a traditional nature, relating to economies of scale, and those associated with problems of information, which give rise to phenomena of imperfect competition, adverse selection and moral risk (Ocampo, 1996).

In economies where there are big disparities in distribution, the most serious problem is the natural tendency generated by the market for the private sector to orient its supply—in terms of quantity and especially of quality—towards the highest-income sectors. This problem is not necessarily solved through a system of demand subsidies, and the State should therefore design instruments to increase the supply directed towards the lower income sectors. As public supply, in many cases, has been equally incapable of reaching certain sectors of the population (as in the case of low-cost housing programmes, for example), it is necessary to promote new agents, generally of a cooperative or community nature.

The above difficulties become still more marked when systems of private participation do not include clear principles of solidarity, as the health system in Chile shows. In this case, adverse selection can become very marked, both as regards economic and social strata and the health risks associated with the age of the population covered. The introduction of

solidarity elements does not automatically solve the problem, however. Thus, for example, in order to avoid these difficulties the health system reform in Colombia provided that benefits must be completely independent of the amount of contributions, but even so the private sector response for the poorest strata was very frustrating in the initial phase.

The private sector response can also be geographically unbalanced: it may be quite good in the larger cities but insufficient in small towns or the rural sector, where –because of the very low economies of scale– there may be “natural monopolies” in many services when their supply is not profitable.

When the response of supply to the incentives generated by demand subsidies is inadequate in terms of quantity or quality, it may be desirable to design intermediate systems, termed perhaps “demand-oriented supply subsidies”, which can influence the supply and even the quality of the services provided and at the same time afford the traditional benefits of demand subsidies in terms of the targeting of beneficiaries. These systems consist of the establishment of contracts with selected agents for the supply of services to a specific group of the population, through a system of competitions or through the promotion of community or cooperative organizations for the explicit purpose of entrusting them with the administration of the corresponding services. This can also be a suitable scheme for promoting the creation of new services or improving the quality of existing ones (for example, for raising the quality of the educational system, as is being done in Chile).

Problems of information are much more serious in the services markets than in those for goods. In particular, there are extremely serious imbalances between the information available to the suppliers of highly specialized services and that available to the recipients of the services. This is especially so in the case of the doctor-patient relationship in the health sector, but similar phenomena are also observed in education. For this reason, the development of quasi-markets for the supply of social services requires the establishment of schemes to ensure at least a minimum of information and highly developed instruments for the protection of users.

Private sector participation and the creation of quasi-markets open up good opportunities for doing

away with some long-standing problems associated with the public supply of social services, but they are not a panacea. The above-mentioned problems and those connected with the development of the necessary institutions for overcoming them must not be underestimated. The reforms adopted in this framework must therefore be pragmatic and must include a substantial component of graduality and learning from experience. Moreover, it must be borne in mind that the new systems of private sector participation are not a substitute for the public supply of services in all sectors. For this reason, it may be desirable to design mixed systems in which public and private agents operate in competition with each other. In many cases, however, competition is not feasible. For this reason, efforts to improve public supply through decentralization, result-oriented public management, autonomy of the bodies responsible for supplying services, and citizen control are essential and basic elements of any reform in the area of social services.

Finally, it should be emphasized that one of the main objectives of reforms to the social services should be the design of suitable systems of regulation, information and quality control in respect of the services provided. This is particularly important when, because of the specialized nature of the services, there is no guarantee of the full and transparent information that consumers need in order to choose their suppliers. This is a matter which is still at an incipient stage and to which considerable efforts should be devoted in the years to come.

Consequently, microeconomic efficiency should be an important guideline in the second-generation reforms, but so too should be equity. In the area of social policy, these reforms should be pragmatic and multi-faceted. They should take advantage not only of the opportunities provided by greater participation of private bodies in the supply of social services, but also of the potential benefits offered by well-managed public bodies subject to competition, when that is feasible. Furthermore, they should be aimed at correcting the shortcomings observed in both systems, including in particular the difficulty in ensuring that the poorest sectors of the population are provided with services and the lack of suitable systems of information and quality control in respect of the services provided.

(Original: Spanish)

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Military expenditure *and development* in Latin America

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Public military expenditure (PME) has been analysed very little in the region, mainly for political reasons, which have also limited access to the relevant information. Because of various events, however, it is beginning to be the subject of economic analysis both by governments and by multilateral bodies, especially with regard to its appropriate level (how much is enough?), its opportunity cost (what are its direct and indirect economic impacts?), and its cost-effectiveness as a system of acquiring arms (what is its effect per monetary unit?). According to the most conservative estimate, based on the official information on defence spending of the countries where this information is available, Latin American and Caribbean PME amounted to 1.3% of GDP (nearly US\$ 25 billion) in the mid-1990s, and its average share of total central government expenditure in the region came to 9.7%. The central governments of the region spend an average of one dollar on defence for every 1.1 dollars of direct expenditure on education or 0.9 dollars on health. As in the case of any other kind of public expenditure, a debate is called for on the efficacy and efficiency of PME in relation to the development process in general and its economic impact in particular. Although there is no exact answer to the question of how to provide the exactly necessary amount of the public good represented by defence, excessive provision of this good undoubtedly represents unproductive expenditure. It is hard to justify the importation of sophisticated arms if this merely serves to restore the balance with a country's neighbours or with the rest of the region, albeit at a higher level of expenditure. Moreover, the opportunity cost of PME is clearly high, while the positive externalities that it generates could be achieved through other forms of public expenditure which provide different and more specialized services.

I

A little-explored area of public expenditure

Public military expenditure (PME) has been the subject of very little analysis in Latin America and Caribbean, mainly for reasons of a political nature, which also limit access to the relevant information, since this is considered to be of a secret or confidential nature. There is thus very little transparency in the analysis of this expenditure, both with regard to its accounting and budgetary treatment and with regard to its effects on efficient resource allocation and the development process in general.

Conditions are changing, however, and PME is beginning to be the subject of economic analysis both by governments and by multilateral organizations:

i) On the one hand, as a result of the end of the Cold War, the role of military expenditure has been reassessed and such spending has been sharply reduced; although the conflicts that still remain are quite serious, they are not so much of a regional or global nature any more.

ii) In the case of Latin America, there has also been a process of pacification and demilitarization, in addition to the current prevalence of democratic regimes which have taken the place of authoritarian governments supported or run by the military.

iii) The rapid process of economic integration has also helped to change the more traditional hypotheses regarding conflicts, even among countries which confronted each other in the past.

iv) From another point of view, the changes which have taken place in the role played by the State and the government in development strategies have led to keen scrutiny of the efficiency and efficacy of public expenditure, including PME.

As a result of these changes, the segment of public expenditure devoted to defence is beginning to be repeatedly mentioned as a key factor in public efforts to intervene in the economy and their results. The United Nations has played a pioneering role in this field, because as long ago as the mid-1970s it already began to establish programmes and lines of information in this respect. Other organizations, too, have repeatedly emphasized the significance of military expenditure. The International Monetary Fund (IMF), for example, has declared that "excessive" or "unnecessary" military expenditure is an unproductive outlay which, like "white elephant projects", could be cut without affecting the services provided by the public sector.¹

The question of regional security after the end of the Cold War was discussed at the Miami Summit in 1994, and after the Williamsburg Conference in 1995 hemispheric machinery for ministerial-level dialogues was set up. The General Assembly of the Organization of American States (OAS) has adopted various resolutions proposing measures conducive to regional disarmament. For its part, the Rio Group has stated its opposition to arms races in the region. Former Presidents Arias and Carter recently proposed a two-year moratorium on arms purchases in order to give time to arrange a broad arms limitation agreement. This initiative has been supported by the Prime Ministers of Canada, Jamaica and Grenada, as well as by the Presidents of Mexico, Uruguay, Paraguay and Colombia.

□ The authors wish to express their thanks for the valuable comments and suggestions made by Oscar Altimir, Martine Guerguil, Arturo León, Juan Carlos Lerda and Osvaldo Rosales, who of course bear no responsibility for the views expressed in this article.

¹ These concepts have been expressed in various documents and statements by IMF officials. Recent examples are the statement delivered by Michel Camdessus, Managing Director of the Fund, at the meeting of the World Confederation of Labour held in Bangkok on 2 December 1997, and the document prepared by the Expenditure Policies Division of the Fiscal Affairs Department of the IMF for a meeting of the Development Assistance Committee of the Organization for Economic Co-operation and Development (OECD) held in Paris on 4 and 5 December of the same year. Both these texts may be found in IMF, 1997.

II

Estimates of military expenditure

Broadly speaking, PME corresponds to the total expenditure associated with the provision of defence. It should include labour, operational and maintenance costs; acquisition of war materiel; military research and development; military construction work; military pension funds; secret defence spending; contributions to international military institutions; civil defence (if its purpose is mainly military); military intelligence; military health and educational institutions; military aid to other nations, and civico-military programmes in which the defence aspect prevails. The indirect costs may be very considerable, as in the case, for example, of tax and tariff concessions granted to defence-related industries.

1. Information sources and problems

There is a general problem with information on military expenditure which is due largely to the confidential nature of much of the activity related to such expenditure. Definitions vary, and there are "gray areas": between public security and defence; between operational and social security expenditure, etc. Moreover, by its very nature military expenditure is less open to public scrutiny and is usually "submerged" in a number of different items.

Information on PME usually leaves out arms purchases, while some items sometimes appear under other headings: military hospitals under health, military schools under education, subsidies for defence industries under economic development, and so forth. Quite frequently, the total annual expenditure reported is only the same as or less than actual imports of arms (when verifiable figures exist for the latter), or else various forms of "creative accounting" are practiced, as for example to cover up expenditure or tone down the figures for outlays. Thus, there are items of expenditure which are not specifically reported, indirect costs, and industrial subsidies and debts related with armaments which are not reflected in the available information. Military expenditure accounts also often do not include statements of net worth which register the assets involved. Military real estate has high maintenance costs which are

quite often out of all proportion to the functions corresponding to defence. Furthermore, military expenditure often helps to finance activities of a civil nature, which should be excluded from accurate accounts on PME.

As noted in a document prepared by the OECD, "the obscurity that surrounds statistics on the national defence spending of the developing countries is an obstacle to the establishment of a constructive dialogue on international security policies and makes it very difficult to assess the appropriateness of the allocation of resources between civil and military expenditure" (Herrera, 1994). The United Nations Office of Disarmament Affairs has made several appeals for the improvement of international data on national expenditure in this field (United Nations, 1983).

There are various international sources of information on military expenditure. The available databases use differing definitions of this expenditure, as well as differing in their coverage and their treatment of expenditure by calendar or fiscal year. The main sources include the IMF, which publishes *World Economic Outlook* (WEO) and *Government Finance Statistics* (GFS); the Stockholm International Peace Research Institute (SIPRI); the International Institute for Strategic Studies (IISS), and the United States Arms Control and Disarmament Agency (ACDA).

SIPRI uses the NATO definition of military expenditure, whereas GFS is based on the classification of government functions proposed by the United Nations. The IISS uses the definitions of the North Atlantic Treaty Organization (NATO) for the countries which are members of that alliance, but it generally uses data from the defence budget for the other countries, whose definitions may vary. The WEO data are mainly based on information provided by governments, and may therefore differ in their definitions and coverage.

There are functional differences between the NATO and the United Nations definitions, such as the following: the cost of military pensions is considered as military expenditure by NATO but not by the United Nations; operations within the government sector are excluded through consolidation in the

United Nations accounts, but not in those of NATO; the United Nations includes reservists and auxiliary forces, but not the police, Coast Guard or frontier guards, whereas NATO includes the police and paramilitary forces if they are equipped for military operations; civil defence is included by the United Nations but excluded by NATO; military financial assistance is included in the defence expenditure of the recipient country according to the United Nations, but not according to NATO; and assistance in the form of equipment is excluded in both definitions.

The WEO information is calculated by calendar years, like that of SIPRI, but the GFS data correspond to the fiscal year and the IISS information is a mixture of data for fiscal and calendar years (Herrera, 1994; Scheetz, 1994; Gupta, Schiff and Clements, 1996).

In view of the need to use a set of data which is as homogeneous as possible in conceptual terms and which at the same time covers a reasonable period of time for making inter-temporal comparisons, in the present study we preferred to use the information from the government statistics that countries provide to the IMF, which served as the basis for constructing the respective indicators.

The primary data were organized in such a way as to make it possible to prepare public military expenditure indicators compatible with other variables such as the gross domestic product, total government current expenditure, government spending on education and health, and per capita expenditure expressed in a common currency. Except for the indicator of PME in relation to expenditure on education and health, the other indicators for the set of countries for which information was available were weighted by the GDP expressed in 1996 dollars. Because of the lack of suitable price indexes representative of PME, the global GDP deflator was used to construct the respective indexes. The information on Cuba and Peru was obtained from the publications of the International Institute for Strategic Studies. Whenever possible, this information was used in line with the same standardization criteria applied to the information from the other countries.

2. World military expenditure

Military expenditure forms a relatively high proportion of the world product, although it has undergone substantial changes in recent years. Up to the mid-1980s, PME represented between 5% and 6% of the

world product (Hewitt, 1993). Towards the end of the 1980s, the industrialized countries were responsible for 55% of military expenditure, while the developing countries accounted for the remaining 45%: a higher proportion than their share in the world product (Bayoumi, Hewitt and Symansky, 1993).

The developing countries imported more than three-quarters of all internationally traded arms between 1978 and 1988 (McNamara, 1991). These imports represented 7% of those countries' total imports between 1972 and 1988. At the peak of their PME (1981), the developing countries devoted 26% of their product to financing that expenditure (Hewitt, 1991a).

With the end of the Cold War and the reduction in military aid, world military expenditure began to go down in the mid-1980s, reaching 2.3% of the world product in 1996 and 1997. This represents a little over 10% of total public expenditure, compared with a level of 14% in 1990 (Gupta, Schiff and Clements, 1996).

3. In Latin America and the Caribbean

According to the most conservative estimate, based on official information on defence expenditure for those countries where this is available, the share of military expenditure in central government expenditure in the Latin American and Caribbean countries averaged 9.7% in the mid-1990s, standing at 8.0% in 1996. In absolute terms, the regional PME came to 1.3% of GDP, equivalent to nearly US\$ 25 billion (table 1).

By definition, these data do not include expenditure on internal security or police work, which according to a recent estimate represented around 0.9% of the regional GDP in 1990-1995. Thus, regional public expenditure on defence, order and internal security amounted to US\$ 45 billion (ECLAC, 1998).²

Military expenditure is lower in Latin America than in the other developing regions, both as a percentage of GDP and also in relation to central government expenditure; it should be noted, however, that the level of armed conflicts is lower in this region than in others.

² Expenditure on public order and internal security has been the most dynamic component in the growth of public expenditure, other than social expenditure. In the 1990s it reached average levels 62% higher than those of the 1985-1989 period in South America and 45% higher in Central America.

TABLE 1

**Selected Latin American and Caribbean countries:
Indicators of public military expenditure, 1996
(Percentages)**

Country	Public military expenditure					
	As a percentage of gross domestic product		As a percentage of general government expenditure		As a percentage of public expenditure on education	As a percentage of public expenditure on health
	1990-1995	1996 ^a	1990-1995	1996 ^a	1990-1995	1990-1995
Argentina	1.5	1.2	9.0	7.2	53.6	40.2
Bolivia	2.5	1.9	9.5	7.6	54.7	127.8
Brazil	1.2	1.3	4.2	4.0	121.8	58.4
Chile	3.3	3.0	13.2	12.2	96.5	116.4
Colombia	2.0	2.9	7.5	8.7	76.0	158.8
Ecuador	2.1	2.0	10.9	10.0	84.5	175.6
El Salvador	1.8	0.8	13.2	5.2	202.1	251.2
Guatemala	1.1	1.1	14.7	16.9	88.8	159.7
Jamaica	0.5	0.3	3.9	4.0
Mexico	0.4	0.5	3.2	3.9	28.8	31.0
Paraguay	2.2	1.2	21.3	9.6	84.0	232.5
Dominican Republic	0.7	0.8	3.9	4.0	160.6	136.0
Uruguay	1.8	1.4	6.7	5.0	72.6	60.6
Venezuela	1.8	1.3	11.5	8.6
Total	1.6	1.7	9.7	8.0	92.7	116.0
	1.3 ^b	1.3 ^b	6.0 ^b	5.3 ^b		

Source: ECLAC calculations on the basis of IMF statistics. The shares of PME as a proportion of expenditure on education and health were taken from ECLAC, 1998.

^a Preliminary figures.

^b Corresponds to the weighted average for the countries listed in the table.

On the other hand, Latin America and the Caribbean is the region whose military expenditure increased most markedly in the whole world between 1990 and 1997. Over that period, the increase in the regional PME came to almost US\$ 12 billion (table 2). In 1996, Latin America's arms imports reached their highest level since 1991, and were almost twice those of 1994 (International Institute for Strategic Studies, 1997). These preliminary results indicate that disarmament has not given dividends in Latin America, in spite of the peace agreements achieved in the Central American area and the almost complete absence of military conflicts in the region.

The size of military expenditure in terms of the size of the central government structures may be seen from table 1. The proportion of military expenditure in central government expenditure has increased compared with that on education (from 78% in 1980-1989 to 93% in 1990-1995) but has gone down com-

pared with expenditure on health (from 162% in the 1980s to 116% in the first half of the 1990s).

In 1990-1995, the central governments of the countries of the region spent an (unweighted) average of one dollar on defence for every 1.1 dollar on education and every 0.9 dollar on health. These ratios display considerable differences from one country to another, since in some countries military expenditure exceeds health expenditure or that on education, and in others it exceeds both of them.

This set of data shows the need to include public military expenditure in analyses of public expenditure in general and to initiate a debate on its impact, efficacy and efficiency both in achieving the specific objective of military expenditure and in relation to public expenditure as a whole.

This issue can be analysed from a dual perspective: consideration of defence as a factor of development (section III), and estimation of the direct impacts of PME on the economy (section IV).

TABLE 2

Variation in military expenditure, by regions, 1990-1997
(Billions of dollars)

	1990-1995	1995-1997	1990-1997
All countries	-99.5	-18.3	-117.8
Advanced economies	-10.3	-30.7	-41.0
Industrialized countries	(-21.3)	(-33.8)	(-55.1)
Recently industrialized Asian economies	(9.8)	(2.3)	(12.1)
Developing countries	12.5	9.7	22.2
Africa	-2.3	-1.2	-3.5
Americas	7.9	4.0	11.9
Asia	8.5	2.9	11.4
Middle East ^a	-1.5	4.0	2.5
Countries in transition	-101.7	2.8	-99.9
Former Soviet Union	-97.7	3.6	-94.1
Central Europe	-4.0	-0.9	-4.9

Source: IMF, on the basis of data from *World Economic Outlook*, published in *IMF Survey*, 18 May 1998.

^aIncluding Cyprus, Malta and the European part of Turkey.

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III

Defence as a public good

The main justification for PME is that it helps to obtain a public good: defence. This good—together with others, such as the quality of the legal system and the legitimacy of the political system—affects the way the economy operates, by providing an environment of security and stability (Lahera, forthcoming).

1. Characteristics of public goods

In the late 1730s, David Hume noted that there were tasks which, although they do not generate gains for any individual in particular, are beneficial for society as a whole and can therefore only be carried out through collective action (Hume, 1739). In the twentieth century, our knowledge of these matters has been furthered mainly by the contributions of Paul Samuelson (Samuelson, 1954 and 1955).

According to this latter author, a public good is a good whose benefits are shared indivisibly among the entire community, regardless of whether particular persons wish to consume it or not. This contrasts with private goods, which, if consumed by one person, cannot be consumed by another. When it is provided, national defence automatically benefits all

persons, who receive the same amount of national security as all the other residents of the country.

Public goods are created through economic activities which bring great or small benefits for the community and cannot be rationed by price; consequently, it is not efficient to leave their provision to private enterprise. The reluctance of citizens to finance services which benefit them regardless of whether they help to finance them or not gives rise to the problem of free-riders, so their financing is made compulsory through taxes (Stiglitz, 1995). Private enterprises do not produce a sufficient amount of public goods because the benefits of the latter are spread so widely among the population that no enterprise or consumer has any economic incentive to supply them (Samuelson and Nord Haus, 1993). Examples of this type of good are the provision of national defence and the maintenance of public internal order, or the financing of fundamental scientific research and public health.

The level of defence provided is not a direct function of military expenditure, and it is not reasonable to use PME as a substitute variable for the level of defence, even if the efficiency factor remains con-

stant. Defining the public good of defence solely in military terms gives a false picture of the actual situation (Ullman, 1993). Security problems include military aspects, but they also include social, political, economic, cultural and environmental aspects. Moreover, the relation of military force to other forms of power is more complex than before. National defence capacity is also determined by other factors, including in particular diplomacy and international law and cooperation (Lahera, 1997).

From another viewpoint, national defence requires the participation of the population, so that the bases of military professionalism lie in the relation between the civilian and military sectors of society.

2. PME and levels of defence

How can the supply of the public good represented by defence be estimated? Ideally, it would be measured by the levels of security obtained against possible aggression or threats from outside, but in a number of countries of the region the main challenge for the defence forces comes from guerrilla groups, and in others there is also the need to combat drug trafficking.

As we have seen, the inputs for defence include largely, although not exclusively, different levels of PME, in view of the external political environment: one assumption is that a reduction in PME brings with it a reduction in security and hence also a similar reduction in well-being.

Before deciding on higher military expenditure, however, it should be considered whether this is really necessary in order to achieve the desired objective or if the same effect could be achieved with less resources. It would also be desirable to estimate the marginal social utility of military expenditure and compare it with that of social or economic expenditure.

As also happens with the notion of individual utility, the notion of defence is rather fictitious and a numerical scale of levels of security probably would not mean much (Hewitt, 1991b). By its very nature, it is impossible to carry out a conventional cost/benefit analysis for defence, and in particular for PME, since the costs and benefits vary within very wide ranges and in ways which are often unpredictable (Berthelemy, McNamara and Sen, 1994). There are various aspects which should be taken into account, however.

On the one hand, there is the argument that the level of economic development is proportional to

TABLE 3
Selected Latin American and Caribbean countries:
Indicators of public military expenditure
and size of armed forces, 1996^a

Country	Per capita public military expenditure (Dollars)	Size of armed forces (number of military personnel per 1000 inhabitants)
Argentina	101.3	2.1
Bolivia	17.8	4.5
Brazil	62.4	1.8
Chile	144.0	6.2
Colombia	68.2	4.0
Cuba	...	9.1
Ecuador	50.6	4.9
El Salvador	18.0	4.8
Guatemala	17.2	4.3
Jamaica	5.6	1.2
Mexico	12.3	1.9
Paraguay	21.7	4.0
Peru	53.4	1.9
Dominican Republic	10.4	3.0
Uruguay	95.2	8.1
Venezuela	65.1	2.1
Total	49.6 ^b	4.0 ^b
	48.0 ^b	2.6 ^b

Source: ECLAC calculations, on the basis of statistics of the International Institute for Strategic Studies, 1998.

^a Preliminary figures.

^b Corresponds to the weighted average for the countries listed in the table.

that of defence, but during the 1970s and 1980s the developing countries systematically spent a higher proportion of their product on defence than the industrialized countries, so it does not seem true that there is any direct relation between an increase in the product and the increase in PME needed in order to maintain the level of security.

Furthermore, although the levels of PME differ from one country to another for reasons which are sometimes due to historical or corporative factors, the dispersion of such expenditure is extremely high. While the regional per capita PME averaged US\$ 49.6 in 1996, there were big differences between countries. The same is true of the number of military personnel per thousand inhabitants (table 3). Finally, there are countries in the region which have comparable levels of defence but very low military expenditure.

From another point of view, technological development raises further queries in respect of defence. There does not seem to be any other sphere of human activity with such a high rate of creation of new technological programmes, either to maintain strategic

superiority or else not to lose ground to opponents (Pivetti, 1992). The cost of a total attack with survivors or of a total defence with survivors has increased to an extraordinary extent for technological reasons, so that it would be very difficult for the developing countries to bring their military technology up to the level of the industrialized countries.

3. The international perspective

Military expenditure by one nation imposes negative externalities on other nations which feel threatened; higher PME by one alliance has a negative impact on the security of a rival alliance. One State's efforts to achieve better defence increase the defensive insecurity of other States. Thus, reactions are caused in which the pursuit of balance leads to greater insecurity for all, or else at best the mere recovery of the previous balance. It is impossible to optimize the public good represented by defence through simultaneous proportional increases in PME by neighbouring countries. On the contrary, it may be expected that this will lead to the restoration of the previously existing defence balance, albeit at a higher level of expenditure.

In contrast, the impact of a coordinated reduction in PME on defence levels is very different from that of a unilateral reduction. Whereas the latter al-

most certainly reduces security, the coordinated reduction of PME may lead to an apparent reduction in security at the national level, but this will be offset by the greater security caused by the lower PME of neighbouring countries.

Depending on the rate of advance of the globalization and economic integration processes, situations may be established which require less defence but at the same time give rise to the appearance of virtual frontiers in addition to the existing territorial borders. States have more and more international economic interests, which can either reduce or increase the demand for defence, according to the particular cases. Traditional outlooks are a liability in processes of economic complementarity and integration, since they merely reiterate the traditional hypotheses of conflict; according to these traditional views, globalization gives rise to new hypothetical conflicts without having eliminated the old ones. There is a corporative bias in the assessment of the international situation and that involving neighbouring countries which plays up the alleged uncertainty, imbalance and instability.

A coordinated reduction of PME would tend to ensure conditions of stability between neighbouring countries and would help to strengthen the ideal of regional peace. Defence would thus become a regional public good.

IV

The economic impacts of military expenditure

1. Aggregate effects on growth

In conventional short-term analysis, an increase in military expenditure on final goods and services can increase domestic demand, like any other public expenditure; the difference would be represented by the composition of PME, which has a higher content of purchases of goods and services than the rest of public expenditure, in which transfers, interest payments and payments to local levels of government are more important. Consequently, PME would have a stimulating effect on the growth rate by inducing an increase in the capacity utilized: i.e., increasing the current

product in relation to installed capacity. Even when aggregate production suffers from demand constraints, in situations of Keynesian unemployment, however, this function of PME can be carried out through more productive forms of public expenditure (Sen, 1987).

Various approaches have been used to examine the economic impact of PME. Generally speaking, the corresponding observations were carried out during the time of the Cold War. One approach makes an aggregate analysis of the correlation between PME and economic development in the past experience of a group of countries. The most frequently cited study

on this question is that by Emile Benoit, according to which there is a positive correlation between military expenditure and economic growth in a sample of developing countries during the period 1950-1965 (Benoit, 1973). Benoit suggested that this result might be due to the demand stimulus caused by PME, the generation of positive externalities, the provision by the military sector of basic consumer goods, and the greater attractiveness to foreign investment of countries with higher levels of PME, while among the negative effects he pointed to the transfer of investment resources to military expenditure. Since then, however, that study has been criticised for the simplistic nature of its econometrics, which are founded on a very basic description of the effects of PME on growth (Deger, 1990).

Subsequent studies have disaggregated the data more fully. The results have varied, but there has been a general tendency to draw negative conclusions about the impact of PME on development, since its adverse effects outweigh the favourable ones. Deger's study, for example, concludes that PME is negative for growth, basing his conclusions on a cross-sectional analysis of 50 countries for the period 1965-1973. In a system of simultaneous equations, it is concluded that the impact of such expenditure is negative with respect to saving, growth and the trade balance. High levels of PME are associated with low rates of saving, which causes low rates of growth, and this effect is greater than the direct impact of military expenditure (Deger, 1986).

According to other studies, the impact of PME will depend on the alternative use that could be given to the resources. There does not seem to be any systematic relationship between PME and unemployment, inflation or the balance of payments. In each observed case, this relationship was the result of various effects operating on supply and demand in different ways. The benefits attributed to PME can be obtained by more efficient means; thus, defence spending can promote growth if it takes the place of private or public consumption, but its impact on growth will be negative if the alternative use of the funds is private investment or reasonably efficient public expenditure on infrastructure. The impact of PME on growth will therefore vary according to time and place (Hewitt, 1991b).

The rate of saving can be influenced by military expenditure through different means: reduction of public saving, pressure on the current account by

reducing foreign exchange saving, and a drop in private propensity to save because of the increase in consumption to make up for the reduction in the public supply of economic and social services.

Another approach—of a more microeconomic nature—for investigating the repercussions of PME is based on examination of the composition of PME, focusing on long-term resource allocation. In order to do this, it is necessary to measure how and how far PME increases civil productivity. In particular, efforts have been made to evaluate the effects of PME on capital formation and resource allocation. The stimulating effects of PME in the short term do not necessarily lead to high levels of capital formation or of the product, since such expenditure has a negative effect on both of these (Knight, Loayza and Villanueva, 1996). An increase in PME can reduce the stock of resources available for alternative uses, such as investment in productive capital, education and market-oriented technical innovation. Moreover, such expenditure normally increases external indebtedness and changes the composition of investment, making it less productive.

Other studies use an approach based on the structural functioning of the economy. In one of them, growth of the product is related with the increases in exports, population and total capital (thus reflecting possible deficits in foreign exchange, labour or capital), changes in flows of external saving, the level of the per capita product, and military expenditure. This latter variable gives the effect of PME on growth: it is interesting to note that the model uses the variation in military expenditure rather than its level. In this approach, the coefficient quantifying the impact of PME on growth is consistently negative (Faini, Annez and Taylor, 1984).

The cost of each job created by military expenditure is high, and the fulfillment of military service obligations represents a very poorly paid temporary occupation. In 1995 the armed forces of Latin America and the Caribbean consisted of almost 1.5 million persons, including permanent staff and conscripts, which represents an increase of 6.5% compared with 1985 (International Institute for Strategic Studies, 1997). The increase in military permanent staff—which grew as fast as or faster than public employment—contrasts with the decline in the share of the latter in non-agricultural employment in the region from 15.3% in 1990 to 13% in 1996 (ECLAC, 1998).

In the event of armed conflict, there is obviously massive destruction of human capital and assets. Defence can help to stop this happening, but it can also intensify its results or increase the possibility of such conflict.

Notwithstanding the potential adverse effects of PME, its economic allocation is not entirely counter-productive or unproductive. The question is rather whether it represents the most efficient form of public expenditure for achieving the desired objectives. The opportunity cost of military expenditure corresponds to three categories: the government can increase its total expenditure, which will generally lead to lower levels of private consumption; it can reduce social expenditure, which will lead to a deterioration in the quality and/or coverage of social services, or it can cut down on investments designed to increase national production capacity, such as those in infrastructure and economic services, thus reducing economic growth (Hewitt, 1991a).

2. Direct effects on production

The direct economic linkages of PME in the industrialized countries are different from those in the developing countries. The latter countries import most of their military equipment, and the possibility of beneficial economic effects is very limited: the intersectoral linkages are small, and the multipliers are low. Military expenditure on locally produced goods is relatively small and highly concentrated in expenditure on personnel. The possibilities for technological spillover effects are very small.

At the same time, PME has various negative externalities for production capacity; various rent-seeking activities are concentrated in military expenditure because of its non-competitive resource allocation. The confidential and strategic nature of its management may aggravate distortions which reduce resource allocation efficiency, thus lowering total factor productivity. Since military expenditure is not directed by market processes, it tends to create distortions in relative prices which become a dead weight on overall production capacity.

With regard to the need to strengthen infrastructure in the developing countries in order to foster growth, capital expenditure in the defence sector may have productive uses. These uses may derive from the benefits obtained from the transport and telecommunications system required by military activities, as

shown by the examples of the Transamazónica highway running through Amazonia in Brazil and the Carretera Austral which has opened up the most southerly parts of Chile. This effect is less frequent than it might appear, however, since infrastructure for exclusive military use does not have any spillover effect on civil activities, while if the infrastructure is normally to be used by the civilian sector there is no reason to consider it military expenditure or to execute it as such.

It has also been claimed that expenditure on military training in developing countries can help to improve the educational level and discipline of the labour force. There are opposite opinions, however, which maintain that the military sector is not a significant source of skilled technical resources in the developing countries; many of the skills taught on military training courses are specifically related to the handling of weapons, and the skills which might be used are not automatically transferred between sectors (Ball, 1990).

With regard to military production of goods and services, governments tend to subsidize armaments industries, in which case, like other subsidies, this would represent inefficient use of resources, and the contribution of such activities to the economy is very probably negative (Hewitt, 1991b). In this case, the general arguments on public enterprises operating in monopoly sectors apply with regard to the principle of subsidiarity, the resulting social utility, public financing and management capacity. In the case of social security services, a privileged public situation tends to be established for the military sector.

3. The Peace Dividend

Up to the 1980s, the high volume of military expenditure corresponding to the industrialized countries, together with high interest rates, imposed an ongoing burden on debtor countries in the East and South and absorbed the savings of the European and Far Eastern countries which had surpluses that could otherwise have been used for investment or economic assistance in Eastern Europe and the Third World or as a means of domestic expansion (Kaldor, 1991). During the last 25 years, there have been 125 wars and other conflicts in developing countries, causing 40 million dead (McNamara, 1991).

Reduction of PME generates positive economic externalities at the international level as a result of

lower interest rates and an increase in the volume of international trade.

The global reduction of military expenditure has generated a "peace dividend" in the form of faster growth. The countries which sharply reduced their PME also reduced their total expenditure, thus potentially strengthening private investment. There is also indirect evidence that the cuts in PME enabled these countries to maintain or increase their social expenditure. In contrast, the countries which increased their PME also increased their other expenditure and their deficits. The higher PME may also have crowded out private and even public investment (Gupta, Schiff and Clements, 1996).

The "Peace Dividend" may be envisaged as an increase in the saving of resources: if the 1990 level of PME had been maintained, military expenditure in 1997 would have been US\$ 357 billion higher than it actually was. It may be expected that at least part of the saving will be used to increase non-military expenditure, but part of it could also be returned to the private sector through reductions in the fiscal deficit or in taxes. An additional requisite would be a reduction in the value of the public good constituted by defence obtained through PME, thus making possible an increase in non-military expenditure without any marginal sacrifice of that good (Lee and Vedder, 1996).

V

Design, management and evaluation of PME

There has been a weakening of the perception of the State as a rational actor which balances the security benefits provided by the forces acquired against the opportunity cost of non-military expenditure.

PME may be viewed as part of an agent-principal relationship: in general, it is a privileged form of public expenditure which is not discussed in a transparent manner—it is not dealt with in terms of traditional public finances—and its effects are not affected by short-term considerations and are often only observed in the long term. Nor is it managed in a transparent manner, since it is exempted from any general discussion on its efficiency and efficacy (without prejudice to its specific nature) in line with parameters comparable to those of other types of public expenditure. The same applies to

At the same time, the reduction of military expenditure raises specific problems. It is possible that there may be serious redistributive consequences for those who previously depended on military or related activities. The difficulty that a developing economy will experience in absorbing part of the labour force previously employed by the military sector will depend on such factors as the number of persons displaced and their rate of displacement, their skills, the availability of work and the relation between the two, and the rate of generation of jobs and the effectiveness and coverage of labour re-training policies.

In some cases, the reduction in military expenditure and the discharge of military personnel have been blamed for possibly generating other undesirable effects such as groups of jobless individuals who engage in unlawful actions and thus increase the insecurity of the population. With regard to military personnel themselves, their reallocation to productive activities is not a simple matter and may even be impossible in some cases.

What happened in the former Soviet Union seems to show that there are only limited positive externalities for the production of civilian goods by relatively sophisticated military industries (Bayoumi, Hewitt and Symansky, 1993).

the evaluation of its impact on social well-being, both in a specific sense and in comparison with the rest of public expenditure.

1. Policy design and level of military expenditure

The elusive nature of the good (defence) which PME is supposed to obtain and the discretionality prevailing in the application of public military expenditure bring in various factors—endogenous and exogenous, objective and subjective—which may bias the choice of the level of expenditure. Otherwise it is hard to explain through a linear analysis (1 to 1 with GDP) the big differences observed in the levels of expenditure between individual countries.

According to Hewitt, seeking to define the optimum level of PME on the basis of the traditional analysis of public goods is a complex matter because the demand for PME is endogenous to the political system and is interdependent with the level of PME of neighbouring countries.

The optimum expenditure on a public good is that which equalizes the marginal willingness to pay through taxes with the marginal cost of producing the good. This means that the composition and level of the budget should be based on the aggregate demand for PME and other government goods, in conjunction with data on technical costs. Whether the government chooses policies which reflect the will of the people or not will depend, however, on the effectiveness of the political decision-making mechanisms. Moreover, the social demand for government goods is only significant when the preferences of consumers are reasonably exogenous to the political process and citizens as consumers are sufficiently well informed to give rise to significant demand functions for the various items of public expenditure (Hewitt, 1991b).

It is hard to estimate the impact of PME on personal utility. The relation between PME and defence benefits is a matter open to discussion: the biggest points of disagreement concern the danger of invasion, the effect of PME in preventing invasion, the defence value of optional systems of arms, and the degree to which PME promotes other national objectives. Moreover, the public has very little information about the level and composition of PME. In view of this severe problem of information, it is by no means clear that the popular perception indicated by public demand is relevant in determining the optimum level of PME (Hewitt, 1991b).

Those who influence the allocation of PME and define its size and content generally use other types of criteria in addition to economic ones. Consequently, the direct economic impact of such expenditure, as well as the positive and negative externalities that it generates, do not serve to explain defence expenditure decisions.

Rational expectations, the corporative interest of the military sector and the personal motivations of those responsible for taking decisions in this respect can be of decisive importance in such allocation. In some cases there are pre-determined floor or minimum levels for PME based on income from the ex-

ploitation of non-renewable natural resources: in Chile, for example, the armed forces are guaranteed, by a constitutional-level law, 10% of the sales of the Chilean Copper Corporation (CODELCO), while in Ecuador it was reconfirmed in 1995 that 15% of petroleum income will be allocated to the military for another 15 years (SIPRI, 1998).

It is worth noting that the allocation of military expenditure in the industrialized countries has often been considered unsuitable, for reasons of both supply and demand, and the same is very probably true in the developing countries, where moreover such expenditure is even less transparent.

Military assistance normally leads to an increase in PME, even when it is provided in the form of donations. Public external credit, or external credit with public guarantees, also potentially tends to favour such an increase, by increasing the resources available to governments.

Among the factors which have been responsible for the reduction in PME are the democratization processes, the improvement in the global security environment, and the associated decline in military aid.

Military budgetary demands can rise for domestic reasons: prestige, or the exertion of pressure by armed public employees, or the personal eagerness of decision-makers who want to go down in history as "modernizers" of the sector of the armed forces in question. Increases in these demands can also be due to the fact that technological advances tend to give rise to an apparent need for higher expenditure on the military sector simply in order not to "fall behind" and thus impose instantaneous minimum levels, or they may be due to tempting offers by arms suppliers. The technological pressure for an increase in PME is constant and seems to be becoming more intense.

One of the areas where game theories find most applications is that of tactical and strategic military problems. It cannot be assumed that the resources and preferences of individuals (or of military institutions) are only known to themselves: they may also be known to their competitors, and in fact this is usually the case. It is therefore necessary to include considerations about personal beliefs with regard to the status of competitors, as well as about the learning process that takes place in the course of time.

From the point of view of strategic behaviour, decision-makers' expectations may help to generate a set of regional or subregional actions and reactions

which give rise to purely reactive military expenditure. On the contrary, however, such expectations can also generate quite different effects: for example, a moratorium on the purchase or sale of arms –at the regional, subregional or bilateral level– may bring about a reduction in such expenditure.

In the industrialized countries, it is quite normal that there should be discussions in Parliament about these matters.³ In the United States, the budgetary functions of Congress are divided up between two commissions: the first one gives technical authorization to carry out projects, while the second one allocates the funds needed for the projects thus technically approved. The whole process takes about six months and favours the high-level civilian management of defence.

Among the factors determining PME at the political level are international or civil wars and the type of government, since monarchies, authoritarian governments and Socialist governments tend to spend more than multi-party democratic governments.

The policies of arms suppliers are also important in determining the level and composition of PME. In the period from 1992 to 1995, total arms exports to Latin America came to US\$ 860 million, of which 30% corresponded to the United States and 25% to the four main European exporters (Lumpe, 1998). The restrictions on the sale of United States war material to the region were lifted in 1997, and one South American country was designated “principal non-NATO ally” by the United States.

2. Management and evaluation of military expenditure

In addition to the general problems displayed by the fiscal institutions of the region –including their insufficient political weight, coverage and flexibility– there are others more specific to PME, such as lack of transparency, vague objectives, inefficient arrangements for distributing resources among the different branches, and weaknesses in their functional organization and staff aspects. The use made of assets controlled by the military is often subject to more liberal and less transparent requirements than those applying to other public assets.

The predominant institutional design in the countries of the region is that consisting of a ministry of defence. Brazil is the only country in South America which, instead of such a ministry, has no less than three military ministries, established during the military governments which controlled the country between 1964 and 1985. In general, the present institutions are insufficient to prevent the frequent duplication of efforts and losses of economies of scale in forces which are complementary to each other.

Public expenditure in general is not the subject of evaluation by professionals who are independent of those responsible for designing or managing public policies in Latin America. PME is no exception to this rule, and it also has a special feature of its own: there are sectors which assert that it is necessary to keep information and analysis on PME under the correlative control of the military.

VI

Some reflections on appropriate policies

As in the case of any other kind of public expenditure, a debate is in order on the impact, efficacy and efficiency of PME with regard to the development process in general and its economic effects in particular.

Although there is no precise answer to the question of how to provide the exactly necessary amount of the public good represented by defence, it is obvious that the excessive supply of this good represents unproductive expenditure. For example, it is hard to justify the importation of ultra-sophisticated arms if all that this does is to restore the balance between neighbouring countries or in the region as a whole, albeit at a higher level of expenditure. Moreover, there is a need to determine the opportunity cost of PME, which is clearly high, and the possibility –which also

³ See, for example, United States Congress, 1997a and 1997b; these two studies openly and sometimes critically analyse the proposals of the Department of Defense, proposing alternative courses of action to make better use of fiscal resources.

seems high— of replacing it with specially targeted public expenditure in the case of its externalities.

At the **national level**, the following aspects should be considered:

i) *Cost/benefit ratio of PME*: Before allocating funds for higher military expenditure, the following questions should be asked: Will this expenditure achieve the desired objective? Could the same effect be achieved with fewer resources? Can the marginal social utility of military expenditure be estimated? And how does this utility compare with that of social or economic expenditure? In this sense, it would be interesting to estimate the costs and benefits which countries like Costa Rica have achieved through their low military expenditure.

ii) *Military fiscal institutions*: The same question needs to be asked as in the case of the other public institutions: How would the armed forces be organized if it were necessary to create them again in the present circumstances? The forms of design, management and evaluation of public military expenditure should be reviewed in the light of their special features. The frequent strategic differences of military institutions and their differing perceptions of the international situation should be institutionally processed to turn them into policy options. The financing and acquisition of military equipment should also be subject to standard regulations (Navarro Meza, 1997).

At the **international level**, the following aspects may be highlighted:

i) *Statistics on PME*: The accounting procedures regarding PME should be improved in order to standardize the way the military accounts are presented in the region.

ii) *Imports of arms*: So far, the exporting countries have often fixed the rules, either through sales on specially favourable terms or through the imposition of embargos. The importing countries should fix their own guidelines for arms purchases, which could serve as a containment exercise. This objective could be furthered by effective fulfillment of the need to register military expenditure and conventional weapons. A considerable number of Latin American countries have signed the United Nations Armaments Register, but only a very small number of them have put registration into practice.⁴

⁴ Half of the countries have signed the Agreement, but only five of them send information to the Register.

iii) *External financial assistance*: International cooperation donors and international financial institutions cannot ignore the fungible nature of such financing, which can be used to pay for PME.

iv) *Moratorium on military expenditure*: It would be desirable to study the conditions needed for a regional moratorium, among which are transparency and an increase in mutual confidence. Such a moratorium could be established for a specific period of time as regards the introduction of given systems of arms. It would also be possible to design mechanisms establishing quantitative and qualitative limitations on armaments systems. Ex-Presidents Carter and Arias recently expressed the need for a two-year moratorium in order to bring into being a broad arms limitation agreement. This initiative has been supported by the Prime Ministers of Canada, Grenada and Jamaica, as well as the Presidents of Colombia, Mexico, Paraguay and Uruguay.

v) *Reduction of military expenditure*: A coordinated reduction in PME which does not change the strategic balance would increase well-being. A virtuous circle could thus be established in which reductions of PME in some countries lead to reductions in such expenditure in other nations, provided the risk expectations go down. Simultaneous reduction of PME at the international level operates in the same way as a cooperative agreement, with all the difficulties that this involves, including the incentives to act deceitfully. There is also the possibility that it might be more advantageous for a particular country to remain outside the agreement. In the absence of a solution based on cooperation, a hypothetical means of correcting the negative externalities has been suggested. An international agency with the necessary authority could improve global well-being by imposing equal fines on each country. The agency would then return the money to the countries according to a given formula. Under reasonable assumptions, reductions in the national defence budget would be sufficient to pay the national fines, even if the latter were not returned. Consequently, each country would be better off (Hewitt, 1991b).

vi) *Mechanisms for preventing conflicts*: In addition to those already mentioned, others could be added such as early warning, including the establishment of academic observatories and virtual diplomacy mechanisms to promote dialogue; greater transparency of military policies and the development of unilateral policies designed to show a willingness to resort to the peaceful settlement of

conflicts; dialogues involving non-traditional actors such as parliamentary commissions and meetings of political leaders and figures, academics and intellectuals; promotion of mutual confidence and security, including the important role played by verification; intervention of guarantors, and the use of compensatory measures, including the possible establishment of compensation funds (Rojas, 1997).

vii) *Peace through development*: During his visit to ECLAC in April 1987, the Pope declared that development is the new name for peace. The United Nations General Assembly has reaffirmed that international peace and social progress are closely interlinked and that the road to peace and justice necessarily passes through development.

(Original: Spanish)

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Growth, *distributive justice* and social policy

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After more than a decade of economic reform and structural adjustment in the developing countries, there is increased recognition that economic growth and social equity must go hand in hand. This article starts by asking what is meant by "social equity". It notes that reduction of poverty and improvement of income distribution are two perfectly complementary policy objectives, since less inequality can help both to reduce poverty and to speed up economic growth. It reviews the main elements of the modern theory of distributive justice, covering the ethical and economic dimensions of inequality. It then turns to the recent analytical and empirical literature on the relationship between growth, inequality and development and addresses the question of whether it is possible to have both sustained economic growth and a simultaneous reduction in social inequality. It also focuses on social policies and discusses the scope and limits of growth-driven poverty reduction, targeting of social programmes and private sector participation in the provision of social services, highlighting the role of education, broader access to credit, more democratic ownership of productive assets (land; stocks and shares), and popular participation in the management of social policies as necessary means of making sustained growth compatible with distributive justice.

I

Introduction

After more than a decade of economic reform and structural adjustment in the developing countries, there is increased recognition that economic growth and social equity must go hand in hand. Economic growth is essential in order to improve living standards, generate employment and reduce poverty. In addition, growth generates income for the government, through taxation, that can be spent on social programmes. However, growth is generally unable, per se, to correct large income and wealth inequalities that can affect macro and social stability and therefore undermine the growth process.

In the 1990s there has been a proliferation of analytical studies on the relationship between income distribution (social inequality) and economic growth which explore the nature, sign and causality directions of the relation between these variables, as well as the transmission mechanisms at work. In addition, a reassessment of the Kuznets curve, the empirical relationship between levels of inequality and development, is underway.

Perhaps surprisingly, the recent academic interest in income distribution, growth, and development has not been matched by equivalent interest or action at the policy level. In fact, social policy is often defined as an anti-poverty strategy, with income distribution considerations remaining as an implicit (or

even ambiguous) objective in the policy agenda of international institutions and governments.

The paper starts by asking what is meant by "social equity", distinguishing between poverty and income distribution as two somewhat different but complementary policy targets, since less social inequality can help to attain both a lower level of poverty and a higher rate of economic growth.

After dealing with the main elements of the modern theory of distributive justice, which takes into account the ethical, philosophical and economic dimensions of inequality, the paper turns to the recent analytical and empirical literature on the relationship between growth, inequality and development and addresses the question of whether it is possible to pursue sustained economic growth at the same time as reduced social inequality.

The paper also focuses on social policies and discusses the scope and limits of growth-driven poverty reduction, targeting of social expenditure, and private sector participation in the provision of social services, highlighting the role of education, health, broader access to bank credit and ownership of productive assets (land, stocks and shares, etc.) and popular participation in the management of social policies as ways to increase equality, foster social mobility and enhance productivity, all of which are necessary elements for the integral reduction of poverty.

II

Poverty and inequality:

what do we mean by social equity?

What we might call a minimalist approach views the reduction of absolute poverty as the only valid concern for social policy, holding that public policy must assure that most of (or ideally all) the population is above the poverty line and that no vulnerable groups

□ The author wishes to express his gratitude to Louis Emmerij and Mario Gutiérrez for their valued comments on a preliminary version of this paper.

(the elderly, children, poor households) suffer income deprivation. According to this view, as society reaches a threshold of basic needs satisfied for the population as a whole, subsequent inequalities could be considered as largely irrelevant.

The extent to which the reduction of social inequality is a valid additional policy objective (besides poverty reduction) is a complex issue related to

at least two considerations: i) ethical and moral questions of distributive justice which may make the reduction of inequality an objective in itself; and ii) the impact of income inequality on other

policy objectives such as sustained economic growth, socio-political stability, and the capacity to direct and implement public policies aimed at furthering development.

III

The theory of distributive justice

The theory of distributive justice¹ focuses on the causes of inequality and provides the philosophical and economic foundations to illuminate discussions on inequality.

1. External factors and personal responsibility

If the inequalities of income and wealth observed in a society reflect to a large extent differences in initial endowments of wealth, talent, family connections, race or gender—factors which are mostly beyond the control of the individual and therefore represent (in philosophical terms) a set of “morally arbitrary” factors—then inequality becomes an ethical issue, since key wealth-creating factors are “external” to the individual. However, observed inequalities of income, wealth and consumption can and do also reflect individual differences in effort, ambitions and risk-taking. To the extent that these latter elements reflect personal preferences and belong to the realm of personal responsibility, they do not necessarily constitute an ethical problem from the viewpoint of distributive justice.

This neat distinction between “external” factors and those belonging to the realm of individual responsibility is blurred when it is recognized that “external” or “morally arbitrary” factors (e.g., initial wealth or talent) are likely to be related to the formation of preferences and the concept of individual responsibility, for individual preferences that ultimately guide efforts, ambitions and risk-taking are influenced by the resources and talents owned (or available) to the individual; in fact, it may well be thought that a wealthy individual’s perception of what constitutes “success in life” or acceptable levels of welfare

can be very different from those of the poor or handicapped. This circularity between resources and preferences or between “morally arbitrary factors” and “personal responsibility” makes the theme of the origins of social inequality both exciting and highly complex.

2. Alternative views on distributive justice and social inequality

The fundamentally different visions of society held by the different schools of thought affect views on inequality. Important liberal thinkers such as John Rawls emphasize that initial wealth, family background, social connections and the like can be unfairly distributed in the “birth-lottery”. For Rawls (1971), the organization of a just society requires a social contract negotiated by the different social actors under a “veil of ignorance” regarding the distribution of wealth and other traits among individuals that shapes their interests in society, and a social arrangement is just only if it is the best for those relatively worse-off in society, compared to other alternative social arrangements (the so-called “difference principle”).

In the neoclassical and utilitarian approaches, welfare economics avoids judging the justice of a given distribution of income and wealth in society by focusing only on maximizing the total sum of personal utilities, regardless of how those utilities are distributed among the different members of society. Moreover, neoclassical economics sees distributive outcomes as the result of voluntary wealth accumulation over generations, with the remuneration of factors of production being given by the levels of productivity and effort, rather than being determined by features outside personal control and responsibility, as emphasized in the theory of distributive justice.

¹ For a study on recent theories of distributive justice, see Solimano (ed.), 1998, chapter 2; see also Roemer, 1996.

Box 1
DETERMINANTS OF INCOME AND WEALTH AND CONCEPTS OF EQUALITY

Determinants of income and wealth	Initial assets: talent, gender, race, family status ("outside" factors or initial conditions)	Effort levels, risk-taking entrepreneurial capacities (personal responsibility)
Equality of opportunities	X	
Equality of outcomes	X	X

Marxian economics, for its part, sees the unequal property relations and command of productive wealth in capitalism as the main factors responsible for generating and reproducing existing inequalities over time (Marx, 1970). In contrast, libertarians like Robert Nozick see the possession of wealth and the right to enjoy its benefits as a natural right of the individual, as part of the "self-ownership" that includes the right of private use of productive assets and natural resources (Cohen, 1995).

3. Concepts of equality

Another important set of issues in the theory of distributive justice relates to the concept of equality.² A crucial distinction is made between equality of opportunities and equality of outcomes: a person may not be responsible for the set of opportunities he faces when he is born—race, gender, talent, wealth and family background are all predetermined variables for the individual—but each person is responsible for transforming favourable opportunities into positive outcomes. Equality of access to wealth-creating factors (e.g., education or credit) is termed equality of opportunities, and would be a valid policy objective from the viewpoint of distributive justice. In contrast, setting the objective of distributive justice in terms of equality of outcomes, measured by

income or wealth, should not necessarily be a target for social policies if outcomes depend to a considerable extent on voluntary choices regarding effort in the workplace and/or risk-taking attitudes in undertaking entrepreneurial activities (box 1).

The (minimalist) view postulating equality of opportunities as the only valid criterion for a distributive policy circumvents the fact that effort and risk-taking are not fully independent of initial background conditions, as already noted, however. A more "activist" view of equality would qualify the concept of equality of opportunities and expand it in several directions: first, it would distinguish between formal and effective equality of opportunities (for example, education might be a universal right in a country, but effective access to it may depend on the income level of the student), and second, it would call for compensation of those relatively less lucky in the "birth-lottery" (for reasons of less talent, race and gender, or vulnerability to discrimination). The implementation of compensation schemes will entail policies of income transfers, affirmative actions and others that go beyond the idea of pursuing only equality of opportunities to equalize access to education, credit or other resources, without seeking to compensate for other background conditions that are important for future individual success in life.

² A telling analysis which has influenced philosophical economics in this regard may be found in Dworkin, 1981.

IV

Inequality, growth and development: Complementarities and trade-offs

Let us now move from the complicated questions of distributive justice to the macro interactions (trade-offs and/or complementarities) between inequality, economic growth and long-term development. Is inequality of income and wealth the price to be paid for accelerated economic growth? Or, conversely, does inequality retard economic growth? How does inequality evolve during the course of economic development? These are key questions that need to be addressed.

1. Links between growth and inequality

The relationship between economic growth and social inequality at the macro level depends on how the growth process is specified.³ In models of saving-driven growth, if profits-recipients save in greater proportion than wage-earners (linear saving functions), a pattern of income distribution more concentrated towards capital will increase national saving and accelerate the economic growth rate (everything that is saved is invested). This model supported the "conservative" notion that a more equitable distribution of income retards economic growth through its negative effect on the national savings ratio, thus pointing to the existence of a trade-off between growth and equity.

Conversely, neo-Keynesian and endogenous growth theories view growth mainly as an investment-driven process and emphasize complementarities between growth and social equality. In neo-Keynesian models in which aggregate demand plays a role in the determination of long-term growth, income distribution affects growth through both effective demand (consumption, investment demand, exports) and the rate of creation of new productive capacity.

A redistribution of income to wage-earners can raise aggregate demand and growth in the short term provided positive consumption effects predominate over adverse effects on investment and exports. However, that initial increase in aggregate demand will probably lead to supply constraints, generating inflationary and balance-of-payments disequilibria that will limit or simply reverse the initial income redistribution.⁴ In the endogenous growth literature, countries with large personal income and wealth inequalities invite, through a political mechanism, higher taxation and the adoption of redistributive policies that depress the profitability of capital, hampering investment and slowing down growth of the product, the main implication therefore being that initial inequality is bad for subsequent growth. Other channels have also been highlighted to show a negative correlation between personal income inequality and economic growth: inequality can lead to socio-political instability and/or to populist economic policies that are ultimately destabilizing and hamper private capital formation and economic growth. In analytical terms, the new literature combines investment-driven growth with a political mechanism causing public preferences for pro-growth rather than pro-redistribution policies to be reflected in actual government policies. This political mechanism ranges from elections or referendums to social pressure (e.g. social activism, strikes, etc.). In the endogenous growth, neo-Keynesian and neo-marxist models the causality goes from initial inequality to future growth (table 1). Interestingly, this literature carries a "progressive" message that social inequality is bad for growth, although it identifies redistributive policies (particularly those that hamper investment) as the reason why initial inequality brings subsequent slower growth.

³ See Solimano (ed.), 1998, chapter 4; Solimano (forthcoming, chapter 2), and Alesina and Rodrik, 1994.

⁴ This was the case with the redistributive policies pursued by Allende in Chile in the early 1970s, by Nicaragua in the early 1980s, and by Peru in the mid-1980s.

TABLE I

Summary of distribution and growth theories

Theories	Model		Economic mechanism		Socio-political mechanism		Causality		Type of relationship between inequality and growth	
	Saving-driven growth	Investment-driven growth	Through classic saving function	Through profitability and investment	Median voter	Bargaining power of capitalists/workers	Income distribution to growth	Growth to income distribution	Inverse	Direct
Classic	X		X				X			X
Solow	X							X		
Kaldor		X	X					X		X
New growth theory/ endogenous policy		X		X	X		X		X	
Wage-led and profit-led growth theories (neo-Keynesian)			X	X			X	X		
Neo-Marxist theories a) Long-run b) Profits squeeze/ social structures of accumulation	X		X			X	X			X
		X		X		X	X			X

Source: Solimano, 1998, chapter 4.

2. Empirical evidence

The empirical part of this literature on the relationship between inequality and growth is largely dominated by cross-section or panel regression analysis.⁵ In general, a number of empirical studies tend to support the hypothesis that inequality (an explanatory variable) has an often statistically significant negative effect on the rate of product growth (the dependent variable in the regressions) after controlling by variables such as initial per capita income, levels of education, and political participation. This result seems to hold for separate samples of developed and less developed economies (Persson and Tabellini, 1992) and is robust for various alternative functional forms of the distribution-growth relationship and different measures of inequality (share of top quintile, Gini coefficient, Theil coefficient (see Clarke, 1992)).

⁵ In the studies on distribution and growth it is still hard to find analyses of time series with institutional and historical information from the countries studied.

However, not all studies agree on this. For example, Fishlow (1995) shows that the negative correlation between inequality and growth ceases to be detected when a dummy variable for Latin America—a region with high inequality—is included in the regressions. There seems to be even less agreement on the influence of the political regime (democracies or non-democracies) on the inequality/growth nexus. While Persson and Tabellini (1992) found that the negative relationship between inequality and growth holds only for democracies, Clarke (1992) and Alesina and Rodrik (1994) found no significant impact of the political regime on the sign and significance of the distribution parameter in the growth regressions. It is worth mentioning that all the models tested which include the economic and political mechanisms are reduced forms. A structural test of the political mechanism (median voter) proposed in the theory is hard to find.

A recent World Bank study by Deininger and Squire (1995b) shows that most of the recent tests of the negative relationship between initial inequality and subsequent economic growth are based on in-

come distribution data of limited coverage, with little cross-country and temporal comparability. Moreover, the results obtained in those previous studies have to be carefully interpreted as they are estimates from reduced forms of a structural model in which other variables may determine the joint co-movement of growth and income distribution observed in the data. Furthermore, in a related study Liu, Squire and Zou (1995), using recent and more consistent data on income distribution, show that income inequality is relatively stable within countries and over time, in stark contrast with the behaviour of the rates of growth of GDP, which change rapidly and are characterized by very low persistence. These two studies strongly caution about the accuracy of the empirical tests of the new growth theory on income inequality.

3. Links between inequality and development: the Kuznets curve

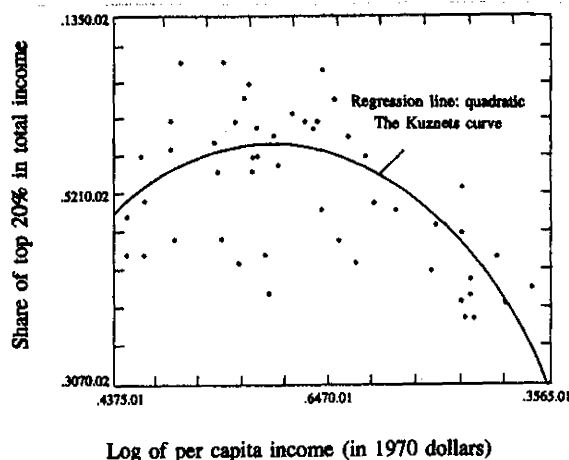
The relationship between levels of development (proxied by the level of per capita income and total income) and inequality (measured by the Gini coefficients or the relative shares of the top and bottom quintiles or deciles) postulated by Simon Kuznets has been the subject of controversy and empirical testing for a long time. As it is well known, the Kuznets hypothesis states the existence of a non-linear relationship between per capita income and an index of income inequality, reflected in an inverted U-curve; income inequality worsens in the initial stages of development, characterized by low per capita income levels, but improves thereafter as per capita income rises (figures 1 and 2). The Kuznets mechanisms focused on the shift from a surplus-labour agricultural sector paying subsistence wages to a modern industrial sector with higher wages during the initial stages of development. Later on, inequality declines due to a narrowing of wage differentials as the pool of surplus labour is exhausted and the skills profile of the work-force is upgraded through formal education and learning-by-doing during the course of development. According to Kuznets, the causality goes from development levels to inequality, and the sign of the relationship evolves over historical time.

4. Empirical evidence

The Kuznets curve spurred a vast empirical effort devoted to testing its shape, determining its robustness to the selection of countries and time periods, and detect-

FIGURE 1

The Kuznets curve: Representative international sample of 60 countries for the 1960s and 1970s



Source: Ahluwalia, 1976, table 8, pp. 340-341.

ing turning points at which income distribution starts improving along the development process.

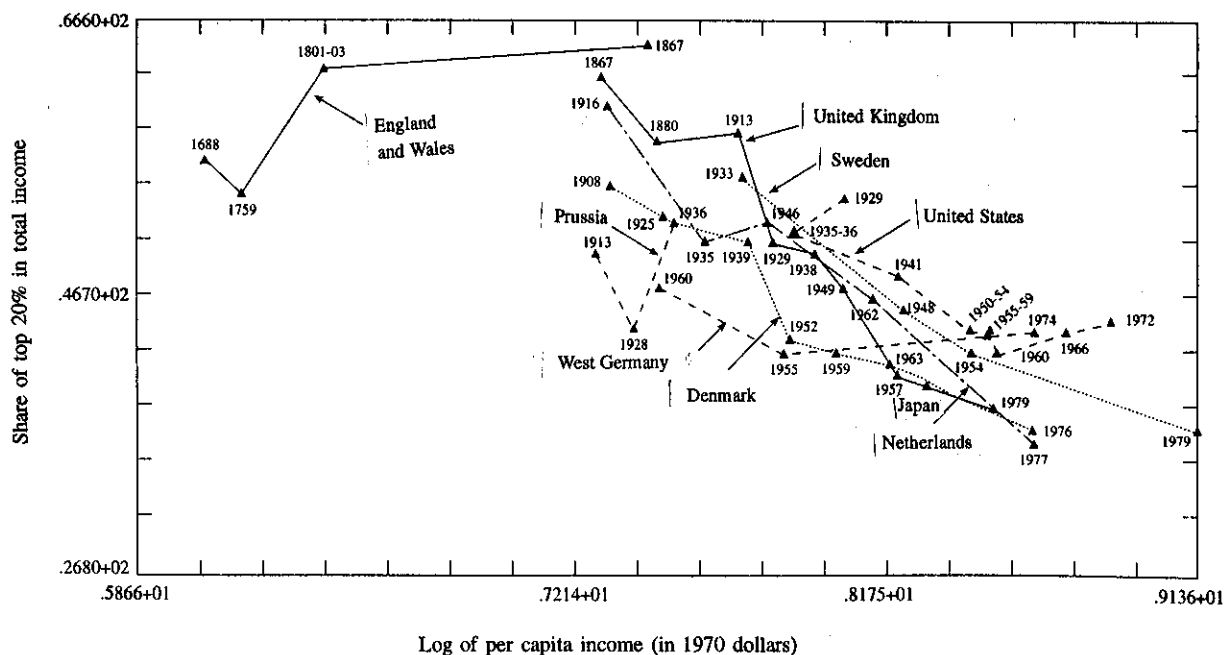
The empirical cross-section analyses of Ahluwalia (1976), Lindert and Williamson (1985), Adelman and Robinson (1989), Bourguignon and Morrison (1990) and others tend to give (qualified) support to the existence of the Kuznets curve. In addition, for cross-country regressions, the inequality portion of the Kuznets curve tends to be more unstable than the portion of declining inequality (see figure 1). Since the inequality part of the curve comprises countries in a range of low to moderate per capita income levels, the relationship is more unstable for these countries.⁶ In contrast, it seems a more established fact that inequality tends to decline in countries at the intermediate and high levels of per capita income (see figure 2)⁷.

⁶ A recent study by Fields and Jakubson (1993) found an inversion of the Kuznets curve in a "fixed effects" model allowing different countries to fit into Kuznets curves with the same shape but different intercepts. In models combining time series with cross-sectional analyses, however, the standard Kuznets curve is maintained.

⁷ This does not rule out changes in the levels of inequality even in high per capita income countries as the result of changes in economic policies. This seems to be the case for the United States under President Reagan and the United Kingdom under Prime Minister Thatcher, where inequality went up (see Krugman, 1994).

FIGURE 2

The Kuznets curve: Historical time series from five European countries and the United States



Source: Lindert and Williamson, 1985.

However, studies for some individual countries in Latin America (Colombia, Brazil, Argentina) and for Asian countries are reported to conform to the Kuznets curve pattern (see Fields and Jakobson, 1993). A comparison of the impact of inequality on growth in Latin America and in East Asia is made in Birdsall and Sabot (1994).

Two recent World Bank studies (Deininger and Squire, 1995a and 1995b) have produced a new expanded data-base on income distribution, giving improved coverage and consistency for the re-evaluation of existing studies of the Kuznets curve. These World Bank studies, which pool cross-sectional with time-series data, show that the Kuznets curve holds only for a very small set of countries (10% of the sample)

and that in general no statistically significant relationship between the level of income and inequality is found for over 75% of the sample. The "universal Kuznets curve" is not detected in the data. These recent studies thus cast doubts on the existence and robustness of the Kuznets curve. More research is needed to settle the conflict between the new World Bank observations and previous evidence on the Kuznets curve. At all events, there seems to be evidence that as countries move up the per capita income ladder, inequality tends to decline. An important practical question is at what levels of per capita income (US\$ 5,000?, US\$ 8,000?) income inequality starts to decline, and how public policies can help accelerate this process.

V

Policy issues

1. Are growth and equality compatible?

A central question is whether public policies aimed at improving income distribution can be compatible with high and sustained growth. The macro-growth models reviewed here offer arguments in support both of "conservative" views that redistribution deters growth and "progressive" views that redistribution and growth are compatible and even mutually reinforcing complementary policy goals. Analytically, the conservative view finds support in two models. In a full-capacity, growing economy, income redistribution to relatively low-saving groups can depress the aggregate saving ratio, thus leading to a decline in growth. In investment-driven models, redistributive policies that entail higher taxation and/or regulation depress privately appropriated returns on human capital and physical investment and harm growth. Are we thus condemned to accept social inequality as the price for high-growth policies? Is the "conservative equilibrium" inescapable? Not necessarily. Three arguments are in order here:

First, the message of the Kuznets curve is that the growth process itself would be "equalizing" beyond a certain threshold of per capita income (the turning point of the curve), making the fruits of progress and development available to a greater portion of the population.

Second, beyond trickle-down, policy intervention to assure broad social access to education (and to credit) can have a big pay-off in terms of both efficiency and equity. The market equilibrium can lead to substantial underinvestment, particular in human capital, in the case of those at the bottom part of the income distribution scale who cannot pay for their education and have very limited access to capital markets. Accelerated widening of the educational base is a policy with great potential for making growth compatible with equity.

Third, a more equitable distribution of income and economic opportunities also contributes to social peace and political stability, which are key ingredients in a policy framework conducive to investment, innovation and growth. In the final analysis, social equity and economic growth can go hand in hand

if properly articulated to respect the key economic and political constraints affecting society.

2. Growth and poverty reduction in a market-based framework: scope and limits

In line with market-based economic reform, during the last decade many countries have moved away from traditional social policies that often involved across-the-board subsidies to large segments of the population on basic foodstuffs, public utilities such as water and electricity and other social services. For a while, in many countries these policies made possible a considerable reduction in illiteracy, substantial educational upgrading of the middle class and lower income groups, and improvement in health indicators. However, these policies eventually led to a growing fiscal burden and they often also benefited higher income groups.

The new social policies tailored to a market-based policy framework rest on the following principles:

- Economic growth should be the main engine for poverty reduction and improvement in living standards (the "trickle-down" effect).
- Relative prices and the market mechanism must guide resource allocation and the incentives to save and invest. Social policies must avoid affecting the relative price structure of the economy through subsidies and indirect taxation. Price controls of basic foodstuffs must be eliminated. Marginal cost pricing must dictate charges to users of public utilities.
- Social policies must be explicitly focused on—or targeted to—the most vulnerable segments of the population (the elderly, children, the handicapped) and the poorest groups in society (the rural population, workers in the informal sector, families in extreme poverty in urban dwellings).
- Private sector participation in the provision and management of basic social services such as education and health must be encouraged through privatization and/or concession schemes.
- The explicit objective of social policy is poverty reduction. Correcting large income or wealth inequalities is not an explicit policy objective.

A full evaluation of the implementation and results of social policies based on these principles is beyond the scope of this article, but a few observations are in order.

As mentioned above, economic growth is seen as the main vehicle for poverty reduction and improvement in living standards. There is no question that economic growth is very important. Growth directly generates employment and real income for labour market participants and provides –through tax receipts– fiscal revenues for the State to finance social policy. Moreover, a growing economy is bound to ease distributional conflicts, as competing claims are over a “growing pie” rather than a zero-sum game. However economic growth also presents limitations as a mechanism to enable poverty reduction and improvement of living standards. First, the poverty-reduction potential of growth depends not only on the level of growth but also its composition: it must be labour-intensive and provide greater benefits for the less-skilled segment of the labour market, and the spatial (or regional) composition of production must favour poorer regions more than others. Second, GDP (or any aggregate measure of the product) is a yardstick that omits distributive considerations.⁸ Third, growth of the product does not directly reach some vulnerable groups such as the elderly, children, the handicapped, or rural dwellers engaged in subsistence agriculture who are outside the labour market and form part of the dependent population. GDP statistics often under-report informal sector activities in which the lower income groups are involved. Action at the level of the family, civil society and the public sector is needed to reach these segments. Fourth, GDP is a commodity-or “opulence-based” measure of economic welfare that does not include non-market goods (such as political freedom, the psychological value of belonging to a community, etc.) or evils (environmental degradation, crime, urban congestion) which also decisively affect human well-being. Fifth, unlike traditional social policies which had a political following in the urban working class, in the powerful unions of the middle class (teachers, doctors) and in other interest groups, the new social policies have as beneficiaries poor and vulnerable groups with a weak voice and feeble political organization; this means that there are only tenuous political incentives for

active poverty reduction beyond that provided by economic growth, and this may be an important factor behind chronic poverty.

Another main element of the new strategy of social policies is targeting. The emphasis on precisely defining the beneficiary groups is a reaction to social policies that often reached, at a high fiscal cost, the non-poor (the middle class and the rich). A basic principle of targeting is to focus social policy on the poor and to avoid reaching the non-poor.⁹ In this context, targeting is more effective in terms of reaching the “real” poor, at a substantially lower fiscal cost than untar­geted, broad-based social policy.

However targeting is not devoid of problems either. First, it makes the beneficiary a passive “victim” rather than an active agent with policy responses and choices.¹⁰ Second, there are serious problems of information and incentives. Delimiting the beneficiaries and the particular features of their socio-economic profile that need to be addressed is not easy (i.e., an information problem). Reaching the most vulnerable groups through the administrative apparatus of the State cannot be taken for granted everywhere. Moreover, some targeted groups have a more active political voice than others, thus biasing the transfer of resources to them (i.e., a problem of incentives). Political favouritism and the clientage of the most prominent groups can lead to failure to reach the neediest.

Private-sector provision and delivery of social services such as education and health is another component of a market-based approach to social policy. Private sector involvement in the social sectors can help to release financial and human resources of the State so that its efforts can be focused on the lower income groups. Privatization of social services, or their provision under concessions, seems to work well in terms of an adequate supply –in terms of quantity and quality– of education and health services for high-income and upper middle class sectors that can afford to pay for the services thus provided, but for low-income groups and the lower segments of the middle class the situation is different. As their ability to pay is low they depend on demand subsidies –such as a voucher system– for gaining access to high-cost, privately-provided social services, or else they must

⁸ See Sen (1987) and Anand and Sen (1996).

⁹ See Cornia and Stewart (1996) for an interesting discussion of two types of “errors” in targeting: the E-error (Excessive coverage, i.e., reaching the non-poor) and the F-error (Failure to reach the poor).

¹⁰ In this respect, see Sen (1987) and Anand and Sen (1996).

be served by the State. In addition, in the case of private health systems, the suppliers often introduce clauses that exclude the elderly, the chronically ill and those with large families from access to these programmes, although these are precisely the most vulnerable groups, which need most protection.

The coexistence of a relatively poor State-provided education and health system, along with a modern and affluent private system, creates serious problems of incentives and equity. Schoolteachers, university professors, physicians and paramedicals often have considerable incentives to work in the highly-paid private sector, thus depriving the State sector of human resources. Moreover, while some citizens will have access to first-class education and health services, others will have to make do with impoverished education, and health services provided by the State. One of the main challenges is how to guarantee good-quality, cost-efficient social services for the large segments of the population that cannot afford to pay for the services offered by the private system and must therefore be served by the State.

3. Policies to reconcile growth, social equity and poverty reduction

Policies designed to increase individual productivity and earning capacities are crucial for reconciling economic growth with better income distribution and less poverty. Education is a clear case in point: it endows people with greater human capital and productive potential and promotes social mobility.

The *quality* of education and the extent to which the poor have access to it are also important, however, but education is a supply-side policy which, in order to be effective, requires a corresponding level of demand for human resources and labour, which in turn depends on the level of effective demand and the pace of economic growth. It would be futile to have pools of educated and well-qualified people who are unemployed or under-employed.

Broadening and democratizing access to credit and the ownership of productive assets is also an equalizing, productivity-enhancing mechanism, because many latent productive projects identified and formulated by small-scale entrepreneurs and low-income households fail to be implemented for lack of credit and finance.

The recent literature maintaining that "inequality harms growth" stresses that redistributive policies pe-

nalize private investment and growth. This means that attention must be given to the way that redistribution is carried out. Capital taxation can depress profit rates and lead to slower investment; the level of taxation must be carefully monitored, as high taxation invites evasion as well as hampering saving, investment and growth. However, investment is also very sensitive to uncertainty and socio-political instability, which in turn are related to situations of severe inequality.

From this perspective, policies aimed at reducing major social inequalities can have a significant "social peace dividend" which is essential for fostering a framework conducive to investment and growth.

The promotion of economic growth must continue to be viewed as a basic engine for better living standards and poverty reduction, but it must be complemented with a greater awareness of the limits of consumption-based welfare. A healthy physical environment, economic and personal security, civic participation and political freedom are all very important dimensions of meaningful human self-realization, beyond the consumption of goods and services acquired in the market.

In addition, paternalistic social policies must be avoided. Paternalism is a defect of both traditional social policies involving broad-based subsidization in low-income countries with fiscal problems and also of social policies concentrating too much on targeting. The network of community and non-governmental organizations which has appeared in recent years in many countries is a useful bridge between individual atomization and an omnipresent State (yet with limited administrative and financial capacities). These intermediate organizations can and do play an important role in the design and management of social policy. "Civil society" is a valuable means of allocating and redistributing resources in addition to the market and the State.

Private provision of some social services can serve an useful role for the higher- and middle-income groups. It can also be a source of innovation and improved practices whose example should spread to the State-provided social services. In developing countries it is clear that the vast majority of the population needs access to good-quality education and health services, whether provided by the market, the State or society itself. The challenge is how to combine these three systems in designing and implementing effective, modern and equitable social policies.

VI

Concluding remarks

Over the last decade or so, social policies in developing countries have been defined almost exclusively in terms of poverty reduction. A fresh look is now needed at the issue of the reduction of social inequality, as an additional means of reducing poverty and achieving other socio-economic objectives.

Analytically, the modern theory of distributive justice distinguishes between "outside factors" or "morally arbitrary" initial conditions (gender, race, initial assets, talent) and "personal responsibility" elements (effort, risk-taking attitudes) in evaluating the determinants of inequality of wealth or income in society. Social inequality is a reflection of individual differences in these two sets of wealth-creating factors.

Any broad and modern social policy needs to define a concept of equality and/or social equity. Equality of opportunities (e.g., for education, access to bank credit, property) must, if it is to be effective rather than merely formal, be accompanied by some complementary actions in the legal, constitutional and economic fields. More complex concepts, such as equality of outcomes, call for mechanisms to compensate for adverse initial conditions in terms of wealth, talent or gender.

The new theories of endogenous economic growth stress the complementarities between social equity and growth, since inequality can engender social conflict, invite taxation of physical investment and induce economic populism: all factors that ham-

per economic growth. The empirical evidence seems to support these complementarities between equity (lower inequality) and higher growth rates.

The Kuznets curve, which links development levels with income distribution, suggests a trend towards lower inequality after "intermediate" levels of per capita income have been reached. Assuming that the Kuznets curve holds good—which is currently in dispute—it is important to know the plausible levels of per capita income after which a decline in inequality is to be expected, and the mechanisms that bring about that decline.

Market-friendly social policies rely on growth-led poverty reduction, targeting and private sector participation in the delivery of social services. Some loose ends in this strategy are: i) insufficient awareness of the limits of commodity-based growth for reducing poverty in conditions of high inequality; ii) informational, administrative and political limitations on the ability to reach the target groups; and iii) excessive segmentation in the quality of the social services provided by the private and State sectors and the population's access to them.

Broadening and deepening of good-quality education for all, improvement of health services, and broader access to credit and ownership of productive assets by low-income households and small-scale producers are key policy measures for making long-term growth compatible with social equity.

(Original: English)

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Equity, foreign *investment and* international *competitiveness*

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Is the degree of competitiveness of countries independent of their degree of inequality? Is competitiveness only a question of microeconomic and sectoral efficiency, of the real exchange rate, or is it also a social question? So far, the specialized literature has ignored the problem of equity in the determination of countries' competitiveness. It has then not been able to fully explain the observed competitiveness, however. In this article, equity is incorporated into the production function and also into investors' decisions in a world of perfect mobility of capital. The predictions of the proposed theoretical system are generally consistent with the data observed in the world economy. In particular, Latin American displays the highest degree of inequality of all the regions of the world, yet its share of foreign direct investment flows is low, and so is its share of world trade (its competitiveness). The theory presented here and the data assembled suggest that the relative levels of productivity of countries depend in a positive manner on the allocation of investments, and this allocation in turn depends, likewise in a positive manner, on the degree of equity prevailing in the countries. The competitiveness of a country therefore depends, among other factors, on its degree of economic inequality. Societies compete in the capital market, seeking to attract private investment in order to make themselves competitive in the goods market, and this is influenced, among other factors, by their current degree of equity.

I

Introduction

International competitiveness is a favorite topic in the recent economic literature. As Krugman (1995) says, there seems to be a dangerous obsession with this question. It is believed that there is a relation between differences in productivity –the basis for competitiveness– and national standards of living: a relation which Krugman finds unacceptable from both the logical and the empirical point of view, since it means that a country's standard of living would depend on its own productivity (i.e., on its absolute productivity) rather than its relative productivity.

What can we say about the relation between competitiveness and equity? Can it be that equity also depends only on absolute productivity and is therefore independent of relative levels of productivity, that is to say, of competitiveness? Or is it the other way round: competitiveness depends upon the degree of equity of the society in question? There is

abundant economic literature which analyses equity and competitiveness separately, but there are very few studies on the interrelations between them. This article seeks to make some progress in this field.

The productivity of a country is an important factor in its competitiveness on international markets. What is the relation between productivity and equity, however? In order to answer this question, which is central to the present study, a theory of production is developed here in which equity is a variable of the production function (section II); the logic followed by investors with regard to country risk is analysed (section III); empirical tests are made of the predictions of the theoretical system (section IV); the role of the natural resources endowment is analysed (section V); and finally, some conclusions are put forward and the prospects opened up by the equity-competitiveness relation are summarized (section VI).

II

Equity and productivity

The competitiveness of a country may be defined as its capacity to win positions in the different international markets. The theory is that in the long term this capacity depends on the relative productivity of the country. But what are the factors that determine a country's productivity? A number of theoretical hypotheses may be suggested here in this respect.

□ This study was initiated in the Regional Office of the International Labour Organisation (ILO) in Lima towards the end of 1995, in response to an invitation by Víctor Tokman. A number of colleagues have offered valuable comments on its successive versions. Thanks are due in this respect to David Drukker, Javier Iguñiz, Ricardo Infante, Félix Jiménez, José Oscátegui and John Sheehan, and in particular to Oscar Altimir. I should also like to express my thanks to the panel of commentators at the Latin American Studies Association (LASA) meeting at Guadalajara, 17-19 April 1997, at which this study was presented for the first time. It goes without saying that any errors are entirely the responsibility of the author.

First, productivity depends on the entire system of production. As may be deduced from Leontief's technological system, the productivity of one sector cannot be independent of the productivity of the other sectors. The road infrastructure, transport services, ports and communications services are factors which also influence the productivity of the system of production. This has been acknowledged in a number of studies carried out in Latin America. Thus, the ECLAC study on changing production patterns with social equity (ECLAC, 1990) considers that productivity is a systemic matter. Indeed, if it is considered that there are interrelations between the sectors in a system of production –like those in Leontief's technological system– this conclusion is beyond question. Even the concept of "factor intensity" must be defined in relation to the total content (direct and indirect) of capital and labour per unit of

product, and not just in relation to the direct coefficients, as is usually done.

Second, the productivity of the economy will depend not only on the intensity of the factors of production, but also on the changes in the quality of those factors and in technological knowledge.

Third, productivity also depends on the quality of the entrepreneurs. This is perhaps the most significant limiting factor. What are needed are entrepreneurs who continually review their methods of production and adopt the new technological developments generated outside the firm, as well as new products. But there is also a need, and indeed a pressing need, for "Schumpeterian entrepreneurs" who develop new methods of production with new practices and inputs, new products, new markets and new sources of inputs. And as the institutional framework within which firms operate is also important for efficiency, Schumpeterian entrepreneurs are also needed in the public sector in order to generate institutional innovations to allow the production system to raise its level of productivity.

The factors mentioned so far have already been dealt with in the economic literature. In this study, however, a new theoretical proposition will be introduced: that productivity depends on investment, and investment depends on social and political stability, which, in turn, depends on the degree of equity reached by society. The challenge, then, is to bring equity into the production function and subsequently prove this theory empirically.

In order to initiate our argument, we will postulate a production function of the following form:

$$Q_t = f(L_t; S_{t,p}, Z_{t,i}) \quad (1)$$

Where Q_t is the amount of a good produced in the period t , L is the number of workers used in the same period, S is a vector representing the stock of private factors of production—land, physical capital and human capital (labour of different levels of skills)—and Z is a vector representing the stock of public factors of production, with both types of stocks being measured at the end of the preceding period.

We thus bring "public goods" into the production function. This set of goods includes not only infrastructure and public domain know-how (i.e., know-how that can be appropriated) but also social order. It is assumed that social order is a public good: once it is present, nobody can be excluded from its

benefits. Social order is brought into the production function because without social order the production process cannot be repeated time after time, using the same amount of inputs for the same amount of product.

These stocks are accumulated through private investment and public investment. We will assume that such investments require one period in order to accumulate the corresponding stocks, so they are shown with a lag of one period in the production function. We will also assume that private and public investments incorporate technological innovations and give rise to the accumulation of both old and new production goods. It is therefore not possible to add vectors from periods which are different by one number (and call the result "amount of capital"), since they include stocks of production goods (physical and human capital) which are heterogeneous and of changing qualities.

In view of the logical difficulties raised by the problem of adding capital in a dynamic economy, the production function could be expressed only in terms of the relation between the product and the number of workers: a relation which changes continually with investment. This is the formulation which we will use here.

If we accept the idea that the social order should form part of the production function, then what are the factors that determine the social order? In another study (Figueroa, 1993), the theory has been put forward that the social order depends essentially on the degree of equity in the distribution of wealth. The axiomatic proposition is that not all kinds of distribution of wealth are socially tolerated. Only a strict subset of the possible distributions of wealth would be socially accepted; if the functioning of the economy led to a solution which lay outside these limits, society would enter into a distributive crisis, that is to say, into social disorder.

A distributive crisis depends not only on the distributive results of the market, but also on the redistributive policy of the State. Public social expenditure would be one of the mechanisms available to the State for reducing the distributive gaps arising from the functioning of the market and thus ensuring social order.

A growing impoverishment of the broad masses of the population (either absolute or relative) which brought society to a situation of distributive crisis would give rise to new forms of redistribution in

which the rights of ownership were no longer fully respected. In such a situation, non-contractual income would take on increasing importance. As a result, there would be an increase in the levels of violence, corruption and uncertainty in the system of production. All this would entail economic costs for society. In the short term, there would be an increase in the cost of personal security and protection of property and in the costs due to stoppages on account of strikes and all kinds of social disorders. These costs would be passed on to the production costs of firms. Part of the social costs would thus be transformed into higher unit costs for the latter, with a consequent loss of competitiveness.

In the long term, the economic costs of a distributive crisis would include a retraction in private investment (to which we shall refer later on) and also a decline in the quality of labour. With the pauperization of the masses, for example, infant malnutrition increases, and it is well known that the learning capacity of human beings is largely determined in their early infancy, so that the quality of tomorrow's labour force is actually being determined today. It will therefore be much more costly to raise the productivity of workers who did not receive proper care in their infancy. The rates of grade repetition and morbidity would be higher, and as a result the investment in education and health needed to obtain a particular type of labour force would also be higher.

In short, our theoretical proposition is that productivity depends, among other factors, on the stability of society, which depends in turn on the degree of economic equity existing in society: if the degree of equity goes down, there will be a greater risk of sinking into social and political instability and the system of production will display lower productivity. Equity (E) is an element in the production function of the various kinds of goods.

In the short term, with given stocks of private and public goods and a given level of technological knowledge, the production function may be written as follows:

$$Q_t = n F(L_t) \quad (2)$$

where $n = n(E)$ and where

$$\begin{aligned} n &= 1 \text{ if } E \geq E^* \\ 0 < n < 1 &\text{ if } E < E^* \end{aligned}$$

There is a distributive crisis when equity (E) has a value below the threshold of social tolerance of inequality (E^*). In this case, enterprises would have to use resources to protect private property and also to reduce their transaction costs (understood as the higher risks associated with labour interchange, that is to say, greater mistrust in labour relations), which will have risen. In a situation of distributive crisis, labour productivity would fall and the curve describing function F of equation (2) would shift downward.¹

In the long term, the production function can be expressed as follows:

$$Q_t = m_t F(L_t) \quad (3)$$

where $m > 1$.

Let us assume that the function F can only move upward, in accordance with the value of the variable m . Labour productivity would thus depend on the values assumed by the variable m .

What are the factors that determine m ? We propose the hypothesis that the variables that move the function F are private investment (I) and public investment (G), since these are the factors that expand the stock of private and public factors of production. Let us assume that the new technological know-how obtained through investment is incorporated both in physical capital and in human capital. We then have:

$$m_t = \phi(I_{t-1}, G_{t-1}) \quad (4)$$

We will assume that public investment is determined exogenously, but private investment will be considered endogenous. From the relations presented so far, it may be seen that in the long term labour productivity depends on investment, since this shifts function F continually upward.

¹ By replacing equity with real wages, we can express in a more analytical manner what has been termed the theory of "efficiency wages" (Solow, 1990). If real wages were to fall below a certain threshold level, labour productivity would fall. According to this theory, labour productivity depends on the level of real wages (and not the reverse, as conventional microeconomic theory maintains).

III

The logic followed by investors

What are the factors that determine long-term private investment in a country, however? We need a theory of investment.

There are as many as three different theories on long-term private investment: the first one holds that investment is endogenous to the economic process; the second, that it is endogenous to both the economic and socio-political processes, and the third, that it is totally exogenous. In the first case, the theory holds that private investment depends on the expected interest rates and yields, which depend only on expected relative prices (Barro, 1990). The second theory brings in the assumption that the expected yields also depend on the degree of stability of the socio-political system (Alesina and Perotti, 1993; Figueroa, 1993). In the third theory, investors would only be guided by their "animal spirits", as Keynes put it.

In this article, we will adopt the second theory. We will assume that investment decisions depend not only on the economic process but also on the socio-political process of society, that is to say, on the social order. Adopting the third theory would mean assuming that economic growth depends only on the state of mind of capitalists, so that there would be nothing to be done in terms of economic policy.

We will take it, then, that in the light of the risks facing an investor, his investment decision would depend on the expected yield and his capacity for absorbing risks. The greater that capacity is, the greater will be the tendency for the investor to enter into games which offer higher expected returns, although the risks are higher too. We will assume that this capacity is limited by the amount of assets that the investor possesses; that is to say, that aversion to risk is part of his restrictions and not of his preferences. Thus, investors with more assets would take greater risks (Figueroa, 1993).

We will also assume that capital is mobile among countries. In this case, how do investors decide which countries to allocate their funds to? In order to answer this question, we present an oversimplified model here. We shall consider two types of risks: product risk and country risk, since the investor must decide in what products and in which country to

invest. In both cases, the investor faces two possible situations. In the case of the product, he can obtain either a good return (r_1) or a bad return (r_2). The expected return on his investment would thus be:

$$r^e = P_1 r_1 + P_2 r_2, P_1 + P_2 = 1, r_1 > r_2 > 0 \quad (5)$$

where P_1 and P_2 can be interpreted as the probabilities that one or the other of these situations will take place.

Let us assume that the private and public production factors are complementary. Consequently, for given values of probabilities, the expected returns will depend on public investment (G).

In the decision regarding the country, we will also assume two situations: in country j there may be either socio-political stability or a situation of instability and chaos. We will term these probabilities V_1 and V_2 respectively, where $V_1 + V_2 = 1$. Let us assume that if the first situation prevails, the investor obtains r^e , but if the second one occurs his return will be zero. Consequently, his expected return, taking into account the country risk effect, would be:

$$R^e_j = V_{1j} r^e \quad (6)$$

In terms of the expected return, the investor would invest in the country with the highest value of R^e_j , that is to say, in the country with the greatest socio-political stability.

In the previous model, the expected rate of return for the product was independent of the country. If we relax this assumption, then the return in country j would be:

$$R^e_j = V_{1j} r^e_j \quad (7)$$

The investor would still invest in the country with the highest value of R^e_j , but now it could happen that a country with relative instability (a low value of V_1) could nevertheless attract investments because the value of r^e is relatively high.

In both models the risk is the same: loss of the whole investment if socio-political instability takes

place. In other words, the risk consists of the country risk factor. If the investor had the capacity to absorb this possible loss, he would make his investment in the country with the highest value of R^e . If he did not have that capacity, he would not invest in any country at all.

If we introduce into this system of relations the theoretical proposition that the probability of having socio-political stability—that is to say, social order—depends on the degree of equity, this means that the return on investment R^e would not be independent of the degree of equity of society. Hence, as well as depending on public investment, private investment would also depend on the degree of equity of the society (E): that is to say, the investment function would assume the following form:

$$\begin{aligned} I &= H(G) \quad \text{if } E \geq E^* \\ &= J(G, E) \quad \text{if } E < E^* \end{aligned} \quad (8)$$

where E^* is the threshold of socially tolerated equity.

Private investment could not be independent of the degree of equity existing in the society. If the degree of equity were above the social tolerance threshold, investment would not be affected by changes in equity, but if it fell below that threshold or were in danger of falling below it, investment would go down. The assumption that investors have different capacities to absorb losses—different “disaster points”, as Hicks (1989) would say—is enough to generate a curve where the relation between investment and equity is positive up to E^* . The lower the degree of equity (and of social stability), the higher the risk for the return on investment, so that only big investors with capacity to absorb possible losses would invest. As E increases, the risk would go down and investors with less capacity to absorb losses would enter the market. Obviously, beyond E^* the curve flattens out.²

Consequently, in a very unequal society the system of equations (3), (4) and (8) gives a production function with the following form:

$$Q_t = f(L_t, G_t, E_t), \quad \text{where } E < E^* \quad (9)$$

² It might be supposed that after reaching a high degree of equity the curve would take a downward direction, since an excess of equity can give rise to disincentives for investors. The curve would then have the form of an inverted U.

The level of production depends on the number of workers employed in the same period and also on public investment and the level of equity (when this is below the social tolerance threshold), both variables from the preceding period. We can thus say that a production process may be more or less “equity intensive” compared with another, depending on the degree of social stability acceptable to private investment. The latter depends on how many linkages this production process has with the other sectors of the economy. The more linkages it has, the greater its need for social stability, and hence the more equity-intensive it will be.

Investors would seek to exploit the absolute advantages, comparative advantages or competitive advantages of the selected country.³ The logic behind their decisions would be guided by the model developed here. But their investments would help to develop those advantages for the future, which would give rise to a dynamic effect. When the production process for a good is less intensive in terms of social stability, the investment may be less sensitive to country risk, and investors could seek to produce that good in enclaves (mines, oilfields, in-bond assembly activities, tourism centres). But if the production process in question is intensive in terms of social stability, the country risk may have a very substantial effect, so that they would not invest in the good in question. Because of the country risk factor, under which lies the degree of equity, the competitive advantages of a country might not be developed and its comparative advantages might not evolve.

In this theoretical formulation, equity results from the functioning of the market in the preceding period (which naturally operates with exogenous variables) and the social policies of the government, which is also an exogenous variable. But the theory we want to put forward here is that in a society whose development process starts from an initial condition of marked inequality, this inequality will be maintained. The market will not be able to reduce it, the political system will have no incentives to do so, and the situation of inequality will tend to persist. There will thus be a state of pronounced inequality in that society.

³ In line with Krugman, we will understand competitive advantages as being those which affect intra-industry trade.

A prediction with empirical content can be derived from this theoretical system: societies with a high degree of inequality will receive little foreign direct investment; other conditions being equal, a country with greater equity would attract a larger proportion of private investment, thereby raising its productivity and improving its share in

the international market. Another empirical prediction which can be derived from this theory is that in very unstable economies transnational corporations (whose capacity to absorb risks is greater than that of domestic firms) will have a bigger share in total private investment. Both predictions are empirically verifiable.

IV

Empirical data

A new set of data on equity presented recently by the World Bank (Deininger and Squire, 1996) is based on a sample of 108 countries from the 1950s to the 1990s, with a total of 682 observations. In this sample, Latin America (with 20 countries and 100 observations) appears as the region with the greatest inequality in the whole world (table 1). Its Gini coefficient has an average level of 0.50, while that of the advanced capitalist countries is 0.33 and that of the Asian "Tigers" is around 0.35. This order is maintained if the index used is the ratio of the shares in total income of the top and bottom quintiles.

In reality, there are two other interesting results which emerge from the data of Deininger and Squire (1996, table 1): first, the order of inequality among the regions is maintained over time; and second, the changes in the Gini coefficients are not radi-

cal within each region.⁴ These data are consistent with our hypothesis of the persistence of pronounced inequality when this is an initial condition of the economy.⁵

⁴ Even at the country level, there is noteworthy stability of the Gini coefficient: for the countries with more than 10 observations, the Pearson variability coefficient does not exceed 12%. This empirical fact raises some interesting questions: for example, is equity a structural characteristic of each society: an initial condition which it is hard to modify substantially?

⁵ The famous scientist Alexander Humboldt wrote that one of the features which impressed him most in his visits to the Americas was the tremendous economic and social inequality. A hundred and fifty years later, we are still talking about this same feature as one of the central problems of Latin America.

TABLE 1

Indexes of inequality, by regions, 1947-1995
(Averages)

	Number of observations (countries per year)	Gini coefficient	Ratio of the shares of the top and bottom deciles in total income
Latin America	100	0.50	16.02
Africa south of the Sahara	40	0.45	11.61
Middle East and North Africa	20	0.41	7.14
East Asia and Pacific	123	0.36	7.15
South Asia	60	0.34	5.50
Industrialized countries	238	0.33	6.63
Eastern Europe	101	0.26	4.05
Total	682	0.36	7.80

Source: Deininger and Squire, 1996, table 1.

TABLE 2

Latin America: Foreign direct investment
(Annual averages)

	Billions of dollars		
	1981-1985	1986-1990	1991-1993
A. All countries	50	155	171
B. Developing countries	13	25	57
C. Latin America and the Caribbean	6	8	17
C/B (%)	46.2	32.0	30.0
C/A (%)	12.0	5.2	9.9

Source: ECLAC, 1995, table II.2, p. 53.

TABLE 3

**Foreign direct investment flows to Peru and
to a group of Latin American countries,^a 1988-1993**
(Millions of dollars)

	1988	1989	1990	1991	1992	1993
<i>Peru</i>	26	59	41	-7	127	349
Normal FDI	26	59	41	-7	-13	60
Debt conversion	-	-	-	-	-	-
Privatization operations	-	-	-	-	140	289
<i>Group of Latin American countries</i>	7 961	7 469	6 951	11 062	12 271	44 420
Normal FDI	3 613	4 570	3 894	7 512	9 826	8 388
Debt conversion	4 154	2 784	1 841	305	133	25
Privatization operations	194	115	1 216	3 245	2 312	6 007
<i>Peru/Group (%)</i>	0.3	0.8	0.6	-0.1	1.0	2.42

Source: ECLAC, 1995, table IX.4, p. 192.

^a Comprising Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Latin America's share in foreign direct investment flows has been going down since the first half of the 1980s, regardless of whether it is measured with respect to all countries or only the developing countries (table 2). Peru, which is one of the countries in the region where economic inequality is most pronounced, suffered from marked political instability in the period from 1988 to 1992. In that period, foreign investment only entered the country in small amounts, beginning to increase only in 1993 (table 3). These data are in keeping with our hypothesis that a bigger share of investments goes to the more equalitarian societies.

The relation between equity and investment, which is a structural equation in our theoretical system (equation (8)), is statistically tested in a study by Alesina and Perotti (1993). For a sample of 70 countries, with data from the period 1960-1985, they find a negative correlation between equity and socio-

political instability, on the one hand, and between socio-political instability and investment, on the other. The 16 Latin American countries included in this sample displayed the highest degrees of inequality and socio-political instability, as well as the lowest rates of investment (Alesina and Perotti, 1993, tables 4 and 5 and p. 19).

These authors' interpretation of their results, and the policy conclusions they draw from them, suffer from a logical difficulty, however. In their model, these authors take income distribution as an explanatory variable: that is to say, as an exogenous variable of the economic process, but there is no economic theory that endorses such an assumption. The best way of solving this logical difficulty would be to consider a theoretical system like that developed here, in which investment in the current period depends on the degree of socio-political instability in the same period, and in which this latter variable de-

TABLE 4

Latin America: Share in world trade
(Percentages)

	Latin America	Developed countries	"Asian Tigers" ^a	Others
1960	7.7	65.9	3.4	23.0
1970	5.5	70.9	3.0	20.6
1980	5.5	62.6	6.0	25.9
1990	3.9	71.4	10.1	14.6
1992	3.7	71.5	11.5	13.3

Source: ECLAC, 1995, table I.4, p. 34.

^a South Korea, Taiwan, Singapore, Hong Kong, Indonesia, Malaysia and Thailand.

TABLE 5

Latin America (8 countries): Relative world market shares, 1964-1993
(Percentages)

	Argentina	Brazil	Chile	Colombia	Costa Rica	Mexico	Paraguay	Peru
1964	0.90	0.91	0.38	0.35	0.07	0.67	0.03	0.42
1965	0.87	0.93	0.37	0.32	0.07	0.67	0.03	0.39
1966	0.85	0.93	0.44	0.27	0.07	0.64	0.03	0.41
1967	0.74	0.84	0.43	0.26	0.07	0.58	0.02	0.38
1968	0.62	0.86	0.39	0.25	0.08	0.57	0.02	0.39
1969	0.64	0.92	0.43	0.24	0.08	0.57	0.02	0.34
1970	0.61	0.94	0.43	0.25	0.08	0.48	0.02	0.36
1971	0.53	0.89	0.30	0.21	0.07	0.46	0.02	0.27
1972	0.50	1.03	0.22	0.21	0.07	0.44	0.02	0.24
1973	0.61	1.15	0.23	0.22	0.06	0.42	0.02	0.21
1974	0.50	1.00	0.31	0.19	0.06	0.37	0.02	0.19
1975	0.36	1.06	0.19	0.18	0.06	0.36	0.02	0.16
1976	0.43	1.10	0.23	0.20	0.06	0.37	0.02	0.15
1977	0.54	1.16	0.21	0.23	0.08	0.40	0.03	0.17
1978	0.52	1.05	0.20	0.25	0.07	0.50	0.02	0.16
1979	0.51	0.99	0.25	0.22	0.06	0.58	0.02	0.23
1980	0.42	1.61	0.25	0.21	0.05	0.82	0.02	0.21
1981	0.49	1.24	0.20	0.16	0.05	1.05	0.02	0.17
1982	0.44	1.16	0.21	0.17	0.05	1.22	0.02	0.19
1983	0.46	1.29	0.23	0.18	0.05	1.29	0.02	0.18
1984	0.45	1.50	0.20	0.19	0.06	1.36	0.02	0.17
1985	0.46	1.41	0.21	0.20	0.05	1.22	0.02	0.16
1986	0.34	1.19	0.21	0.26	0.06	0.82	0.01	0.13
1987	0.27	1.11	0.22	0.20	0.05	0.89	0.02	0.11
1988	0.34	1.25	0.26	0.19	0.05	0.77	0.02	0.10
1989	0.33	1.17	0.28	0.20	0.05	0.79	0.03	0.12
1990	0.37	0.93	0.25	0.20	0.04	0.81	0.03	0.10
1991	0.35	0.92	0.26	0.21	0.05	0.79	0.02	0.10
1992	0.33	0.98	0.27	0.19	0.05	0.75	0.02	0.09
1993	...	1.05	0.25	...	0.06	0.82	...	-

Source: IMF, 1974 and 1994.

depends on the degree of equity in the preceding period. In this dynamic system, in the absence of data on the distribution of asset stocks, income distribution can be used as an initial condition in the time-paths of the endogenous variables.

Indeed, in the statistical analysis made by the above-named authors they use the income distribution at the beginning of the period studied (1960), while for the other variables they use the averages for the period 1960-1985. But in this case the interpretation of the results cannot be that which they do in fact make: that investment depends on the degree of inequality –“income inequality increases political instability, which in turn reduces investment” (Alesina and Perotti, 1993, p. 18), for both are endogenous variables. If these data are considered to be generated by a dynamic system, the causal relation would have to be different: that high income concentration, as an initial condition, increases the risk of socio-political instability, which leads to lower investment and growth rates.

Moreover, Alesina and Perotti's policy conclusions also need to be reformulated. They conclude that income redistribution has unpredictable net effects, since the higher tax pressure needed to secure such redistribution would reduce the incentives to invest. This effect may be one of levels and not of rates, however. This confusion is similar to that which exists when it is considered that international trade barriers based on protective tariffs, which are also tax rates, constitute a factor affecting economic growth. As Lucas (1988, pp. 12 and 13) rightly points out, the easing of such barriers could have an effect on the level but not on the rate of growth. If we adopt Lucas's theory that income distribution affects the growth rate, the logical conclusion of Alesina and Perotti's study, in the light of our reinterpretation of its empirical results, would have to be different: re-

distributing income, as a change in the initial conditions, would give rise to a different path marked by higher investment and growth: in other words, it would affect the growth rate.

Judging by its share in world trade, Latin America has lost competitiveness since the 1960s. Table 4 illustrates this trend very clearly. Between 1960 and 1992 the region's share in trade fell by more than half, from 7.7% to 3.7%. The developed countries account for most of world trade and have increased their share still further. The group that has increased its competitiveness most markedly, however, is that of the so-called “Asian Tigers” (South Korea, Taiwan, Singapore, Hong Kong, Indonesia, Malaysia and Thailand).

A sample of eight Latin American countries reveals the same pattern as for the region as a whole: loss of participation in the world market, although with differences of degree which are worthy of note (table 5). The loss of market shares has been most serious in the cases of Argentina and Peru, but less severe in Colombia and Costa Rica. Chile lost part of its market share between 1964 and 1986 and subsequently began to recover somewhat, although it did not manage to recover its market level of the early 1960s in the period studied. Paraguay has maintained its market share almost unchanged over the period, albeit with big fluctuations from year to year. Brazil registered successes during the period from 1964 to 1984, but since then it has lost ground and declined to levels similar to those of the early 1960s. The relatively most successful country is Mexico. It lost ground in 1964-1976, made substantial gains in 1977-1985, only to lose part of its advances between 1986 and 1989, settling down since then at a level somewhat higher than that of the early 1960s. In short, the Latin American sample does not include any case comparable to that of the “Asian Tigers”.

V

The role of resource endowment

The importance of equity in determining private investment depends, as we already noted, on the degree of integration of the export sector in the national economy. Private investment will seek to exploit the absolute, relative or competitive advantages, according to the country's initial conditions as regards resource endowment and equity. A society which only has an ample endowment of natural resources, with a high degree of initial inequality, could only attract investments seeking to exploit its absolute advantages and some of its comparative advantages. With such investments, however, it would be hard for the country to emerge from its social backwardness.

A significant endowment of natural resources can be counterproductive. A country in such a position may find it difficult to develop on the basis of absolute advantages. The exploitation of a country's absolute advantages does not require that it should have socio-political stability. The export activities can take place in an enclave. The more integrated the export sector is in the productive system of the country, however, the more important social order, and hence equity, will be for attracting private investments to develop the export sectors.

Consequently, societies with a good endowment of natural resources will have a higher level of foreign investment, for a given degree of inequality in the society. This is another empirical prediction of the model.

What kind of goods has Latin America specialized in? Throughout almost its entire history, up to the late 1970s, the region has specialized mainly in primary commodities such as those produced by the mining, petroleum, fishery and agricultural sectors; only in recent decades has it developed exports of manufactures (table 6).

With primary commodities, the region is exporting its abundant natural resources endowment, including its climatic advantages. Its deposits of minerals and petroleum enable it to export those products, while thanks to its biodiversity it can export fishery products, coca, coffee, cotton, sugar, asparagus, llama wool: in other words, goods that cannot be produced just anywhere in the world or at just any time of year. Tourism also

represents the export of a natural resource based on the climate or historical remains.

A combination of absolute and comparative advantages lies at the basis of this specialization. Except in the case of some agricultural products, however, the exploitation of these natural resources has not meant that the region exports goods making intensive use of labour, which is its relatively most abundant factor. Minerals, metals and fuels make relatively more intensive use of capital. Through them, Latin America is exporting goods with a high rate of return. Thus, a considerable part of its exports do not depend on variations in international prices, or the exchange rate, or wages, at least to a significant extent, but on investment.

Agricultural production, which makes relatively intensive use of labour (especially unskilled labour), has lost relative importance in the region's exports (table 6). In absolute terms, the data show that the volume of agricultural exports grew by 4% per year in the 1970s, but this rate went down to 2.3% in the 1980s (ECLAC, 1995, p. 70).

Although there has been an expansion in exports of manufactures throughout the region, the data in table 6 conceal marked differences between countries. Almost 75% of exports of manufactures in 1993 were accounted for by Brazil and Mexico alone (ECLAC, 1995, table III.5, p. 77). Without these countries, the simple average for the region is only 18% instead of the 39% shown in the table.

Within manufacturing activity, there is a traditional goods sector which is relatively labour-intensive: textiles, clothing and footwear. In this sector, the relative abundance of labour seems to play an important role in competitiveness. The location of in-bond assembly activities for these products by transnational corporations in various countries of the region appears to be based precisely on the existence of cheap labour.

There are not sufficient data to prove the hypothesis that investments in primary sectors require less socio-political stability, but there is a story which serves to illustrate this hypothesis. Cusiana, in Colombia, is the biggest oil deposit found in Latin

TABLE 6

Latin America and the Caribbean: Export structure
(Percentages)

	1962	1970	1980	1990	1992
Agricultural products	52.4	47.1	31.2	28.3	29.8
Metals and minerals	13.1	18.2	10.4	11.7	9.7
Fuels	29.1	22.9	40.6	26.5	21.6
Manufactures	5.2	11.5	17.3	32.9	38.5
Others	0.2	0.3	0.5	0.6	0.4
Total	100.0	100.0	100.0	100.0	100.0

Source: ECLAC, 1995, table I.6, p. 39.

America in the last twenty years and involves an investment of US\$6 billion. The oil company in question, which was foreign, had to interrupt its prospecting work on a number of occasions because the guerrilla movements invaded and destroyed its installations, and soldiers have been stationed in Cusiana to drive the guerrilla out (*El Comercio*, 1996, p. E6). This oilfield will be put into operation immediately, even though Colombia is a country plagued by poverty, political chaos, guerrilla activities and dope trafficking. It would appear that there are no prior requisites in terms of socio-political stability for exploiting oilfields: they operate as physical and economic enclaves.

The other hypothesis is that different factor endowments give rise to different patterns of trade and different degrees of distributive equity. More specifically, investments which develop an export sector based on the exploitation of natural resources are likely to lead to greater income concentration. This hypothesis was empirically tested by Bourguignon and Morrisson (1989, chapter II) in a cross-sectional analysis for 1970. The sample included twenty developing countries, of which six were in Latin America (Argentina, Chile, Colombia, Costa Rica, Peru and Uruguay).

For its statistical analysis, the study by Bourguignon and Morrisson included income distribution as an endogenous variable (measured through the shares of selected deciles in national income), while the exogenous variables were the degree of trade protection, the weight of agricultural exports and exports of minerals and petroleum products in the gross domestic product, the structure of land ownership, and education. The results show that protection has a negative effect on equity, as also does specialization based on natural resources, except when agricultural exports come mainly from small farms. Trade patterns based on absolute advantages lead to concentra-

tion of income, while those based on comparative advantages in agriculture depend on the degree of concentration of land ownership.

These results can be re-interpreted in the light of our theory: inequitable societies well endowed with natural resources will attract investments aimed mainly at exploiting their natural resources, so that they will continue to be inequitable and unstable. This mechanism leads to the maintenance of the initial condition of highly unequal societies.

From this theoretical standpoint, public social expenditure may be seen as a means of establishing minimum floor levels for the income and well-being of the population, thus giving stability to the social and political system. These actions may be termed "social policy". This floor level would have to be established as a set of rights, however: a redistribution of income to finance economic rights. This means that the goods and services in question would have to be withdrawn from the play of the market forces and political and electoral interests. Social stability, like democracy, is a public good: once it has been established, no-one can be excluded from its consumption. It is therefore clear that public social expenditure is a form of investment in a public good: social stability.

The Latin American experience has not moved in this direction, however. An ECLAC study (1994) shows that in the 1980s and early 1990s social expenditure in a group of countries in the region did not amount to a significant proportion of their GDP, the variations in such expenditure were not anti-cyclical with respect to changes in GDP, and it did not have significantly progressive effects on distribution. Clearly, the prevailing political system has not used social policy to change the situation of marked inequality observed in most Latin American countries. This empirical result is also consistent with the theory proposed in this article.

VI

Conclusions

The question which has been the guiding theme of the present study is whether a society can become developed even though it starts with a high degree of inequality and, in particular, whether a country can be competitive in the international economy regardless of its present degree of inequality.

If the initial conditions of an economy are a notable natural resource endowment and a high degree of inequality, private investment will be directed towards exploiting those resources and producing them in enclaves. With such initial conditions, it is unlikely that the investment will lead to the development of comparative and competitive advantages. Thus, international trade will not help to reduce the excess labour that the economy may have, nor will inequality be reduced through trade.

If there were any relation between trade and equity, it would be rather in the opposite direction: in order to develop comparative and competitive advantages, a country must have quite a low degree of inequality. The logic followed by investors would lead them to place their investments in countries with socio-political stability, which would depend on the degree of equity of society. Exports do not induce economic growth, as is usually claimed; exports are endogenous. It is investment which generates growth and higher productivity, so that the country increases in competitiveness. And the more intensive in their requirements for social order are the goods that a country exports, the greater will be the effect of equity on its net exports. The international competitiveness of a country depends on its degree of equity: that is the theory which has been developed in the present article.

When empirically tested, the theory shows an acceptable degree of consistency with the data for Latin America. One prediction of this theory is that the economic performance of countries depends on their initial degree of equity and factor endowment. At the beginning of the 1960s, Latin America started with pronounced inequality and an abundant endowment of natural resources and unskilled labour; South

Korea and Taiwan, in contrast, started with the opposite conditions: greater equity and an endowment of human capital. The evolution of our region and of those two Asian countries in terms of growth, equity and competitiveness has been as predicted by the theory: nowadays we talk about "Asian Tigers" but not "Latin American Tigers".

Another prediction of the theory which is in keeping with the actual trends displayed by the world economy is that long-term capital flows tend to go preferably to the more equalitarian countries. At the present time, there is greater world economic integration, especially in the financial field. Exchange-rate controls have been abandoned and the capital markets have been globalized. According to a study by the Organization for Economic Co-operation and Development (OECD), world foreign direct investment flows have increased in recent decades at unprecedented rates, three to five times greater than the growth rate of international trade flows (Oman, 1996, p. 26). This indicates that countries (including those of the Third World) cannot be viewed as being different in terms of their capital endowments, since capital can now be considered as being internationally mobile.

In short, the relative levels of productivity of countries (what we defined here as long-term competitiveness) depend on the distribution of investments among them; these investments depend on public investment and on the degree of socio-political stability of the recipient countries, which in turn depends on equity. Hence, competitiveness depends on equity. Since socio-political stability requires a certain degree of organization of society in order to maintain an acceptable level of equity, competitiveness is clearly not just a question of microeconomic or sectoral efficiency, nor is it merely a question of the macroeconomic balances: it is also a social question. Societies compete with each other to attract private investment in order to become competitive, and the factors in this competition include their degree of equity.

(Original: Spanish).

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Tensions in Latin American *structural adjustment:* allocation versus *distribution*

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In the economic history of Latin America, a growing population demanded jobs; creating more jobs required industrialization; and industrialization made it necessary to cover a productivity differential. There were two feasible options for this purpose: i) to preserve allocative efficiency and generate a major regressive income redistribution process; or ii) to lose allocative efficiency but leave the distribution of income largely unchanged. Governments chose the latter and built in lasting distortions in the foreign exchange market. Import substitution industrialization ended in stagnation. Increased pressure in the labour market could have driven wages sharply downward, but instead the informal market arose and, thanks to its monopolistically competitive structure, segmented the goods markets and ensured a minimally acceptable form of income distribution. No government policy was involved. The market generated a "natural" safety net on its own. However, allocative efficiency was sacrificed and lasting distortions were built into the labour market. Financial development could not keep up with the new needs, and capital market segmentation further reinforced the distortions in the price system. Structural adjustment policies removed some of the price distortions in the foreign exchange and credit markets, and redistribution of property over the years changed the distributive consequences of relative price changes. However, with structural adjustment came an inflow of capital that generated substantial currency over-valuation, while the split in the labour market persisted, affecting even more workers than before. In turn, trade liberalization has shown up on the books of the banks as weakened collateral and bad debts of companies now deprived of protection by lowered tariffs and an overvalued exchange rate. The market price system hence does not provide anywhere near the correct signals for a good allocation of resources. The need to earn some income continues to drive the growth of the informal sector, while domestic capital and labour eye foreign investment with ambivalence, uncertain as to whether it is friend or foe.

I

Introduction

Tensions between allocation and distribution in the context of economic growth have traditionally given rise to two main lines of inquiry. On the one hand is the set of concerns summarized by the Kuznets curve: is an initial rise in inequality in the first phase of growth unavoidable, or can it be mitigated or even completely eliminated by a suitable policy mix?

The second line of inquiry has focused on differential saving rates: if the rich save more than the poor, then inequality will produce faster growth than equality. The policy challenge, then, is either to find forms of intervention that can equalize the saving rates or, failing that, to generate sufficient public saving to offset any negative effects arising from greater equality.

A potential conflict between allocation and distribution already exists, however, even in a static context. It is well known that Pareto-optimality does not guarantee distributional acceptability. At the same time, attempts to correct distributive effects by policy interventions almost inevitably distort the efficiency of resource allocation.

The existence of tensions between distribution and allocation during structural adjustment in an economy is thus almost to be expected on *a priori* grounds.

In the Latin American context, the importance of distribution has been highlighted in a number of respects. First, there has been extensive research literature on income inequality in the hemisphere which generally concludes that Latin America has on the whole been much more unequal than other developing areas of the world, particularly Asia. Second, the role of distribution has been high-

lighted as a driving force behind the creation of the traditional social safety nets: public wage setting mechanisms, legislation on fringe benefits, protection of unions, social security legislation, etc. Third, distributive considerations have been identified as integral elements in Latin America's inflationary processes. While some authors have regarded a number of notable cases of Latin American inflation as being the result of distributive fights between different organized sectors of society, there is quite widespread agreement that indexation, both implicit and explicit, has been due to attempts to insulate distributional shares and real incomes from the corrosive effects of inflation.

The purpose of this paper, however, is to focus on quite a different range of topics. It is intended to look at the effects of distributive concerns on the pattern of sectoral specialization, whether explicitly as a result of government policy or implicitly through the functioning of the price system.

We will begin by exploring how fundamental distributive concerns shaped industrialization policy and thereby determined the course of import substitution industrialization (ISI) in Latin America. We then proceed to examine how distributive concerns play themselves out spontaneously in the price system during stagnation, thereby determining the initial conditions for the structural adjustment phase. We go on to examine this latter phase to find out to what extent the earlier tensions continue to exist or have been left behind. Some new sources for distributive tension are also explored. The concluding section provides a summary overview of the above sequence and the arguments put forward.

□ An earlier version of this paper was presented at the Southern Economics Association Meetings in Washington, D. C.

II

The active industrialization phase

That the various Latin American countries are different is a commonplace. Despite all the differences, however, there is a common pattern to Latin American economic development which is usefully captured in a set of stylized facts. We will ascribe this stylized reality to "Latinia": a "typical Latin American country".

Before active industrialization took place (generally speaking, in the early post-World War II years) Latinia was a country where the principal economic activities were agriculture and mining, both largely for export, although some agriculture was devoted to satisfying domestic food consumption; where industrial products were largely imported, and where the exchange rate was set at a level enabling traditional exports to compete in world markets, while import duties were largely motivated by the need to obtain revenue for the treasury. Export production was concentrated in fairly large units, which were owned by a small number of people, most of them part of the country's elite, which also tended to take turns in governing the country. In addition, some export activities were owned by foreign investors.

Industrialization was driven simultaneously from below and from above. From below came population pressures, fed largely by dramatic improvements in public health. A rapidly growing labour force could not be accommodated in agriculture or mining, since the natural limitations of the mining sector and the declining marginal product of labour on the land set severe limits to the number of additional people who could be employed in the traditional sectors.

Industry, on the other hand, was only subject to man-made limitations to its employment potential. With sufficient replication of factories, any number of additional workers could be employed. Thus, a growing labour force which demanded work presented a cogent argument in favour of industrialization to the ruling elites, who certainly wanted to avoid having their boat rocked.

From above came the concept of modernity. The elites recognized that modern countries were virtually synonymous with industrial countries. Wanting their countries to be modern, therefore, required

industrialization. Since the pressures from below and from above coincided, there was no reason for Latinia's government to resist industrialization as a development strategy.

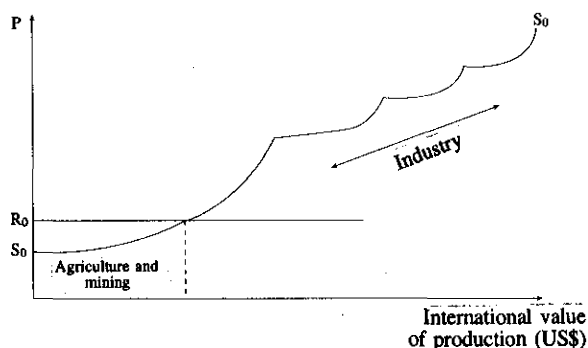
However, developing industry in Latinia meant moving up the comparative advantage cost curve to higher-cost activities. Industrial processes had a higher cost than traditional agriculture and mining for a number of reasons: a) they were new activities, and therefore (during a learning period at least) they were going to have a higher cost than the ones in which the country had experience; b) industrial processes have economies of scale, and Latinia's markets were small, so that once again costs would initially be high; c) new industry would require supplier industries, which were non-existent, therefore making domestic production more expensive, as a natural consequence of the systemic nature of an industrial system; d) infrastructure was not oriented towards industrial production but towards agriculture and mining exports; e) consumer preferences were strongly in favour of imported goods, which were presumed to be of better quality, therefore requiring an artificial price discount on domestic production. In addition, industrial production would involve activities subject to advanced labour legislation, with rules on maximum hours to be worked, minimum wages, fringe benefits, social security, bargaining rights for workers, unions, etc., most of which were not applicable to agriculture and to small- and medium-scale mining.

All these features generated a perceived requirement for the adoption of policies to make the new industrial production competitive.¹

The problem faced by policy-makers is illustrated in figure 1. The curve SS is the aggregate supply curve showing the cost differentials between the primary sectors of agriculture and mining and the new industrial sectors. R_0 is the level of the exchange

¹ Note that the idea that infant industry protection is really a second-best alternative to perfecting the capital market so that the private sector can finance its own risk-taking was far too sophisticated an argument for the policy-makers of the time to have even remotely considered it.

FIGURE 1



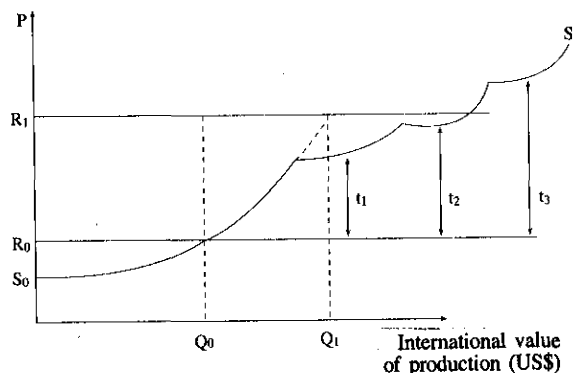
rate, measured in pesos per dollar, which stands at a level which allows traditional production to continue exporting but at the same time is too low to allow the new industrial production to compete with imports. Accordingly, production takes place only on the part of this supply curve corresponding to the primary sectors. The policy problem is how to make the industrial activities competitive.

In these circumstances, Latinia's government has basically three options: i) general devaluation, ii) selective devaluation, or iii) compensated devaluation. Let us explore each one in turn with the aid of figure 2:

i) General devaluation: Under this option, the exchange rate R_0 is devalued to R_1 , giving a larger number of pesos per dollar. Netting out any cost push effect of the devaluation in figure 2, it can be seen that with R_1 , a number of industrial activities become competitive. Moreover, there is expansion of primary production as primary producers move up the cost curve. At the margin, the productivities of the primary and industrial sectors are equal; therefore, there is efficiency in the allocation of resources. In addition, however, there is a massive redistribution of income, as the intra-marginal producers of primary goods obtain significantly greater income for the quantity they originally produced. This additional income comes, directly, from the buyers of food on the domestic market and, indirectly, from the higher exchange rate which leads to higher prices of imported goods for all consumers. In consequence, with a general devaluation, owners of mining and agricultural enterprises obtain a substantial transfer of income from all consumers.

ii) Selective devaluation: This alternative involves raising only the exchange rate corresponding to imports competing with the products to be pro-

FIGURE 2



duced domestically. Under this alternative, domestic production is made competitive with imports by levying import duties which effectively devalue the exchange rate only for the products for which protection is desired. In terms of figure 2, the general exchange rate stays at R_0 , but tariffs are levied on the importation of industrial goods, t_1 and t_2 , in order to cover the cost differentials for those particular products. Under this alternative, there is no expansion in the production of the primary sector and as a result marginal costs of production are different between the primary and industrial sectors, which signifies inefficiency in production. However, there is only a minimal income distribution effect, for in this case the original producers of mining and agricultural goods do not receive any windfall gain. The only redistribution that exists is between buyers of the newly protected domestically produced goods and their producers. This means mostly that high and middle income consumers pay higher prices for goods produced by lower middle class workers and high-income capitalists.²

iii) Compensated devaluation:³ In this case, the exchange rate is devalued as in a general devaluation, from R_0 to R_1 , but import duties are reduced by a similar amount and taxation is levied to pick up the windfall received by primary exporters. In the simple version of compensated devaluation, an export tax is

² Low-income consumers are also affected by the higher prices, but in a much smaller proportion, since proportionately they do not consume as much of these kinds of goods.

³ First proposed by Marcelo Diamand of Argentina in CARTTA (1966), independently proposed by Schydlosky (1967), later adopted with some changes into the mainstream by Balassa (see Balassa and others, 1982).

levied on traditional exports in order to keep the net exchange rate for traditional exporters at R_0 . In another variant, a Ricardian property tax is levied, designed to pick up the windfall revenue only on preexisting production. In either case, redistributive effects are kept to an absolute minimum, while efficiency of allocation is achieved through a land tax but not an export tax. A final element of the package consists of a mechanism for returning to consumers the additional cost of buying traditional goods resulting from the devaluation which cannot be compensated for by import duty reduction or by export taxation. It follows that compensated devaluation is considerably more complex to design and administer than the other two options.

Seen from the perspective of any government of Latinia at that time, the obvious choice was alternative ii), protection. Alternative iii) was not even within the set of options, since it was far too complex in design, administration and execution. Alternative i) could have been feasible, but even an elite government of Latinia would have been reluctant to undertake a measure so obviously leading to concentration of income, let alone more labour based governments such as those of Perón in Argentina or Vargas in Brazil.⁴ Thus, country after country in the hemisphere implemented the stylized logic of Latinia: raising tariffs in order to make the new industrial production competitive with imports.

Once the policy was set, all the well-known consequences of import substitution industrialization began to fall into place:

i) Anti-export bias restricted the new industry to the domestic market;

ii) The "Inefficiency Illusion" made sectors competing with imports appear more inefficient than they really were;⁵

iii) Partly because of the "Inefficiency Illusion", export promotion was mostly weak, with the notable exceptions of Brazil and Colombia, and as a result more import substitution had to be undertaken behind still higher tariffs if further foreign exchange was to be saved;

iv) Vulnerability to balance of payments fluctuations increased, as imports became progressively more essential;

v) Foreign exchange availability determined the business cycle;

vi) Borrowing was undertaken to increase foreign exchange availability, but in the absence of structural changes in relative prices and in the market orientation of production such borrowing only repressed the symptoms; expansion took place, while the foreign exchange borrowed was used to pay for imports, but then came the crash, made even greater by the need to service the debt.

The structure of production in the traditional economy and the differences in comparative advantage between traditional production and industrial activities gave rise to an underlying policy requirement induced by the desire to minimize distributive consequences. The effect was a trade policy which ultimately produced the stagnation in what has become known as the "lost decade" of the 1980s.

III

The stagnation phase

While economic growth ground to a halt, the same did not occur with population growth. New workers continued to enter the labour market but had ever-increasing difficulty in finding jobs. Unable to find wage employment, workers became self employed for want of a better alternative. In essence, they

migrated from the labour market to the goods market. Initially they became street vendors and began to compete with established businesses by differentiating the product: they offered different locations (traffic lights, customers' homes), different packaging (unwrapped, so that customers could examine the merchandise), and even different forms of sale (bargaining instead of fixed prices).

⁴ Pedro Beltrán, who acted as effective Premier under the second Prado administration in Peru (1956-1962), brought in the legislation that systematically raised protection to stimulate industrialization.

⁵ See Diamand (1973) and Schydlosky (1972).

The market structure corresponding to this part of the economy was monopolistic competition, with its two characteristics: price equals average cost, and excess capacity exists (see Chamberlain, 1933). In this informal market, total cost equals cost of material plus cost of living. Moreover, since the cost of living is a fixed cost to be spread over the number of units sold, this generates a classical downward-sloping cost curve, with marginal cost below average cost. In turn, excess capacity takes the form of under-employment of labour.

As the population continues to grow, more and more individuals crowd into the informal sector. Three responses then occur: i) there is innovation in the informalization of new sectors, new geographical areas and new products (e.g., car silencers are repaired on the street, informal clothing manufacturers sell their products informally); ii) the segmentation of already existing informal sectors increases, lowering each individual's market share, as foreseen by Chamberlain; and iii) there is a downward adjustment of the target cost of living, accommodating to the straitened market circumstances of participants.

As a result of the combined effect of these adjustment mechanisms, the monopolistically competitive sector of the economy grows, underemployment is rife, market "wages" are increasingly different from the marginal cost of labour, and the non-fulfillment of the Pareto conditions in the economy becomes more firmly anchored.

The development of an informal sector operating with a market structure based on monopolistic competition is a natural adaptation to distributive requirements. With competitive markets, labour income would fall precipitously. Legislation prevents this from happening in the formal sector, but evasion of the rules or their avoidance through informalization could lead to such income falls. In contrast, monopolistic competition spreads the available income. At the same time, the informal sector transfers some income away from the formal sector by product differentiation and even somewhat relaxes the macro foreign exchange constraint by shifting the product mix towards goods whose production is less intensive in foreign exchange. Thus, distributive requirements critically affect the mix of output and the choice of technology. But this occurs spontaneously, by market response. Along the way, the price system becomes firmly distorted, with a strong wedge installed between market wages and the marginal cost of labour.

Developments in the financial market interact with this modification of the productive structure of the economy. During the pre-industrial phase, extending credit is a highly personalized activity. In this phase bankers know most of their clients personally or are even related to them. Borrowing and lending occurs within a small elite where reputation is all-important. Moreover, the purpose of credit is typically a simple business transaction, most usually in the import or export trade.

During the period of active industrialization, the nature of credit changes. Extending credit becomes depersonalized, as banks grow and bankers hire loan officers, whose loss function is asymmetrical in the sense that whereas the banker risks his own money, the loan officer risks somebody else's. A bad loan will get him fired, but not making a good loan will not be noted. Thus, credit is extended in this phase in a much more risk-averse fashion. At the same time, borrowers are no longer known to the lenders. They no longer went to the same school, there are now too many of them to have family relationships or to have widely known reputations. Furthermore, the type of venture for which lending occurs is now much more long-term and much more complicated: for example, industrial production. As a result, collateral becomes the essential element in credit. With no collateral, no credit is extended. This introduces a very clear segmentation between those individuals who have assets to pledge and those who do not.

As stagnation takes place and the economy becomes increasingly informalized, credit is available principally to the formal sector. Members of the informal sector have no collateral, whereas formal firms do. However, the stagnation affects the quality of the collateral of formal firms. First, their cash flows cease to grow because of the stagnation. Second, their cash flows often shrink as a result of the inroads which the informal sector makes on formal markets. Deteriorating cash flows on the part of borrowers translate first into deteriorated collateral, and thence into an increasing number of bad debts. Banks react at first by rolling over credits, expecting things to get better. But as the stagnation lasts, the unpaid bad loans form an increasingly large proportion of the portfolio, ultimately putting the banking system under severe stress.

"Credit layering" is a mechanism by which credit can be transferred from the formal to the informal sector, using as intermediaries those formal firms which sell products to the informal vendors. However, the scope

for this is very limited. First, a major part of the informal sector has no stable connection with specific formal firms. Second, the majority of informal vendors have no collateral to pledge: they may be here today and gone tomorrow, prefer to deal in cash, and constitute significant risks to the firms selling to them. For layering to acquire substantial momentum requires a change in the basis of credit. Rather than lending against the security of the collateral, lending (and repayment) must be based on the incentive of gaining access to ever-greater credit as a good payment record is accumulated. In other words, the credit function has to evolve from one based on guarantees to one based on incentives. This has indeed occurred in a number of cases, but it takes a long time to permeate the whole economic system.⁶

The evolution of the capital market described above has two major impacts of macro importance:

i) The access to credit in different quantities and at different prices by the formal and informal sectors reinforces a technological dualism which is quite independent of any labour market legislation. The result is two different labour income levels and two different decision structures.⁷ The distribution of credit thus helps to anchor significant distortions in the price system.

ii) The deterioration in the portfolio of the banking system implies an increased operating cost which is not fully recognized on the books of the banks. Accordingly, the true cost of lending in the economy goes up. This is accompanied by an increase in the perceived country risk on the part of foreign investors, which raises the price at which the country re-

ceives capital inflows. Both internal and external factors, then, work to generate domestic interest rates well above international levels. Such capital costs, in turn, affect the international competitiveness of domestic production, consequently weakening the balance of payments, and this feeds back into the system in the form of a lower level of activity, greater informalization and further weakening of formal-sector firms and their banks.

At this point, the price system is affected by distributive factors in its major markets:

i) The foreign exchange market has been segmented by a system of *de facto* multiple exchange rates, constituted by a single financial rate and a large number of "product" or "commodity" rates, due to the existence of a diversified tariff and trade tax structure;

ii) The labour market is severely affected by the difference between the average return to labour in the monopolistically competitive sector and the marginal cost of labour at large, as well as by the increasingly irrelevant but none the less durable labour legislation;

iii) The capital market is deeply segmented due to the requirement that collateral must be provided in order to obtain loans and the weakness of layering.

With the interdependence of markets in the General Equilibrium, it is clear that no market price equals its respective shadow price. Allocation by the market will hence not be Pareto-efficient. However, there is no guarantee that distribution will be satisfactory either, although the structure of the labour market acts as a market-produced safety net.

IV

The structural adjustment phase

Structural adjustment policy consists of a basic package of measures intended to correct the existing distortions and composed of the following elements:

- i) Trade liberalization (almost free trade, e.g., low tariffs and no export subsidies);
- ii) A freely floating, "equilibrium" exchange rate;

- iii) Market interest rates;
- iv) Little or no government intervention in markets;
- v) Fiscal balance;
- vi) Privatization;
- vii) Labour market flexibilization.

For our purposes, the most critical elements of this package are in the foreign trade policy area. Almost-free-trade with a flexible exchange rate translates in effect into low tariffs and a high exchange

⁶ For a highly illuminating description of the different phases of development of the financial system and its interaction with events in the real economy, see Otero, 1996, section 5.

⁷ See Ramos (1980) and Mezzera (1981).

rate. In this sense, it is virtually the same as the general devaluation solution which the Latin American countries failed to adopt in the early stages of their active industrialization phase. The following question then arises: If such a policy of low tariffs and high exchange rates was not adopted in the active industrialization stage because it was not distributionally acceptable, what has happened in the intervening years to make it a feasible policy now?

The answer comprises two kinds of effects: i) differential changes in the productivity of sectors, and ii) changes in the structure of ownership of resources.

Productivity in the different sectors of production of the Latin American economies changed at different rates as a result of a number of interacting factors:

i) Learning by doing: firms move down the learning curve as they gain experience. Since there was more to learn in the newer industrial activities than in the older, more established, primary ones, productivity grew faster in the industrial sectors than in the long-established primary activities;

ii) Export market penetration: Latin American firms learned to market their exports in a number of sectors in which they were originally not capable of selling abroad. This means that they received higher effective FOB prices, which is equivalent to greater productivity per factor unit deployed.

iii) Freight rates and communications costs declined: an independent factor which has raised effective FOB prices and lowered CIF prices for a whole range of products. In addition, as the nature of ocean transportation changed from an emphasis on general cargo to containerization, the relative cost of shipping non-bulk, non-primary commodities came down, translating on balance into higher effective productivity of industrial production.

iv) Violence and insurrection affected rural sectors in a number of countries, notably Peru, El Salvador, Nicaragua, and parts of the jungle areas of Bolivia and Colombia. Such violence increased the cost of production in the primary sectors, making them relatively less productive compared to the more urban industrial sectors.

v) New crops were introduced in some countries, ranging from coca products to kiwi fruit. Although some of these crops were illegal, they helped to establish highly profitable, high-productivity new activities in the primary sector.

The combined effect of all these elements was to flatten the aggregate supply curve, lowering the productivity differentials between the different sectors. This is shown in figure 3, which also shows, for comparison, the original supply curve from the beginning of the active industrialization phase.

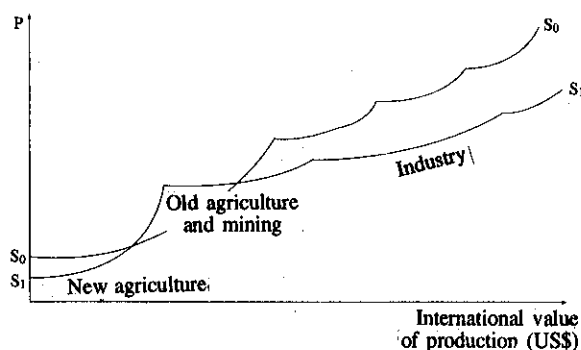
Changes in ownership, for their part, took two main forms:

i) Agrarian reform: in many Latin American countries, systematic efforts were undertaken to transfer the lands of large agricultural estates to smaller producers, and in some instances to cooperatives or producers' associations. More recently, there has been a move to encourage the active functioning of agricultural land markets.

(ii) Mining properties: both metal ore and petroleum extraction activities were systematically transferred to State ownership, most often from foreign owners but frequently also from large domestically owned enterprises. This nationalization had the effect of transferring the profits of a large part of the primary sector to the State, in a manner analogous to what would have been achieved with a 100% tax on the profits of primary producers. In effect, this system implemented a part of the windfall recovery scheme which could have been implemented in the early active industrialization phase through compensated devaluation, but which was beyond the administrative capacity of the time.

When both of these changes are taken together, we find that an almost-free-trade policy under present circumstances would generate a smaller income redistribution effect than in earlier years, and that this redistribution of income would benefit a wider ownership group in agriculture and mainly the State in

FIGURE 3



the mining sector. In consequence, the distributional objections against a low tariff, high exchange rate policy have largely been dissipated. It would therefore appear that a policy which was rejected on distributional grounds several decades ago would indeed be feasible now.

The reality of structural adjustment, however, has been somewhat different from the theoretical predictions. Rather than a low tariff with a high exchange rate, the reality has been a low tariff with a low exchange rate, as indicated in figure 4. The low exchange rate has been the consequence of substantial capital inflows pursuant to a dramatic reduction in the perceived risk of investing in Latin America, as a result of the policy turnaround signified by the adoption of structural adjustment packages, together with the attractive investment opportunities offered by the privatization of public utilities and the high interest rates obtainable in the financial sector.

The lower effective exchange rates have interacted with interest rate liberalization and labour market flexibilization to produce a number of consequences:

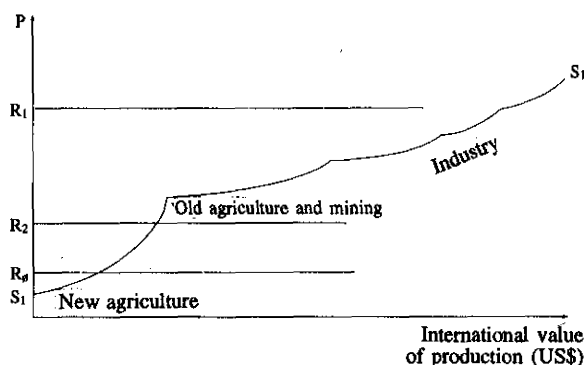
i) The low exchange rate has made a wide range of domestic products uncompetitive. This can readily be noted in figure 4.

ii) As a consequence of the foregoing, an increased number of people have been driven into the informal sector. To the extent to which this sector was able to accommodate this increasing population, through informalization of a greater number of activities, through geographic expansion, or through reduction in target cost of living levels, the gap between the market wage and the marginal cost of labour became still wider.⁸ However, in some instances (e.g. Argentina) the informal sector was not able to absorb the influx, and high rates of overt unemployment resulted.

iii) The pressure of foreign competition on formal enterprises due to low tariffs, along with the rise in interest rates following liberalization of domestic capital markets, seriously weakened formal company finances, and this, in turn, weakened the quality of the assets held by the banks and increased their bad loan portfolio. A further consequence was to reduce the capacity of the banking sector to innovate in order to provide the dynamic part of the informal sector with the appropriate depository and credit instruments.

⁸ Note also, however, that the reduction in the target income reduces the ratio of market income to the shadow price of labour.

FIGURE 4



iv) The stresses affecting banking systems led to the closure of financial institutions and, in some cases, to losses on the part of depositors.

v) Weakened formal-sector companies sold out to foreign private investors or went bankrupt, thereby making space for new foreign-owned businesses to replace them.

vi) Labour market flexibilization had little impact, since the formal sector was suffering substantial shrinkage, and most of the action took place in the informal sector, where labour market legislation either did not apply or was not effectively implemented.

Parallel to these developments, the privatization programmes generated their own dynamics. Large privatizations were principally of public utilities, which because of their size had perforce to be acquired by foreign investors, or at least by consortia with large foreign participation. Such investors, however, were well familiar with past experience in which government regulated their prices and constrained their profits. Therefore, in this round of privatization, investors made sure that adequate protection was provided in the terms of sale against domestic inflation and/or devaluation and exchange control. In essence, they obtained indexed returns in foreign currency. This created a direct link between the level of activity and profitability in the non-tradeable sector and the outflow of profits on the balance of payments. A similar phenomenon took place in the non-tradeable segment of the private-sector economy, where foreign private investment significantly expanded its share in activities such as retailing (par-

ticularly supermarkets). Here, too, the level of activity and the attendant profitability became directly connected with the outflow of profit remittances on the balance of payments.

The inflow of foreign private investment has therefore given rise to three different important effects:

i) An exchange rate level which is overvalued with regard to the long-term equilibrium rate consistent with the low tariff regime;

ii) A new distribution of property holdings, which may well be the harbinger of future distributional disputes;

iii) A dynamic whereby domestic economic expansion leads to greater profitability of the non-tradeable sectors, which leads to a greater outflow of foreign exchange in terms of remittances, which in turn limits the expansion on the balance of payments side. This amounts to a new form of the old foreign exchange constraint on Latin American growth.

At this stage of the structural adjustment phase, the old distributional problems are interacting with the expectations raised by the structural adjustment policy itself to produce a new set of allocation problems: the capital inflows have generated an exchange rate which does not correspond to long-term balance of payments equilibrium, nor does it accurately reflect either the marginal social cost or the marginal social benefit of foreign exchange in the present. In

the labour market, the informal sector continues to drive a wedge between market wages and the marginal cost of labour, while in the capital market, the combination of collateral requirements and the accumulated weakness of formal-sector firms means that interest rates do not effectively capture the marginal social productivity of investment nor the marginal social cost of savings. No market price reflects the true partial equilibrium of the corresponding market. Even less do market prices reflect the underlying general equilibrium levels of shadow prices.

Moreover, the allocation biases operate in a direction tending to delay convergence towards a more efficient price system. Since the value of foreign exchange is understated and the market cost of labour overstates its true scarcity, production activities will tend to underproduce and overuse foreign exchange while underusing labour. Hence the secular foreign exchange scarcity will be overcome at suboptimal speed, while the excess endowment of labour will be absorbed more slowly than is optimal.

At this stage, the contribution of distributional tensions to the distortions in the price system resides on the one hand in the labour market, as evidenced by the existence and size of the informal sector, and on the other hand in the as yet not clearly visible line of cleavage between domestic factors of production (capital as well as labour) and foreign investors, particularly in the non-tradeable sectors of the economy.

V

Summary

More jobs required industrialization, and in order to achieve industrialization it was necessary to cover a productivity differential. There were two feasible options for this purpose: a) to preserve allocative efficiency, while generating a major regressive income redistribution, or b) to lose allocative efficiency but leave income distribution largely unchanged. Governments chose the latter and thereby built in lasting distortions in the foreign exchange market.

Import substitution industrialization turned into stagnation. Increased pressure in the labour market could have driven wages sharply downward, but instead the informal market arose and thanks to its mo-

nopolistically competitive structure segmented the goods markets and ensured minimally acceptable income distribution.

No explicit government policies were involved in this. Distributional requirements drove the market to develop a "natural" safety net, but once again allocative efficiency was sacrificed and a lasting distortion was built into the labour market.

Financial development could not keep up with the new needs, and capital market segmentation further reinforced the distortions in the price system.

Structural adjustment policies removed some of the price distortions in the foreign exchange market

thanks to liberalization. However, they induced capital inflows that gave rise to substantial overvaluation. At the same time, the division in the labour market is still present, possibly even more so than before, while trade liberalization, for its part, has shown up on the books of the banks as weakened collateral and bad debts of companies now deprived of protection by lowered tariffs and an overvalued exchange rate.

The market price system hence does not provide anywhere near the correct signals for a good allocation of resources. At the same time, the urgent need to earn at least some income continues to drive the growth of the informal sector, while domestic capital and labour eye foreign investment with ambivalence, wondering whether to consider it friend or foe.

(Original: English)

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Competitiveness *and labour regulations*

Luis Beccaria
Pedro Galín

This article analyses the relations between the competitiveness of an economy and the labour regulations in force in it. It is argued that economic theory is not conclusive regarding the impact of labour regulations on competitiveness, since different schools of thought maintain opposing positions in many respects. Moreover, empirical research has shown that the information provided with respect to these assumed linkages is not very relevant. Various policy consequences follow from this: countries have a variety of strategies at their disposal and greater leeway that is usually suggested, since many policies aimed at improving equity do not necessarily involve any restrictions on competitiveness. A country can therefore choose the desired level of social protection. The improvement of competitiveness becomes, at least partly, a matter of income distribution. The most conventional formula proposes the reduction of workers' quality of life for a period whose duration is difficult to forecast, with the aim of providing enterprises with certain initial conditions which will allow them to make up for differences in productivity. This is not the only formula, however, nor is it the most equitable or effective. In order to generate those same conditions, income redistribution schemes can be designed which make investment for international competitiveness attractive, without resorting to further erosion of the wages of those who were most seriously affected during the last years of application of the import substitution models. The analysis made suggests that there is ample leeway for choosing between various combinations of equity and efficiency, and their selection depends on the power relations of the various social actors and the structure of the State.

I

Introduction

Competitiveness and labour regulations, which are the main subjects of this article, relate to issues of great scope and enormous repercussions which go back a long way in history.

It is not a question of the relations between two different sciences (such as economics and labour law),¹ or between two facts, but between an economic phenomenon—competitiveness—and labour law, understood here as positive law of broad scope (including social security). Labour regulations do not of course only involve costs: their main functions include the protection of both workers and production, since they organize the latter and establish “industrial legality”. Although this issue is dealt with here from an interdisciplinary standpoint, it should be noted that whereas there are an enormous number of studies on this matter in the economic literature, there are only a few quite isolated contributions dealing with labour law.

With regard to the antiquity of this matter, it may be recalled that in the debate over laws to limit the working day it was frequently argued that these would ruin the industries of any country which adopted them, because of international competition from those which did not apply such rules. The preamble to the Constitution of the International Labour Organisation declares that “Whereas also the failure of any nation to adopt humane conditions of labour is an obstacle in the way of other nations which desire to improve the conditions in their own countries”, and the original British proposal for the formation of the ILO stated that one of the main objectives of the new organization was to do away with competition based on sub-human working conditions.² The current debates and arguments also contain reminders of some quite far-off controversies: a recent publication reproduced an article originally published in 1927,

which it included in order to show that the present economic problems are not totally different from those which existed then.³

The repercussions of this matter are not exclusively academic. On the contrary, it involves the interests and positions of various social and political forces and States, with differing interpretations of the values of social justice, protectionism, international competition and even the preservation of civilization. The most heated international debates are currently about the “social clauses” or the so-called social dimensions of the liberalization of international trade: a matter which warrants a specific study on it and will therefore not be dealt with here.

These three features: the broad scope, antiquity and importance of the issue, make it necessary to limit the objectives of this study: we will set forth here what is currently known about the matter without pretending to make original contributions or substantive empirical additions to the existing body of knowledge.

The layout of the article will be as follows: section II will set forth the main approaches of economic theory, often stylized both in order to save space and for institutional reasons: there will be no econometric expositions, which would be long and tedious for the present context. Section III sets forth the most recent arguments put forward in the specific debate on labour regulations. The effects of such regulations, as indicated by empirical studies, are dealt with in section IV, which also includes the most salient aspects of the way in which this matter is being dealt with in Argentina. Finally, section V sets out some final reflections.

With regard to the sources, most of the contributions come from the economic literature, since there are few legal studies on this matter.⁴

□ A preliminary version of this paper was presented at the IX Jornadas Rioplatenses de Derecho de Trabajo y de la Seguridad Social (Punta del Este, 11-12 May 1996).

¹ It would appear that labour law has not escaped an onslaught “such as has not been seen since the 1890s: a deliberate tendency to impose the monopoly of economic method on all studies of society”, as Adam Przeworsky noted a decade ago (Przeworsky, 1987, p. 97).

² Cited by Caire, 1994.

³ The 1927 article was by Herbert Feis, reproduced in Sengerberger and Campbell, eds., 1994, pp. 29-55.

⁴ In the Argentine legal literature we only found two articles: those by Armando Caro Figueroa, 1992, p. 383 et seq., and Geraldo von Potobsky, 1995.

II

Economic theory and State intervention

This section briefly sets forth the basic economic arguments on State intervention, in order to provide a frame of reference for more specific consideration of the impact of labour regulations on competitiveness.

With regard to State intervention, conventional neoclassical thinking asserts that the market –if allowed to operate without interference– ensures achievement of the greatest possible well-being of the population. It does, however, offer two justifications for State intervention: on the one hand, the presence of market flaws such as the existence of monopolies, oligopolies, monopsonies or oligopsonies, externalities, lack of information, or the fact that public or free goods are involved, and on the other hand, the need to change income distribution when the result of the free play of the markets is considered to be unsuitable. In reality, it concerns interventions seeking to move the economy from one optimal state (optimal from the point of view of efficiency) to another.

Neoclassical economists point out, however, that State action does not always improve aggregate well-being even when there are market flaws or distribution is manifestly inequitable. Thus, for example, it is usually argued that many interventions based on the objective of redistribution do not keep the system on the leading edge of its potential but bring it to points which are below that level, thus causing a reduction in global efficiency. Actions based on the existence of market flaws are also open to question because there may be “government flaws”, especially as public interventions are designed mainly in the light of the objectives of politicians or bureaucrats, thus leading to losses of efficiency greater than those deriving from the presence of externalities, public goods or monopolies.⁵

Neoclassical authors assert that in a dynamic context State interference leads to unsuitable resource allocation which affects the growth capacity of the economy by reducing the profitability of investments, discouraging saving or giving signals which lead to a reduction of investment in the activi-

ties with the greatest growth potential. Furthermore, in an open economy State intervention is also alleged to alter the structure of incentives, thus diverting many investments towards branches which have fewer advantages and thereby causing inefficient resource use, lowering the global competitiveness of the economy and reducing its growth capacity.

The criticisms of these basic postulates of neoclassical thinking made by heterodox neoclassical authors or those who do not support this school of thought are located on two levels of analysis. On the one hand, there are conceptual differences regarding the impact of regulations and institutions on economic efficiency, and on the other hand there are controversies about empirical questions regarding the very existence of certain market flaws or the quantitative impact that various kinds of intervention can have on efficiency.

With regard to the conceptual discussion, it is stressed that certain institutions have a positive impact on efficiency, and it has also been asserted that prices do not only constitute a signal for the allocation of resources but also influence the quality of the product. In these circumstances, the free play of the market does not always automatically achieve optimal results (Stiglitz, 1987). There may also be possible conflicts between the short term (inefficient resource allocation) and the long term (increased productivity). Protectionist trade policies were justified precisely on the basis of the infant industry argument or, in more general terms, the need to “create” competitive advantages.

Another idea which is in opposition to the orthodox view is that the economic determining factors leave a more or less broad margin for the actors involved –buyers or sellers, workers and entrepreneurs– to negotiate levels of prices and quantities without this adversely affecting efficiency. This means that in all cases buyers and sellers have some bargaining power, thus making necessary various institutions to regulate exchanges and balance the natural differences in the competitiveness of the actors.

With regard to the discussion about the very existence of market flaws, neo-Keynesian thinking

⁵ According to Self (1993), neoclassical authors lay frequent stress on the many opportunities that bureaucrats have to distort policy objectives for their own benefit.

holds that many of them –such as the capacity to exercise some degree of control over the market– are very important and prevent adjustment to optimal levels. With regard to the appraisal of the distortions

that regulation might cause, a number of studies have shown that some of its costs in terms of inefficiency are not significant compared with its clear positive impact on income distribution.

III

Labour regulations

In the preceding section we briefly reviewed the positions of neoclassical economists –and also of some schools of thought which are critical of this orthodox view– on State intervention in general. In this section we will concentrate specifically on the development of the different analytical approaches regarding labour regulations.

The archetypal expressions of the orthodox view in this respect are, with regard to supply, that any programme which protects the population from the consequences of unemployment gives an incentive not to work at all and is a hindrance for the economy, and with regard to demand, that social assistance changes employment decisions in a socially inefficient manner (Blank and Freeman, 1994).

From the orthodox perspective, unemployment benefit programmes or social security benefits can lead workers to prefer idleness to work until such benefits run out; this increases the well-being of the beneficiaries, but reduces the global social product and prolongs unemployment. Programmes which establish compulsory social benefits may constrain workers' choices, leading to suboptimal and inefficient results and higher labour costs. Generous sickness benefits can lead to an epidemic of headaches, backaches and similar ills until the coverage of sick leave is completely used up.

In terms of the demand for labour, it is considered that regulations limiting the hiring or firing of workers, for example, can distort the labour market signals and reduce profitability because of over-manning or else cause employers to take on fewer workers in expectation of higher future costs. Laws which impose taxes on employers to finance retirement pensions or unemployment benefits may cause firms to under-declare the wages actually paid or may make it uneconomic to hire low-income workers, depending on the rate of such taxes. Legally fixed minimum wages may reduce employment in low-wage activities or occupations.

This approach emphasizes the distorting effects exerted on saving and investment by the taxes needed to finance such programmes. These programmes, it is claimed, divert capital away from more fruitful investment options and hence, if the latter options had greater potential for job creation, the money spent on sustaining low-income families could lead to a permanent reduction in job opportunities, leaving those families, like the rest of society, in worse conditions in the long run. Many such programmes expand public sector employment, thus further strengthening labour market rigidities.

Finally, the orthodox approach claims that in an open economy there is a further adverse impact if social protection programmes have any of the negative effects mentioned above, because by increasing labour costs, protective legislation may reduce international competitiveness. We shall return to this point later.

The opponents of the orthodox neoclassical school, who base their views, as we already noted, on various different theories, formulate a number of reservations regarding approaches like those reviewed above.

Firstly, they highlight the role of social protection programmes in increasing human capital and productivity in the labour market. According to this viewpoint, labour regulations can create long-term incentives for investment in training (Blank and Freeman, 1994; Standing, 1992; Boyer, 1994). If there are restrictions on the dismissal of workers, there is an inducement for employers to invest more in training the labour force, since these laws give rise to long-term relationships which make investment in specific training a profitable proposition.

In other respects, long-term links may give rise to higher productivity of workers through, for example, their identification with the aims of the enterprise and their loyalty to it.

The theory of "efficiency wages" also provides various arguments in favour of the beneficial effects of equitable treatment of workers. According to this approach, wages are not just an allocation mechanism but also a means for promoting the efficiency of the labour force. Consequently, preventing wage rates from going down too much would have a positive effect on productivity. Some versions of this approach, in particular, see wage-earners' attitudes in a different light from the neoclassical approach: workers do not try to reduce the effort needed to carry out their tasks – a view which is implicit in the idea that this effort reduces the individual's own gain – but always make a given effort, which can be influenced by the remuneration they receive: workers who consider themselves to be fairly treated will assuredly work harder (Akerlof and Yellen, 1988, p. 45).

Minimum wages, which have been criticized, as already noted, on the grounds that they reduce the demand for less skilled workers, are considered to have a possibly beneficial effect on efficiency by increasing the supply of such groups.

Furthermore, orthodox arguments about the distorting effects of regulations usually take as their frame of reference a situation of perfect competition, without analysing the global economic context, in which there are market flaws and other regulations. An example of this is the British legislation on equal pay adopted in the early 1970s: in contradiction of neoclassical theories, there is no proof that the relative increase in women's wages brought about by this law has been reflected in any reduction in female employment, which may be due to the fact that the paradigm of perfect competition did not fully apply and employers exerted some degree of control over the market. In this context, the law made it possible to increase overall efficiency (Gregg, Machin and Manning, 1994, p. 109).

From a more empirical standpoint, some heterodox authors note that although protective regulations do have distorting effects on labour markets, no measurement is made of the benefits that they bring, which are in any case difficult to quantify (Blank and Freeman, 1994, pp. 31 and 32; Sengerberger and Campbell (eds.), 1994, pp. 13-14; Standing, 1992). The economic benefits of labour regulations – some of which were already mentioned earlier – are indirect, hidden, intangible, spread over time and not localized (Boyer, 1994, p. 26). Mention has been made

in this respect of the example of the costs imposed by regulations on health and safety, which are generally easy to estimate, as are some of the benefits they generate (saving of outlays on the treatment and replacement of workers injured in accidents, for example), which may exceed such costs. It is more difficult to estimate the loss of productivity and purchasing power and the total amounts lost in some recent very costly industrial accidents (Sengerberger and Campbell (eds.), 1994), not to mention human values which cannot be measured in economic terms, such as life and health. Many of these phenomena also generate negative externalities which are generally hard to calculate. In order to make a full cost-benefit analysis of each social programme, it is necessary to compare the increase in the economic well-being of citizens with the direct and indirect costs involved. A mere demonstration of the distorting effects or the costs in terms of inefficiency is not enough (Blank and Freeman, 1994, p. 32).

This latter observation also points up the fact that orthodox arguments generally fail to take into account the effect of protective rules and institutions on income distribution. Institutions like trade unions not only play an important role from the point of view of efficiency, by reducing transaction costs, but also tend to offset the natural difference in bargaining capacity between workers and employers. Indeed, insofar as employers recognize a certain amount of power of the market, as noted in a previous paragraph, trade unions increase rather than reduce efficiency.

Heterodox thinkers maintain that the assertion that labour regulations or social programmes reduce economic growth is weak even in terms of orthodox economic theory. The analyses indicate a loss of efficiency in static terms, but not a reduction in growth rates. Growth theory does not provide any clear predictions on how static distortions alter the rate of economic development. Indeed, in line with various arguments mentioned above, short-term inefficiencies can be offset by dynamic efficiency.

Some specific comments on the subject of competitiveness are called for in concluding this section. Competitiveness does not depend only on efficiency or relative productivity. A country can flood another nation with goods that it produces less efficiently if the difference in the prices of the inputs and factors that enter into their production is greater than the difference in the efficiency with which those inputs

or factors are used.⁶ From an aggregate standpoint, this means that a country can be "competitive" on the basis of low wages. Consequently, lower competitiveness does not always mean less chance of competing, but a lower standard of living.

The orthodox approach holds that the relative decline in productivity may only give rise to a temporary reduction in competitiveness, because the market mechanisms cause a drop in wages and/or other factor prices (exports go down and/or imports go up, thus leading to a drop in production and employment) which tends to restore competitiveness. As this self-regulating mechanism is felt to be partially impeded by the existence of labour regulations, it is proposed that these should be reduced: this would reduce wage costs, thereby improving competitive-

ness and making the activities in question more attractive to investments, and this would lead in time to a rise in productivity and—in a context of growing employment—in wages too.

The heterodox criticisms of this approach point out, firstly, that the improvement in competitiveness based on lower wages: i) leads to the abandonment of the quest for increased efficiency; ii) encourages specialization in relatively simple goods which require relatively unskilled labour and usually have little future; and iii) does not really constitute a strategy, since it cannot be repeated and its effects are overtaken by the increases in productivity in other countries. Secondly, they question, on the grounds already mentioned earlier, the orthodox idea that deregulation and lower wages favour increased productivity.

IV

Empirical data

Now that we have briefly set forth the theoretical arguments regarding the incidence of labour regulations on competitiveness, it is worth looking at the empirical data adduced in support of the respective positions. Generally speaking, the data have been prepared in the light of the differences between the behaviour of the developed countries, particularly those of the Organization for Economic Cooperation and Development (OECD), on the one hand, and the countries of the South, on the other.

A general assertion may be made at this point which serves to sum up the conclusions of this section: when we analyse the arguments on the relations between social protection programmes, labour market flexibility and aggregate economic well-being, we see that very little information is available on numerous questions (Blank and Freeman, 1994, p. 36).

1. The industrialized countries

With regard to the developed world, comparisons have been made between, on the one hand, the Euro-

pean economies—especially those of the European Union—which have extensive regulations and social protection machinery, and on the other the United States, where social security benefits and labour regulations are notably looser. The analysis has often also been extended to Japan, which has stricter labour regulations and social protection systems than the United States, although the level of collective bargaining is decentralized.

In principle, the orthodox school considers the United States as a model country in terms of competitiveness because of its limited regulations, whereas the European Community is seen as representing the opposite.

The most systematic study made by the orthodox school is probably that which analyses the behaviour of the OECD countries which have signed regional trade agreements: i.e., the European Economic Community (EEC), the European Free Trade Association (EFTA), made up of the Scandinavian countries, Switzerland and Austria, and the North American Free Trade Agreement (NAFTA).⁷ This study analyses the regulations and provisions regarding working hours, contracts, minimum wages and rights of representation of workers and concludes

⁶ The greater competitiveness displayed by a given activity is not due solely to its greater efficiency and/or the lower prices prevailing in it. It may also be due to the lower prices paid for inputs (whose production may be very efficient and/or involves the payment of low factor prices) or for consumer goods (which means that wages can be lower).

⁷ In reality, Mexico is not analysed for lack of information.

that there is no single direct relation between labour regulations and trade results, but that it is too soon to draw a final conclusion in this respect and that more empirical research is needed (OECD, 1995). A more recent study by the same organization (OECD, 1996) mentions the difficulties encountered in trying to make an empirical analysis of the links between basic labour standards and trade flows, the main limitation being the fact that the available information on basic standards is limited and incomplete, except with regard to freedom of association and collective bargaining. The conclusions of the study therefore refer mainly to the latter two basic standards. The empirical data confirm the analytical results whereby basic labour standards have hardly any influence on trade performance. The idea of sinking to a lowest common denominator in the sense that countries with mediocre standards win portions of the export market at the expense of those with good standards is not confirmed by empirical observation. According to the conclusions of this study, the developing countries have no empirical justification for believing that an improvement in basic labour standards would adversely affect their economic performance or competitiveness in world markets.

This skepticism about correlations between protective regulations and productivity is shared by other international organizations. Thus, an official ILO document asserts that the theoretical advantages of open, decentralized competition in the labour markets must be contrasted with the fact that three of the world's most successful economies—the United States, Japan and Germany—have vastly different systems of wage fixing, union density, levels of negotiation and forms of coordination of the whole economy. The most elementary conclusion is that such disparities do not count as far as global employment and other macroeconomic variables are concerned (ILO, 1995). Several documents of different tones have been prepared in the European Commission. One of them states that there is general agreement that the labour markets do not work well and that the origin of the rigidities observed is the lack of flexibility of the labour market, especially from the point of view of the organization of working time, wages and mobility (European Commission, 1994a). In another official document, however, the “general agreement” on this matter is questioned and it is noted that there are those who argue that excessively restrictive labour regulations entail costs that reduce

the competitiveness of firms in one country or region compared with others. On the other hand, many experts believe that productivity and high labour standards have always been an integral part of the competitive formula. The tension between these two points of view has been very evident and it must be admitted that there is no clear agreement on this point (European Commission, 1994b). A study published by the United Nations Conference on Trade and Development (UNCTAD) states that there is no empirical information to support or deny the claim that loose labour rights give a competitive advantage in trade, so that studies in greater depth need to be carried out on each of the labour standards in question (De Castro, 1995, pp. 9 and 10).

Nor are there any studies which provide conclusive data in this respect in the academic field. At the Fourth European Regional Congress of the International Industrial Relations Association the main topic was the competitive advantages of European, United States and Japanese industrial relations, and the official report noted that the documents prepared were marked by cautious attitudes and reserved judgments with regard to the advantages and potential development of the European, Japanese and United States blocs. According to those documents, none of the properties behind those three great world blocs was generally superior to its competitors, since each of them had its relative merits and disadvantages (Jacobi, 1994, p. 18). Another study highlights the complexity of the subject and the “over-simplification” displayed by the various interpretations, although in some cases certain labour regulations, such as the extremely rigid Italian regulations on hiring or the lack of regulations to protect job security in the United States, may be associated with a loss of global economic efficiency (Buechtemann, 1993, p. 62). Other studies note that although the United States—the industrialized country with the most flexible labour regulations and the lowest degree of social protection—has had the highest productivity in the world for a number of decades, it will lose that leading position towards the year 2000 and be overtaken by France and Belgium, since its productivity growth rate is below that of the OECD countries, except for Australia and the Netherlands (Freeman, 1994, p. 9). Nor are categorical conclusions reached in a comparative study of five industrialized countries (the United States, France, Great Britain, Germany and Sweden) on competitiveness and the Welfare State,

since it is noted that while lack of economic discipline can cause the Welfare State to be at odds with competitiveness in terms of prices, productivity and quality are nevertheless benefited by it (Pfaller, Gough and Therborn (eds.), 1993, p. 368 et seq.). In another more recent study it is asserted that both the theory and the empirical data give few reasons for believing that differences in labour regulations make a significant contribution to differences in production costs and, hence, to investment and trade patterns.⁸

In the light of the wide range of studies examined, it may be suggested that there is no empirical information which backs up the existence of linkages between labour standards and competitiveness, even with regard to the general direction in which those linkages operate.

2. The developing countries

It has been hotly argued that liberalization of the labour market is an essential feature in the structural adjustment programmes that the developing countries need to apply in order to stimulate the economy and successfully integrate it into the world market by improving its competitiveness. This orthodox approach maintains that over-regulation of the labour market in Latin America has both entrenched labour market dualism between a highly protected urban formal sector and a largely unprotected informal sector and has impeded labour market adjustment to changing market forces. In contrast, it is argued that labour markets are only sparsely regulated in the recently industrialized Asian countries and that this has been an essential factor behind the successful implementation of export-led development strategies. It is also claimed that the repression of trade unions—especially in their wage-setting role—has contributed to this (ILO, 1995, p. 93).

Followers of the heterodox school of thought, however, have claimed that in the light of these repressive interventions it is rather ingenuous to expect that price distortions can be avoided in successful cases of industrial growth (Standing, 1992, p. 26). It has also been said that the repression of trade unions was not completely generalized (Hong Kong re-

spected British liberal traditions, yet its economic performance was as successful as that of the other "tigers"). In Singapore and Taiwan, a different manner of intervention in the trade unions was used: they were kept under control through a single party. Thanks to its participation in the National Wages Council, the trade union movement in Singapore has been able to exert some influence on economic and social policies, within admittedly narrow limits. At all events, along with the intervention in the 1970s which was aimed at restricting wage rises to keep them below GDP growth, wage correction policies were adopted to tackle the shortage of labour and encourage firms to enter into more technologically complex activities.

The question has been raised of whether these labour market control systems in Southeast Asia were really necessary for those countries' competitive success. As the World Bank itself notes, generally speaking workers are more willing to accept wage flexibility when there is a rapid upward trend, because a downward adjustment only means a slower rate of increase rather than an absolute reduction in real labour income.⁹ In other words, the constant rise in real wages observed in the "Asian Tigers" would appear to have facilitated the generalized acceptance of flexible wages even though their rate of increase has been lower than that of productivity. At the same time, the degree of State intervention in the economy was very intense, with very active industrial policies of a coercive nature which may have had a much more decisive influence on the economic success than deregulation of the labour market or, more exactly, its repressive or paternalist regulation, as noted by Standing (1992, p. 38). It has been asserted that one of the most important features of South Korea's economic development is probably the strong role of the State, especially in its capacity to influence and discipline the great companies which dominate the Korean economy (Park, 1994a, p. 209). It has also been asserted that what enabled the East Asian countries to discipline their companies was the relative weakness of both the industrial and the agricultural groups at the beginning of the post-war industrial development process.¹⁰

⁸ K. Anderson, *The entwining of trade policy with environmental and labour standards*, paper presented at the World Bank conference on the Uruguay Round and the developing economies (26-27 January 1995), quoted by De Castro, 1995, p. 10.

⁹ G. Fields, "Changing labor market conditions and economic development in Hong Kong, the Republic of Korea, Singapore and Taiwan", in *World Bank Economic Review*, vol. 8, No. 3, quoted in ILO, 1995, p. 95.

¹⁰ A. Amsden, "A theory of government intervention in late industrialization", cited by Hikino and Amsden, 1995, p. 6.

Finally, the growing incorporation of protective institutions –the minimum wage in South Korea and Taiwan, and unemployment insurance in South Korea– and the growing independence of the trade union movement do not seem to have altered the growth rates of these countries. “These policy developments in Asia thus highlight the fact that neither a totally deregulated labour market nor labour repression is indispensable for success in export markets” (ILO, 1995).

Other views even question whether State intervention in South Korea has been exclusively repressive and consider that it is necessary to take into account the important paternalist elements in labour policies over the last 30 years. In order to gain competitiveness in international markets, labour was extensively regulated by the government. This did not necessarily mean, however, that the intervention in the labour market was aimed exclusively at benefiting employers. In order to prevent exploitation of workers in view of the absence of (collective) labour rights, the government took a number of protective measures and even encouraged employers to improve working conditions as far as was compatible with the degree of economic development (Park, 1994b). A World Bank study has noted that the South Korean government intervened to ensure that wages did not increase faster than productivity, but that, at the same time, workers shared in the fruits of growth (Mazumdar, 1994). Although trade union autonomy was restricted, the revisions of labour legislation in the early 1960s strengthened individual protection. In spite of the severe repression of collective rights, the revisions of the labour legislation in 1970 included some measures to increase workers’ well-being, and in 1981 a number of measures were taken to improve health and safety regulations. An analysis of the history of labour legislation shows that the State continued to increase protection of individual labour relations, while at the same time reducing the legal provisions protecting collective relations. Since 1965, real wages have grown at a cumulative annual rate of 7.5%, which surpassed the performance of all the industrialized countries, including Japan, in periods of rapid growth. Income distribution also improved substantially, becoming more equal, and the share of wage earners’ income in total national income rose from 31.8% in 1965 to 59.7% in 1990. Although the South Korean working day is the longest and the incidence of accidents is the highest among all the

countries supplying data to the ILO’s Labour Statistics Yearbook, the length of the working day has gone down significantly since 1980, and with regard to accidents, these are said to be recorded more fully than in other countries (Park, 1994b).

In more general terms, a strong correlation has been found, in a sub-sample of recently industrialized countries, between equality of income distribution and productivity growth (Hikino and Amsden, 1995, p. 17).

The orthodox argument is well known in Latin America: by altering the relative returns of the various sectors, tariff barriers and the high degree of State involvement are supposed to have given rise to economies with little growth capacity and/or serious macroeconomic instability. Labour legislation, in particular, is supposed to have deprived the labour market of flexibility, increased non-wage costs and, in some cases, excessively increased the capacity of the unions to exert pressures. This, it is alleged, explains a level of wage costs which is not in keeping with the productivity achieved, thus adversely affecting the competitiveness of those economies and their capacity to generate productive employment. This is reflected, it is claimed, in a high degree of under-utilization of labour which is manifested in the high proportion of informal workers; the resulting segmentation is said to largely explain the unequal personal income distribution, and the low rates of growth of production and generation of employment have meant that in the long term the share of wages in national income was not able to increase.

Comparative studies made in the Latin American context, however, share the general skepticism about the conclusiveness of the available information. Thus, it has been asserted in a World Bank study that if, for example, the relatively successful adjustment of Costa Rica is contrasted with the problems encountered by Bolivia, it is clear that the dismantling of labour institutions is neither necessary (Costa Rica) nor sufficient (Bolivia) to ensure that an adjustment has satisfactory results. It is added that in future studies it would be useful to analyse the role of labour institutions, trade unions and economic policy before embarking on a global defence of the dismantling of such institutions (Horton, Kanbur and Mazumdar, 1994, pp. 45 and 57).

From a different standpoint, it has been asserted, on the basis of an analysis of the labour protection systems of Mexico, Colombia, Peru, Argentina, Chile, Brazil and Uruguay, that it is by no means

clear that labour legislation has any clear effects on overall industrial productivity and that the principle underlying the present policy proposals of a number of Latin American countries –namely, that it is sufficient to make the regulations on dismissal and labour contracts more flexible in order to improve the economic results– is based on a serious misconception (Marshall, 1994, pp. 76-77).

An even more recent study seeks to establish whether reduction of labour costs is necessary in order to improve competitiveness. The analysis concentrates on the evolution of the manufacturing sector over the period 1990-1995 in Argentina, Brazil, Chile, Mexico and Peru. It is concluded that although labour costs rose in four of the five countries studied, productivity rose even more. This shows that labour costs are not an impediment to higher competitiveness, since the evolution of the latter is determined more by labour productivity than by labour costs. The study concludes that the increase in labour costs measured at international prices –which could have affected competitiveness– was due mainly to macroeconomic policies which have established overvalued exchange rates with respect to the dollar and hence alterations in relative prices to the detriment of primary and industrial goods. This has meant that the increase in such labour costs for employers in the tradeable goods sector has not necessarily been reflected in proportional improvements in the real wages of workers. Industrial wages grew over the period in question, but at the end of it they were lower than in 1980 in Argentina (-21%), Mexico (-38%) and Peru (-57%), while they were 10% higher in Brazil and 29% higher in Chile (Tokman and Martínez, 1995). In other words, there is no conclusive evidence of an association between labour legislation (expressed as total labour costs) and competitiveness, since the decisive variables are of a different nature.

In short, the information available from the studies on Southern countries is not conclusive with regard to a possible relation between labour institutions and competitiveness: both World Bank studies and those of the ILO question the simplistic approaches which directly associate deregulation or absence of rules with competitive advantages. At all events, more research is needed to clarify the complex interrelations among the host of variables which determine competitiveness, not only in the short term but even more so in the long term, as the studies on South Korea suggest.

3. Argentina

The proposal to abandon the accumulation model based on import substitution and adopt a system involving greater exposure to international competition was originally part of the economic proposals made a few days after the 1976 coup d'état. It was only from 1991 onwards, however, that a broad programme was put into effect which enlarged on some trends already identified years before and made substantial changes in the rules regarding trade and financial relations with the rest of the world and the State's role in the economy.

In this context, labour regulations become merely one particular element in the broader question of State intervention. The orthodox view is that these regulations impose high production costs and disincentives for investment which have adversely affected the competitiveness of the production apparatus. The elimination or adaptation of labour market regulations should therefore form part of a more general adaptation of the framework of rules which was essential in order to put Argentina in its proper place in world markets.

In particular, it was stated that non-wage costs were high compared with other countries of the region, with the Southeast Asian nations, and even with some industrialized economies. In a comparative study of the situation of the MERCOSUR countries, it is noted that total labour costs exceed gross wages by 39% in Argentina, 23% in Chile and 52% in Brazil (FIEL, 1992). This greater burden of indirect wages is explained by the high payroll taxes to finance social security and other regulations such as family allowances, unemployment insurance or severance pay.

Negotiated wages and strong trade unions were also blamed for the fact that wages were high and have not responded to the situation of the labour market or levels of productivity. For example, in almost all the activities covered by the FIEL study, gross wages in Argentina were between 10% and 20% (or even more in some cases) higher than in Chile and Brazil.

Some regulations, such as those relating to dismissal, not only involve high average costs but also, since they are of a contingent nature, increase uncertainty and investment risks. It is also claimed that regulations on dismissal reduce the flexibility of the labour market. Consequently, it is claimed that these regulations were not only a factor in the high labour

TABLE 1

Argentina: Wages and productivity in manufacturing
(Indexes)

	Real wage ^a	Wage cost ^b	Wage in US\$	Productivity
1980-1988	137.8	90.8	76.9	86.9
1991	100.0	100.0	100.0	100.0
1993	105.7	137.1	135.6	135.4
1994	109.5	144.6	146.3	144.5

Source: Monza (1993) and Szretter (1995).

^a Nominal wage deflated by consumer price index.

^b Nominal wage deflated by national non-agricultural wholesale price index.

costs at the beginning of the period following the adoption of convertibility, but also had a negative effect on the capacity to improve production efficiency. It was claimed that the main way of reducing unit labour costs should be sought with respect to two very closely related aspects: making labour conditions more flexible and increasing the productivity per employee (Bour, 1995, pp. 196-197). The argument would therefore be that greater external flexibility is associated with higher productivity.

Orthodox analysts have therefore repeatedly proposed the reduction of costs and more flexible regulations as means of instantaneously improving competitiveness and allowing productivity to improve on an ongoing basis. They also maintain that this would bring down the relative price of labour and make possible more dynamic growth of employment for a given level of growth of production.

The increase in unemployment – a tendency observed even before the international crisis of late 1994 – was identified by some analysts as evidence of the effects of the rigidity and high costs deriving from labour regulations. During the early years of the period following the adoption of convertibility, however, production, productivity and exports all expanded. Even though there was a significant increase in imports, it cannot be argued that the regulations have been a serious obstacle which has prevented firms from adjusting to the new conditions. It has been asserted, however, that the increase in industrial productivity was largely due to a “defensive” strategy on the part of firms (Kosacoff, 1993, pp. 50-55) and that there was not a significant generalized flow of investments seeking to take advantage of the new rules. It was suggested that this could be explained by the high initial labour costs, which made tradeable goods activities uncompetitive and hence unattractive

to investors. It should be borne in mind, however, that the high relative labour costs registered in Argentina in the early years following the adoption of convertibility were largely the consequence of the real exchange rate level. Thus, as may be seen from table 1, which includes data on industry, labour costs in dollars were high, but real wages continued to stand at historically depressed levels (although higher than in the years of hyperinflation). As occurred in other countries of the region (see section IV.2), this tendency became gradually more pronounced during the period 1991-1993, since whereas wages grew in relation to the prices of the consumer shopping basket (although much less than productivity),¹¹ industrial prices remained practically unchanged (influenced by the fixed exchange rate), while the prices of services rose, and also, in consequence, nominal wages and the ratios between wages and industrial prices and wages and the exchange rate. This deterioration in the relative prices of tradeable goods greatly slackened as from 1994, so that in that year labour costs increased both in terms of pesos and of dollars (table 1) at a rate closer to that of real wages and also of productivity.¹² It is even argued that the devalu-

¹¹ J. Schvarzer (1994) questions the official figures on the growth of industrial production because he considers that the change in the domestically produced component, which went down in many branches of manufacturing, is not taken into account in the national accounts calculations. When the latter are recalculated in the light of this, the growth rate of the industrial GDP is 10% below the official figure for 1994. From this standpoint, the increase in industrial productivity shown in the table would be overestimated.

¹² Furthermore, in that year the reductions in the employer's contributions came into effect. According to Szretter (1995), this led to a reduction in unit wage costs (i.e., the costs which take account of the effect of productivity).

ation of the Argentine peso with respect to the Brazilian Real and the devaluation of the dollar with respect to other strong currencies, together with the improvement in the prices of the products exported by Argentina, were other factors which further increased as from 1994 the beneficial effects on competitiveness exerted by the increase in productivity (Kacef and Machinea, 1995).

At all events, the mere comparison of wages in terms of dollars is not an adequate index of the degree of competitiveness either, since, as shown in

sections II and III, it is necessary to take into account the differences in productivity too. In this respect, the FIEL study already referred to shows that in some sectors the differences in wages in terms of dollars between Argentina and other neighbouring countries were more than offset by the big differences in the product/employment ratio.

In short, none of the known country-level studies have contributed substantive empirical proof of the negative repercussions of labour regulations on competitiveness (Feldman, 1995).

V

Conclusions

In the course of this paper it has been argued, first of all, that economic theory is by no means conclusive regarding the impact of labour regulations on competitiveness, since the positions of the different schools of thought are contradictory in many aspects. Empirical studies have shown the very limited relevance of the information put forward regarding these presumed links. This conclusion may be due partly to the intrinsic difficulty of singling out the effects of regulations as compared with other factors.

It may be concluded from the foregoing that, among other things, there are various strategies open to the countries, so that they have more leeway for action than the orthodox positions usually suggest, since many policies aimed at improving equity do not necessarily involve any restrictions on competitiveness. A country can therefore choose its own desired level of social protection. Indeed, labour regulations are by no means identical, even in the closely integrated European countries (De Castro, 1995). The institutional framework of the different countries is the result of a large number of historical and cultural factors, and the range of feasible changes is strongly influenced by such traditions.

Thus, the question of how to improve competitiveness goes beyond merely technical analysis and develops, at least partly, into an examination of income distribution. The orthodox formula, which does not seem to have a sufficient conceptual or empirical basis, holds that there must be a reduction in the quality of life of workers for a

period whose duration is difficult to predict. While it is true that a country which must increase its trade relations yet has a backward productive base must provide firms with certain initial conditions which will enable them to make up for the differences in productivity which may exist, this formula does not seem to be the only one, and it is certainly not the most equitable or necessarily the most effective. In order to generate these conditions it seems perfectly possible to design systems of income redistribution which will make it an attractive proposition to make investments in order to compete internationally without resorting to further reductions in the wages of those who were precisely the persons most heavily affected during the last years of import substitution policies.

The question of the links between labour regulations and competitiveness cannot be seen as a conflict between equity and efficiency. As we have tried to show here, it is really a question of differing economic and legal concepts of equity and efficiency. The orthodox approach—at least in its most common form—maintains that there is one and only one way of optimizing efficiency and that it involves temporary sacrifices of equity. The review made here, however, suggests that there is broad leeway for choosing between various combinations of equity and efficiency, and their selection depends on the power relations of the different social actors and the structure of the State, rather than on inflexible, exclusive and indubitable formulas.

(Original: Spanish).

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Latin American families: *convergences and divergences in models and policies*

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The structure, functions and everyday practices of families have changed considerably due to the impact of the demographic, social and economic transformations which have taken place in Latin America. This article begins by describing the complexity and diversity of urban families, on the basis of quantitative data. It then analyses the material conditions through which families have passed and the new approach to these changes. Particular emphasis is placed on such matters as female heads of household and poverty, intra-family violence, and the economic contributions of women and children to the household and to society. Some forms of support are suggested to help family groups exercise their functions, according to the different types and stages of the family life cycle, without prejudice to the necessary concern for the basic functions which allow families to maintain themselves over time—access to material resources and coverage of basic services—since fulfillment of these minimum functions can help to broaden families' channels of social mobility and build more democratic family structures. An analysis is also made of the role of the family in the construction of solid and integrated societies, even though paradoxically they are assigned functions and called upon to carry out actions which are difficult to comply with in view of the great changes undergone by the family itself, the change in the role of the State in the coverage of certain services, the new roles that family members must play in society, and the scanty domestic resources that families currently have.

I

Introduction

In its capacity as a means of mediation¹ between the individual and society and as a link between macro-economic and microeconomic changes, the family is increasingly considered as the main space for the action of public policies and the area in which they can have the greatest impact. The family is the social ambit in which, in one way or another, individuals take important decisions on their life, their work and other actions affecting their well-being. From the perspective of the State, the family is a mediatory institution in initiatives to promote equity, guarantee basic human rights, and integrate individuals into social and community networks (ECLAC, 1994a). There is a debate from various angles on the role of the family in building solid, integrated societies, but paradoxically no consideration is given to the fact that it is assigned functions and faced with demands which are increasingly difficult to fulfill, both because of the great changes which have taken place in its formation, size and functions, the new roles that its members have to play in society and the scanty internal resources available to families today, and because of the changes in the State's role in providing certain services.

In Latin America, the changes which have taken place in the family in recent decades are widely recognized by governments. The evolution of the institution of the family in the countries of the region displays generally similar tendencies: reduction in the size of the family unit; decline in nuptiality and postponement of the age of marriage;² and an increase in early motherhood, common-law marriages, broken marriages,

single-parent and single-person households, and reconstituted families (ECLAC, 1993 and 1994a). In a context of relatively rapid economic and social change, it is noted that not only do the children form families of a different type from those in which they were born but also families within the same generation differ according to their stage in the life-cycle, thus giving rise to a wide range of different family structures (Arriagada, 1995), and this must be taken into account when adopting decisions on public policies.

With the processes of modernization, there have been changes not only in the structure of the family but also in its functions and the way they are carried out. Some functions within the family have lost importance (religious and legal functions and economic production functions), while functions such as early socialization and new functions such as those connected with leisure have come to predominate over others such as social control (Rodríguez, 1995). The functions which symbolically and traditionally define the family are mainly those of reproduction and regulation of sexuality, but it is observed that families are having fewer and fewer children, that there is an increasing number of births out of wedlock or outside the relationship of the couple, and that sexual activity is also carried on outside the institution of marriage.

Today, the family continues to concentrate the reproductive and affective functions and those of the care and early socialization of children and looking after old people. Functions of a more instrumental type, such as education or economic production for the market, have been transferred to other social levels. With regard to the economic functions, a distinction must be drawn between participation in production activities in the labour market and the economic functions of consumption and reproduction that the family must fulfill through housework. As a result of changes in the structure of production, many functions of the family which were carried out within the home have come to be carried on outside it, thus reducing the amount of time that people spend in it. However, the recurrent economic crises have reversed these trends, especially with regard to employment (home work and own-account work), pre-school education and

□ A previous version of this study (Arriagada, 1997) contains more statistical data. The data from household surveys were processed by Ernesto Espíndola.

¹ The concept of mediation concerns aspects of social reality which act as a "filter" that can heighten, shape or modify the relation between the structural conditioning factors and individual or group actions (Jelin, Llovet and Ramos, 1986; García and De Oliveira, 1994). It is used in the sense of a vertical mediation developed by Berger and Luckmann, that is to say, it refers to the institutions and processes which act as intermediaries between the individual in his personal life and the great social institutions (Berger, 1997).

² This is not so in all countries: Cuba registers high nuptiality of very young persons (UNFPA/UNESCO/UNICEF, 1997) and a lowering in the age of the first union, as also do Haiti, Jamaica, Panama, Paraguay and Uruguay (CELADE, 1996a).

health. Likewise, families in the most under-privileged economic and social circumstances must cover a much broader range of functions (for example, ex-

clusive care of small children and old people), which is reflected in an extension of housework, for which women are usually responsible.

II

Current trends in the urban family

The demographic, social and economic changes which have taken place in Latin America have transformed the region's family structures. In the last two decades, the region's population has grown by 146 million persons; in addition to a further increase in inequality of income, between 1980 and 1994 the population in a state of poverty increased by 73.4 million persons (ECLAC, 1997); the rate of urbanization increased, and in 1995 the urban population amounted to 74% of the total; both mortality and the birth rate went down, so that between 1975 and 1995 the expectation of life at birth increased by five years for both sexes; the global fertility rate went down from 4.5 to 3.1 between the same years, and the refined rate of female economic activity³ went up between 1980 and 1995 from 27% to 34% (CELADE, 1996b). Thus, urbanization, a smaller number of children and an increase in female work outside the home were the most important phenomena in these changes in the family.

Processing of the data from urban household surveys in 12 Latin American countries reveals some relations between the types of families and the incidence of poverty in the home, work and education. For purposes of this comparison, households were classified according to the types of family, constructed on the bases of the family's relationship with the head of household and the stages of the family cycle, defined as a function of the presence and age of children (see Arriagada, 1997). The preparation of this statistical information serves the purposes of comparison and follow-up of trends, but above all of quantitative diagnosis for proper policy design.

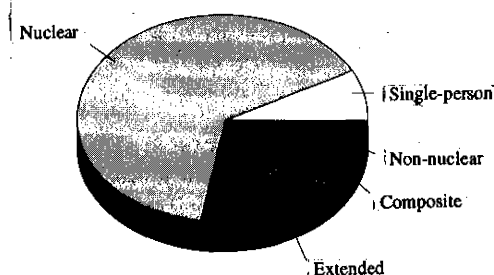
The following conclusions may be drawn from the information processed:

i) In 1994, between 55% and 71% of the families in the countries studied were of the nuclear type. Between 1986 and 1994, the regional averages of the different types of family remained relatively stable, albeit with differences between countries. Households with a female head increased slightly, representing around a quarter of the total number of households

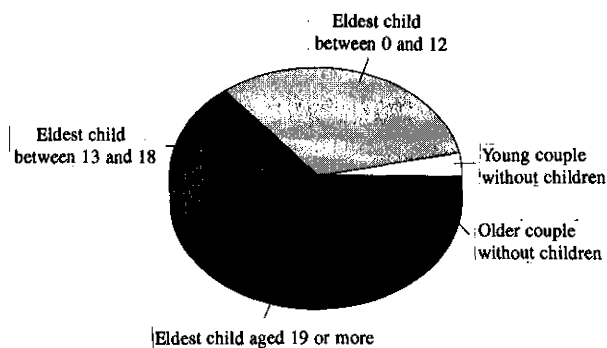
FIGURE 1

Latin America (12 countries): Distribution of family and non-family households, by type and by stage in family life cycle, 1994

A. Distribution of family and non-family households, by type^a



B. Distribution of family households, by stage in family life cycle^a



Source: ECLAC, on the basis of special tabulations of household surveys for 12 countries.

³ The refined rate of activity is the quotient of the total number of persons economically active at a given date and the population of an age considered to be potentially active on the same date; in this case, the population in question was taken as those aged 10 or over.

TABLE 1

Latin America (12 countries): Types of household and family, by sex of head of household, 1994
(Urban areas)

Country	Female head of household ^a					Male head of household ^b					Total
	Single-person household	Nuclear family	Extended or composite family	Non-nuclear household	Subtotal	Single-person household	Nuclear family	Extended or composite family	Non-nuclear household	Subtotal	
Argentina	10.4	7.2	2.7	2.3	22.6	4.9	59.4	11.0	2.2	77.5	100.0
Bolivia	2.9	8.6	4.5	1.8	17.8	4.7	62.6	12.8	2.0	82.1	100.0
Brazil ^c	4.3	9.2	4.7	2.4	20.6	3.6	61.7	12.5	1.6	79.4	100.0
Chile	4.5	7.6	6.1	2.5	20.7	3.5	56.5	17.6	1.7	79.3	100.0
Colombia	2.7	9.5	7.7	3.0	22.9	2.3	54.7	17.5	2.5	77.0	100.0
Costa Rica	3.2	10.0	7.5	2.0	22.7	2.6	57.1	15.8	1.7	77.2	100.0
Honduras	1.5	8.7	10.2	3.1	23.5	1.9	49.5	23.5	1.6	76.5	100.0
Mexico	3.0	7.4	4.4	2.0	16.8	3.0	63.4	14.5	2.3	83.2	100.0
Panama	2.7	9.5	7.8	2.6	22.6	5.5	51.2	17.6	3.2	77.5	100.0
Paraguay	3.3	7.4	7.2	3.1	21.0	4.5	47.5	25.4	1.7	79.1	100.0
Uruguay	11.0	7.5	4.2	3.1	25.8	4.2	55.4	12.6	1.9	74.1	100.0
Venezuela	2.0	8.6	10.4	2.3	23.3	3.5	48.4	22.7	2.1	76.7	100.0

Source: Special tabulations of household surveys for the respective countries.

^a The nuclear, extended and composite families are single-parent families.

^b The nuclear, extended and composite families include two-parent families without children, two-parent families with children, and single parent families with a male head of household.

^c Data for 1993.

TABLE 2

Latin America (12 countries): Stage in life cycle of families, ^a 1994
(Urban areas)

Country	Life cycle					Total
	Young couple without children ^b	Eldest child aged between 0 and 12	Eldest child aged between 13 and 18	Eldest child aged 19 or more	Older couple without children	
Argentina	4.5	24.3	19.2	35.3	16.7	100.0
Bolivia	3.3	40.3	22.6	29.7	4.2	100.0
Brazil ^c	5.1	37.1	20.1	29.9	7.7	100.0
Chile	2.4	28.9	18.1	41.2	9.3	100.0
Colombia	3.9	35.0	20.8	32.4	7.9	100.0
Costa Rica	4.4	27.7	22.0	37.1	8.8	100.0
Honduras	2.9	35.9	23.7	34.3	3.2	100.0
Mexico	3.7	36.7	20.5	34.2	4.9	100.0
Panama	3.5	31.7	20.2	37.6	7.1	100.0
Paraguay	5.8	38.3	19.9	28.8	7.2	100.0
Uruguay	3.4	22.2	17.7	36.1	20.6	100.0
Venezuela	2.8	28.2	22.2	42.1	4.9	100.0

Source: Special tabulations of household surveys for the respective countries.

^a Excluding single-person and non-nuclear families.

^b The female head of household or spouse is aged 35 or less. In older couples, she is over 35.

^c Data for 1993.

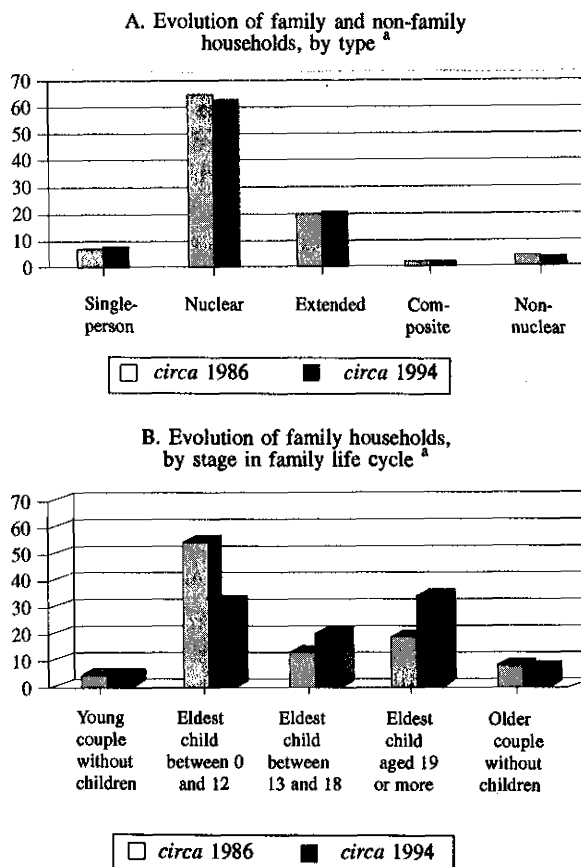
(between 18% and 26%). Comparable information is not available for countries in the Caribbean and Central America, where there is a high prevalence of households with a woman head (figure 1 and table 1).

ii) Over this same period there was a slight increase in single-person households, partly because of population ageing in the countries at an advanced stage of the demographic transition, while the proportion of extended and composite families remained unchanged.

iii) In terms of the life-cycle (figure 2 and table 2) there were also very considerable changes in the number of families in each stage, due to major demographic changes (particularly the decline in the birth rate in the 1970s). Thus, there was a big increase in families whose oldest child was over 13 and a reduction in those whose eldest children were below that age.

iv) Households with a female head are concentrated in that stage of the life-cycle in which the oldest child is over 18 (between 56% and 72% of households with a female head with children), indicating the accumulation of prior breakups of the couple, without the formation of new unions, together with situations of widowhood. Although marital status is not very well registered in the surveys or is even not included among the questions at all, there is a great variety of situations in the countries with regard to the marital status of female heads of household: the proportion of widows varies from 55.8% of woman heads of household in Uruguay (the country where the demographic transition is most advanced) to 26% in Paraguay and Venezuela. In short, there were few variations in the proportions of families by types of household but big changes in terms of the stages in the family life-cycle.

FIGURE 2
Latin America (12 countries): Evolution of households, by type and by stage in family life cycle, 1986-1994 (Percentages)



Source: ECLAC, on the basis of special tabulations of household surveys for 12 countries.
^a Simple averages for urban areas.

III

Gender-linked contributions to research and policies regarding the family

The term "gender" has given rise to a great deal of controversy in Latin America, and even researchers themselves have used it indistinctly to refer to female matters, sex, women's movements, feminist movements or women as a whole.⁴ Gender has been de-

finied as a social, cultural and historical construct

⁴ For a more theoretical analysis of the evolution of the concept of gender, see Anderson (1996), De Barbieri (1992 and 1996) and Lamas (1996).

asymmetrical valuation of men and women and the power relations established between them (Rico, 1993; Scott, 1990). A valuable epistemological quality of the gender perspective is that it makes it possible to link together structural elements and processes with subjective aspects. It also brings out the historical dimensions by showing that certain hierarchical constructs of male and female can be modified over time. All in all, gender studies have made it possible to bring out aspects relating to the family which had remained invisible in the past and take a fresh look at housework, inequality within the family, families with a woman head and intra-family violence, thus helping in the design of policies in areas considered to be of a private nature.

Inequality between families has been extensively analysed from the demographic, economic and social perspectives in studies on the formation of families and measurements of access to consumption, poverty, income distribution and coverage of health, education, housing and social security services, etc. The traditional studies on the family carried out from the 1950s onward were centered on the nuclear family. The prevailing assumption in them was that the processes of modernization of society tended to generate a progressive trend towards nuclear families. The organization of this type of family was assumed to be based on a clear differentiation of roles between the sexes: the man should be the breadwinner through his presence in the labour market, while women would mainly take care of the reproductive aspects and the domestic and affective care of men, children and old people (Aguirre and Fassler, 1994). Although these roles were seen as complementary, in reality this division of roles upheld the authority of the male through his role as the breadwinner of the family (Ariza and De Oliveira, 1997). Recent studies from different social, cultural, psychological and gender perspectives have shown that the situation was actually much more complex, not only historically but also with respect to the families of the present.

Traditional neoclassical theory on marriage holds that both members of the couple benefit economically from the increased efficiency achieved through the specialization of the man in production for the market and of the woman in the upbringing of the children (Becker, 1981). Gender-based studies, however, showed up the family as the scene of unequal economic, social, educational and psychological exchanges among members with very different

degrees of power through their family relationship, sex and age, and also as the breaking point in the private-public dichotomy. The family relationship, sex, age and skill⁵ of the members of the family are important dimensions which must be taken into account not only with regard to the structure of households but also the bargaining capacity, decision-making and access to and use of material and symbolic resources within the home. The gender bias is seen in access to land and housing ownership and in the implicit and explicit contracts and arrangements on the distribution of resources within the family, which have a major impact on social institutions and the perpetuation of differences (Folbre, 1995).

Inequality within the family is thus a recent subject of research, connected with gender studies and the interest in improving the living conditions of women and children.⁶ The extreme workload of women and the time that they devote to housework, together with child and adolescent labour in times of crisis, brought into question the distribution of power within the home, as well as the distribution of housework among the members of the family and the ways of making these chores compatible, especially in poor households, with work outside the home. In the developed countries and the more modern enterprises, the links between work and the family are now recognized from a systemic perspective which considers their interrelations not as contradictory, but as opportunities for generating positive synergies to improve both areas of activity through organizational changes within the enterprise (Bailyn and others, 1996).

This better understanding of the interrelations between the public and private worlds and the different levels of power of the members of the family has been an important contribution by gender studies. This valoric area has given and continues to give rise to major controversies in the developing and developed worlds, because of the difficulty of striking a balance between the privacy and intimacy of persons and the responsibilities of the State for the defence of their rights, which are often very severely violated within the family.

⁵ It should be noted that the lack of skills or physical or psychological disability of some of the members of the family also places them in a situation of vulnerability.

⁶ For an interesting comparative study on intra-family relations in Mexico, Central America and the Caribbean, see Ariza and De Oliveira (1997).

The dividing lines between the public and private worlds are flexible and constantly changing, although the historical tendency with regard to the functions and structure of the family points in the direction of the expansion of the public space. The heterogeneity of the social actors who carry out these functions and the functional specialization of institutions is increasingly marked today, in line with the greater complexity of modern societies. It is essential to take these elements into account when considering the construction of the families of the future and especially when formulating policies which will affect them.

In the following sections, on the basis of statistical data, some salient issues in gender studies will be analysed which reflect both the changes in material conditions undergone by families and the new ideas on these changes. Thus, on the one hand the unsatisfied needs of families are highlighted, with special attention to female heads of households and their relation with poverty, together with intra-family violence, and on the other emphasis is placed on the economic contributions of women and their children to the household and the contribution made by women's housework to the maintenance of society.

1. Female heads of household

Studies and measurements on female heads of household began in the early 1980s, with the pioneering studies of Buvinic and von Helm. They formulated a theoretical statistical measurement of female heads of household, taking into account all the situations where there was no man in the house (mothers who were separated, divorced, widowed, unmarried, etc.) and showed that this was a significant and growing phenomenon in the developing countries which should be taken into account for the formulation of effective policies.

It is claimed that the number of female heads of household is increasing, because of economic trends in general and the poverty which obliges women to seek an income of their own which will give them greater independence, and also because of demographic, social and cultural conditions such as migrations, widowhood, broken marriages and adolescent fertility (Buvinic, 1991). Although the data are not completely reliable, in view of the differing definitions of female heads of household in censuses and surveys⁷ and the fact that the statistical data are not

complete, in Latin America at least one out of every five urban households is headed by a woman. Such families represent between 17% and 26% of the total number of households, and in the Caribbean they account for 40% or more, which, in view of the cultural and statistical definition of "head of household", means that there is no stable couple.⁸ The growth in these figures will probably continue or increase still further if the phenomena causing it also persist (ECLAC, 1994b and 1995).

Female heads of household are usually unmarried or separated mothers, who make up one of the most vulnerable groups of women in the region because they suffer the greatest difficulties in their motherhood. This is particularly so in the case of the group of adolescent mothers, which has increased and combines extreme youth and poverty with a precarious status of head of household (Buvinic and Rao Gupta, 1997). As noted earlier, in countries in an advanced state of the demographic transition, such as Argentina and Uruguay, there is an increasing number of households headed by older women who are widowed or alone, especially in urban areas, which also needs to be taken into account when preparing social policies.

Indigence is more prevalent in households headed by a woman because such households usually include more dependents, because the wages that women receive in the labour market are lower, and because women simultaneously have to carry out economic and household functions, which limits their choice when seeking employment (which must be compatible with looking after the children).

However, acting as head of household may also be an option for more educated women with greater resources, since the majority of households with a female head are not poor and are those which have increased most in recent decades. Thus, there is a great variety of situations as regards the marital status of heads of household, depending on the level of eco-

⁷ In household surveys, the head of household is the person recognized as such by the remainder of the members of the household. In view of the prevailing cultural patterns, there is a tendency to under-record the number of female heads of household.

⁸ It has been considered that the proportion of households headed by women is very high when it represents more than 40% of the total number of households; high, when the figure is between 30% and 40%; moderate, between 20% and 30%, and low, when the proportion is less than 20% (Ariza and De Oliveira, 1997).

conomic and social development and the demographic transition of the countries, as well as more contingent situations such as migration or armed conflict.⁹

2. The economic contribution of women and children to the household: virtuous cycle or spurious cycle?

In the last twenty years there has been an increase in the number of women who live alone or as heads of household with dependents, so that the responsibility for their own survival and that of their family has also increased. Adolescent mothers often do not receive any support from their male partner, and older adults are no longer cared for by their sons: both these tendencies increase the burden on women. Even when women live with a man, the income obtained by the latter is sometimes so inadequate that women and children have to take on the double burden of housework and work outside the home in order to make up the family budget. A study made in Mexico revealed that 17.1% of households, regardless of the sex of the head of household, reported that family income came exclusively or mainly from women (Rubalcava, 1996), although this is one of the countries which registers the smallest proportion of households with a female head.

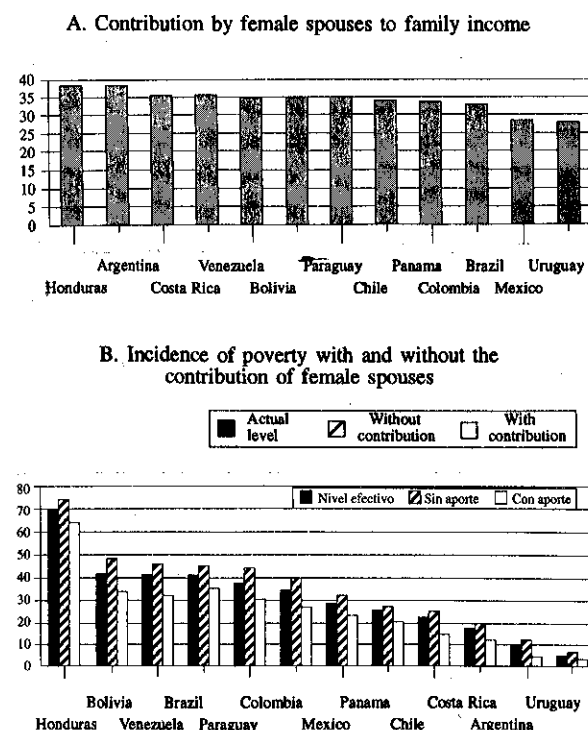
A simulation exercise¹⁰ to find out how much poverty would increase if wives did not contribute their income to the household gave very eloquent results: without that income, in 1994 the number of poor urban households would have increased by between 2% and 7%, depending on the effective level of poverty and of female labour participation in the countries. In contrast, if all spouses contributed their income to the household, poverty would have gone

⁹ Separated or divorced female heads of household represent 54% of the total in Honduras, 43% in Costa Rica, 42% in Colombia, 36% in Bolivia, 24% in Uruguay, 20% in Chile and 15% in Paraguay.

¹⁰ The simulation exercise consisted of deducting from the effective income of households the income in respect of the work of the wife, calculating the new per capita income of the household, and comparing it with the poverty line, thus updating the percentage of households which would be in a state of poverty if it were not for the contribution of the wife. Secondly, wives who did not declare any income were taken into account, they were imputed the income of spouses who did work, in line with the various categories of poverty, a new per capita income was calculated for the household, and it was compared with the poverty line, thus giving the percentage of households which would be in a state of poverty were it not for the potential contribution of all the spouses.

FIGURE 3

**Latin America (12 countries, urban areas):
Contribution by female spouses to family income
and its effects on the incidence of poverty, 1994
(Percentages)**



Source: ECLAC, on the basis of special tabulations of household surveys for 12 countries.

down by between 1.4% and 9%. For the total number of households, wives who were working in 1994 contributed between 28% and 39% of total household income (figure 3).

The economic contribution made by the work of the children, especially in indigent households, is also very important for the survival of households with female heads. The proportion of young people and children in the region who work depends on the countries and age groups, although the available information under-records the number of children and young people who work, because most national legislation prohibits work by persons under 18. Work by children under that age and even as young as 12 is usually accepted on certain conditions, however (that they go to school and that they only do light work for short periods). Taking the total number of households with children, it was found that when the latter worked they contributed between 16% and 36% of household income (Arriagada, 1997).

The information on the work of women and young people reveals that there are two circles, one virtuous and the other spurious, in the participation of family members in the labour force. The first of these refers to the economic participation of more adult members of the family, which allows the latter to emerge from a state of poverty, while the second refers to the economic participation of children under 18, which takes them out of the educational system and causes them and their future families to suffer from economic and social deficits which will lead to the reproduction of the inter-generational poverty cycle.

3. Intra-family violence

The feminist movement and gender studies also brought into the light of day an old hidden phenomenon: intra-family violence. This is a copybook example of how social movements have redefined some aspects of the family –a private ambit– and turned it into a subject of research and an item on public policy agendas.

The main difficulty in typifying and penalizing intra-family violence is that it is carried out within the household; the aggressor claims that he loves the victim, who depends economically and affectively on him and fears reprisals from him. There are three types of intra-family violence: physical, psychological and sexual. Some studies also include indirect violence, such as forbidding the spouse to study or work, isolating or locking her up in the house and otherwise restricting her freedom. The special features of this phenomenon make it very difficult to break the cycle of violence: a spiral that begins with a buildup of tensions and hostility, leads to a violent act, continues with the repentance of the aggressor and a promise that it will never happen again (the so-called “honeymoon” stage) but is then followed by a repetition of the same aggressive conduct.

According to world data, one out of every ten women is being or has been subjected to aggressive behaviour by her partner. International statistics indicate that 2% of the victims of family violence are men, 75% are women, and in 23% of cases the violence is mutual (Rico, 1992). This intra-family violence has been registered in all social classes, although the violence tends to be psychological rather than physical in the higher strata. A study carried out in Chile by the National Women’s Service (SERNAM)

shows that in 60% of households there is some kind of violence against women, and in one out of every three households there is psychological violence, while in one out of every four there is physical violence; another study, by UNICEF, revealed that 63% of all children are victims of physical violence and that the culture of physical punishment is deeply rooted in Chilean households.

Gender studies have shed some light on the phenomenon of intra-family violence. They have pointed out that the family is a paradoxical ambit which fosters not only affection but also violence (Jelin, 1994). They have highlighted women’s ignorance of their rights and duties and of the machinery established by the law to apply and guarantee them; the problems that exist at the judicial and police level which hinder the reporting of violations of those rights and the follow-up of the complaints made; and the lack of machinery and institutions to protect the rights of women, young people and children. They have pointed out that women have internalized social values whereby the subordination of women is something “natural”. There is thus an acceptance of cultural norms which regulate the life of the couple and the roles of mother and wife; the family and marriage are idealized and made to appear as the only option for women, and social pressures are exerted in different areas of family and neighbourhood life which force women to comply with the dominant cultural mandates (Rico, 1992).

There are also other factors which can be added to these, such as the impunity of criminal acts carried out in private circles; early socialization in a subculture of violence which accepts ill-treatment of women as something natural; the feelings of insecurity and frustration experienced by men when they feel that their authority over women is being threatened, and the precarious conditions in which much of the population live, which can act as triggering factors: overcrowding, poverty, and unemployment, and alcoholism and drug addiction on the part of the aggressor (De Oliveira (ed.), 1996).

Intra-family violence is thus a form of conduct which is learned and can therefore be changed. It is based on unequal relations between men and women and on the fact that masculinity takes the form of the domination of women by men, which can be reflected in physical and psychological violence against those who have less power: women and children.

Box 1

LATIN AMERICA AND THE CARIBBEAN: LEGISLATION AND
STATE ACTION AGAINST INTRA-FAMILY VIOLENCE

Country	Legislation	Examples of State action
Argentina	Law No. 24.417 against family violence (1994)	Preventive programmes, shelters, special police units (Buenos Aires), 24-hour telephone
Bahamas	Law on sexual offences and domestic violence (1991)	Shelters, "hot lines", legal support
Barbados	Law on protection orders against domestic violence (1992)	Special training for police officers, legal support, "hot lines"
Belize	Law No. 28 on domestic violence	Shelters, legal support, training for professionals and volunteers in the health and social sectors and the police
Bolivia	Law No. 1.674 against family or domestic violence (1995)	Public Prosecutors' Offices for family affairs, special police department for protection of women and the family, integral legal services
Brazil	Legislative Decree No. 107 giving legal force to the Convention to prevent, punish and eliminate violence against women (1995)	Special police units to attend to victims of domestic and sexual violence, shelters, Women's Support Centre
Chile	Law No. 19325 against intra-family violence (1994)	Municipal centres for attention to battered women, Press campaigns, research, information centres, special police units, national training programme for public officials and police officers (intra-family violence will form part of the police training programme)
Colombia	Law No. 294 on intra-family violence (1996)	Special police units for family matters, training workshops on violence against women (CERFAMI, Medellín)
Costa Rica	Law against domestic violence (1996)	Special department for women's affairs and defence, national plan for dealing with and preventing violence (1996-1998), temporary shelters
Cuba	Revision of the Family Code	Centres for the guidance of women and the family
Ecuador	Law No. 839 on violence against women and the family (1995)	Press campaign, legal aid, special police units for women and the family
El Salvador	Decree-Law No. 902 against intra-family violence (1996)	Public Defender of women's human rights
Guatemala		Public Defender of women's rights, in the Office of the Public Prosecutor for Human Rights (Woman and Child Unit)
Guyana	Law on domestic violence (1994)	Training courses on domestic violence
Honduras	Law for the prevention, punishment and elimination of violence against women (1997)	Workshops to generate increased awareness of the problem; legal aid
Jamaica	Law on domestic violence (1996)	Preventive campaigns in schools on dispute settlement; shelters
Mexico	Law on the prevention of intra-family violence in the Federal District and assistance to victims (1996)	Centre for dealing with intra-family violence; specialized agencies to deal with sexual offences

Box 1 (continued)

Country	Legislation	Examples of State action
Nicaragua	Law No. 230 to reform and expand the penal code to prevent and punish intra-family violence (1996)	Commission against domestic violence; special police units
Panama	Law No. 27 defining the offences of intra-family violence and ill-treatment of minors (1995)	National commission against intra-family violence and ill-treatment; municipal centre
Paraguay		Preventive campaign; special police stations; special public prosecutors' offices for the family and minors
Peru	Law No. 26260 (1993) amended by Law No. 26763 on domestic violence (1997)	Special women's units; shelters; special police procedures
Dominican Republic	Law No. 24-97 defining the offences of intra-family violence, sexual harassment and incest (1997)	Programme of legal clinics; shelters; "hot lines"
St. Vincent and the Grenadines	Law on domestic violence (1994)	Training programmes
Trinidad and Tobago	Law No. 10 on domestic violence (1991)	Shelters; "hot lines"; legal aid
Uruguay	Law No. 16707 (Law on the Security of the Citizen) introduces into the penal code article No. 321 bis defining and punishing domestic violence (1995)	Special telephone service; special police units; shelters; information centres
Venezuela	Draft Bill on intra-family violence and sexual harassment (1993)	Legal aid system; assistance offices; shelters; training

Sources: Data prepared on the basis of ISIS International, Information and Documentation Programme on Violence against Women, 1996 and 1997; Valdés and Gomáriz (eds.), 1995; for the Caribbean: information provided by the ECLAC Subregional Headquarters for the Caribbean; FEMPRESS, No. 177 (July 1996), No. 187 (May 1997) and No. 189 (July 1997).

The acceptance and implementation of gender-based policies runs into serious difficulties connected with resistance to change, with the large number of social and political actors involved, with conflicts of interest, with the diversity of institutions which exists in each country and, in particular, with ideological resistance. In spite of this, in recent years most of the Latin American countries have included punishment for intra-family violence in their legislation, and all of them have ratified the inter-American convention for the prevention, punishment and elimination of violence against women (Belén do Pará, 1994).

National and international legislation with regard to children has a somewhat longer history, as it began in 1959 with the Declaration of the Rights of the

Child and culminated in the International Convention on the Rights of the Child in 1989, which included a set of legally binding commitments concerning the survival of children, their personal and social development, and the protection of their physical, psychological and moral integrity. There have also been important legislative advances and State action in this field in the 1990s (box 1).

In most of the countries of the region, State and non-governmental measures have been taken to help and protect battered children and women, including information, dissemination and preventive campaigns, legal and psychological support, the training of monitors for cases of domestic violence, the establishment of "hot lines" for seeking help by telephone,

reception centres, etc. An important feature has also been the establishment of institutional machinery for dealing with violence, such as centres for specialized attention and assistance to victims, special police stations for dealing with women and the family, government offices for women's affairs, and the establishment of support networks for women's movements. However, the continuing implementation of State and non-governmental action is constantly threatened by budgetary constraints: in many cases it depends on resources from abroad which, when they run out, also lead to the termination of the programme, while in other cases they depend on the goodwill of the current national, state or municipal governments.

Nevertheless, the end of intra-family violence is a cultural change which may be expected in the long term thanks to changes in the socialization and education of boys and girls and in the values of society, which should lead to greater equality between the sexes and the establishment of more democratic relations within the family.

4. Housework

Housework is another of the items of analysis highlighted in gender studies. A major theoretical contribution in this area is the conceptualization of the different types of reproduction: biological, day-to-day and social. All societies make women responsible for the day-to-day reproduction effected through housework, which is carried out in each household in isolation, is not recognized as having an economic value, and is shared unequally according to the level of development of each country, social class, family life cycle and geographical area. The United Nations Development Programme (UNDP) has calculated that in developing countries 66% of women's work is outside the system of national accounts, so that no accounts are prepared in respect of it, it is not recognized, and it is not assigned a value (UNDP, 1995).

The traditional family model in the light of which plans are usually prepared is that envisaging a head of household who is the breadwinner, a woman who acts as housewife and carries out the housework, and children who, depending on their age, are in the educational system or the labour market until they form their own family units. We know that this family model does not represent the majority, however. In Chile, for example, this model applies in

the case of less than half of the families—only 33%, according to Bravo and Todaro (1995)—since a growing proportion of families have more than one breadwinner, there are others where the only breadwinner is a woman (Valenzuela, 1995), and in the extreme cases of indigent families the children also participate in the labour market.

It would appear that we are currently witnessing a process of change in the relations between the sexes within the family system: family roles are tending to become more flexible and to evolve from a highly segregated model like that which traditionally prevailed towards a more democratic model with shared roles, in which men and women come to various kinds of arrangements for the care of the children and the housework.

The most readily visible phenomenon—which marked the beginning of the break with the traditional model and will continue in the future—has been the massive incorporation of women into the labour market. Paradoxically, so far in the great majority of cases women have not succeeded in breaking with the traditional model, so that they have to carry out a double working day (ECLAC, 1989). Some case studies indicate that men are less reluctant to share in the care and attention of the children than to participate in the housework (Durán and others, 1988; Sharim, 1995). Other studies, carried out in a male population with a high level of education, note that in two-parent families there is a disparity between the symbolic discourse of the men, in which they express their agreement with the change in traditional gender roles, and the practical application of their words, since they do not display any systematic commitment to a real change in the unequal distribution of burdens and privileges in the relations between the sexes (Vivas, 1996). In other groups, a slow and laborious process of negotiation has been begun within the couple to work out a new model of shared responsibilities in the home, but there are few studies which bear witness to these changes and to new trends in the distribution and exercise of power in the family.¹¹ An aspect which is highlighted in gender studies is that of the changes which take place in the distribution of tasks in the household according to its stage in the family life-cycle (Reca, 1996), in which the arrival of children is a crucial landmark.

¹¹ A recent case study on family responsibilities may be found in ECLAC, 1998b.

IV

Institutional support for the family: new public policies for new functions

It is the responsibility of the State and other social bodies and institutions to intervene in the area of the family by defining those who make it up, regulating the relations between its members, monitoring its functioning, imposing limits on its members and offering supportive solutions through social policies, legal and juridical mechanisms, and concrete institutions and practices (Jelin, 1994). The neo-liberal model rejecting State intervention, which has been applied in various countries of the region, has led to the deregulation of many economic activities, with increases in poverty and unemployment which have had to be palliated through social measures and regulations by various public bodies (employment programmes, housing subsidies, special benefits for female heads of household, etc.).

In other areas relating to the family, the intervention of the State is sometimes implicit and only becomes visible when people do not comply with the established patterns of behaviour: in Chile, for example, children born in and out of wedlock do not enjoy equal rights, and the responsibilities of the parents and the extended family towards so-called illegitimate children are therefore not recognized.

When the family is considered as a target group for policies – apart from the legal rules regulating it in accordance with national legislation – it is also necessary to take into account other dimensions of the family group (ECLAC, 1982):

i) The modes of formation, development and dissolution of the family: age when the couple is formed, formal establishment of unions, number of children, stability of the union, stage in the life-cycle.

ii) The internal relations within it: husband-wife; parents-children, relations between brothers or sisters, relations between the nuclear family and the network of relatives, forms of socialization, distribution of power within the family, communication.

iii) Its external relations as a group and the various circumstances affecting them, such as income, housing, and infrastructure and access to services in the areas of health, education and social security.

As the object of government policies, the approach to the family depends on what it is desired to change or retain in this form of functioning. It is therefore necessary to know what are the prevailing modes of organization of the family and the rationale underlying it (for example, organization/disorganization of households). It is likewise necessary to carefully examine its evolution, that is to say, not only its structure at a given moment, but also the changes in the ways it is formed and in its internal and external relations, in order to obtain guidelines regarding the families of the future.

The experience accumulated in the formulation and execution of policies aimed at certain members of the family – such as the children or female heads of household – highlights the importance of developing systemic approaches for the application of these policies, since if the effects of the changes on the other members of the family are not taken into account the results may be wiped out or may be slower than expected. The challenge is therefore to formulate policies by types of families, as a function of their structure and their stage in the family life-cycle, without losing sight of the special features of each of the family's members or their individual needs.

As already noted, because of the diversity of situations through which families pass, the fact that they are constantly affected by the absence or existence of implicit or explicit policies, and the State's ever-increasing difficulty in providing the population with basic services, policy formulation must be adapted more closely to the specific needs of families, according to criteria of selectivity which take account of the families' structure and their current stage in the life cycle.

It is necessary not only to increase the support that social institutions can give to the family but also to improve the participation of the members of the household in family life, so as to strike a fairer balance between the roles of men and women in social reproduction. In achieving this objective, a central role belongs to the world of work, where the organi-

Box 2

FORMS OF SUPPORT FOR FAMILY FUNCTIONS

Family functions	Forms of support		
	Laws and policies	Benefits	Services
Establishment of bonds between the couple	Laws and customs regarding marriage, divorce, and the roles of the spouses	Aid for married couples and tax reductions	Family education; mediation in the event of divorce
Procreation and sexual relations between the couple	Laws and policies on rights with respect to reproduction, customs regarding family size, and the roles of the spouses	Marriage allowances, maternity leave, tax reductions and assistance with housing	Mother and child health centres, midwives, family planning, training in family matters
Giving children a name and status	Laws on paternity and adoption	Allowances paid by the father and the State	Legal guidance; adoption services
Basic care of children (and of relatives)	Laws and customs on child care and equality of the sexes	Child allowances	Education of the parents; day nurseries
Socialization and education of children (and their parents)	Laws on education, traditions and educational policies	Free or subsidized schools; free foodstuffs and school materials	Pre-school education, schools, family guidance centres
Protection of family members	Laws on protection of minors and of battered women; penal legislation on intra-family violence	Subsidized housing; legal and psychological support activities	Child protection services; therapy; shelters
Providing affective care and recreation for family members	Customs on family life and democratization of the roles of family members	Subsidized sick leave for family members	Family guidance; therapies
Providing services and resources for family members	Rules on everyday life and division of work within the family unit	Allowances and benefits	Self-help services in the home

Source: United Nations, 1993, p. 21.

zation of work can be redesigned to help both men and women to fulfill their labour and family roles.

The coverage and quality of institutional support systems (such as day nurseries and pre-school education) are not usually sufficient to ensure that special attention is given to those who need it most: the poorest women and those who work outside the home. In Latin America, in 1991 pre-primary attention to children between 0 and 5 years of age only covered less than one-fifth of that age group, and in most cases was concentrated in the private sector and urban areas. Some countries in the region have managed to increase the coverage of pre-school education and others have tried to make it legally compulsory, but in most countries there is still a great deal to be done in this respect.

Different forms of support for the functions of the family have been designed, and each country should adopt them in keeping with its own appraisals of the situation of households and the quality of the services provided, as well as the level of relative importance given to the prevention or correction of problems. By way of example, some possible forms of action in the areas of legislation, benefits and services designed to support some key functions of the family are set forth in box 2.

Likewise by way of example, the most important functions that should be strengthened and the institutions and services that should take action in this respect are identified for different types of families (box 3) and different stages in the family life cycle (box 4). The types of families selected include, for

Box 3

SUPPORT FOR DIFFERENT TYPES OF FAMILIES: EXAMPLES OF FUNCTIONS AND SERVICES

Types of families	Functions to be strengthened	Supporting institutions and services
Nuclear families with a female head in a situation of poverty or indigence	<p><i>Production:</i> Generate opportunities of employment and income for women</p> <p><i>Socialization:</i> Attention to pre-school and school children</p> <p><i>Provision:</i> Of affective and recreational care</p>	<p>Special programmes of access to credit; training and employment for female heads of household (social investment funds, etc.)</p> <p>More flexible working hours</p> <p>Coverage of basic and pre-school education</p> <p>School meals</p> <p>Open day care centres to look after children during working hours</p> <p>Subsidized transport for minors and school children</p> <p>Mother and child health services; family planning and guidance services</p>
Nuclear families with a male head in a situation of poverty or indigence	<p><i>Production:</i> Generate training and employment opportunities for heads of household and their spouses</p> <p><i>Socialization:</i> Attention to pre-school and school children</p> <p><i>Distribution of roles</i> within the family</p> <p><i>Democratization</i> of family life</p> <p><i>Protection</i> of women and children</p>	<p>Special training and employment programmes for persons in a situation of extreme poverty (social investment funds, etc.)</p> <p>Coverage of basic and pre-school education</p> <p>Services for taking care of battered women and children</p> <p>Mother and child health services; family planning and guidance services</p>
Extended families	<p><i>Socialization</i></p> <p><i>Provision:</i> Of affective and recreational care for family members</p> <p><i>Democratization</i> of family life</p> <p><i>Distribution of functions</i> within the home</p>	<p>Services caring for the elderly</p> <p>Self-help services in the home</p> <p>Day care centres for the elderly</p> <p>Cultural and community recreation centres</p>

illustrative purposes, those in a situation of poverty or indigence, since they have the most urgent needs, although some of the functions which need to be strengthened for them should also be strengthened for families which are not poor. There can be no doubt that a fundamental requisite for the formation of integrated citizens is that the adult members of the family should have access to employment, since this is a basic condition for the maintenance and survival of the household.

Defining the specific aspects which should be strengthened, according to the type of family and its stage in the life cycle, does not mean that there is no need to worry about the basic requisites that all families need to enjoy in order to maintain themselves over time: access to material resources and adequate coverage of housing, health, education and social security services. The fulfilment of these minimum functions helps to improve the quality of life of families and to broaden their channels of social mobility.

In conclusion, it should be repeated that the study of the family as a system is indispensable if it is desired that social policies should actually reach those who need them, and if such policies are to be effective, their analysis should also include the forms of relations within the household between relatives of different ages and sexes and the possible effects of social policies on all of them.

Certain types of traditional functions of the family—especially early socialization—can be expected to lose prominence as they are shared with other social institutions, but at the same time there will be an increase in the importance of other functions, such as those of providing affection and support, which will become more and more significant for persons in an increasingly demanding, competitive and impersonal environment.

There can be no question about the permanence of the institution of the family, which will continue to exist in the twenty-first century with increasingly

Box 4

SUPPORT FOR FAMILIES AT DIFFERENT STAGES IN THEIR LIFE CYCLE:
EXAMPLES OF FUNCTIONS AND SERVICES

Stage in life cycle of family	Functions to be strengthened	Supporting institutions and services
Families at the initial stage	<i>Formation of family:</i> access to housing <i>Division of work</i> within the home <i>Production:</i> access to employment <i>Family education</i>	Family planning services and legal guidance on family matters Centres providing services for families Job opportunities and employment centres for young people Allowances and training for young unemployed persons Subsidies for gaining access to housing
Families at stage I of their life cycle (eldest child under 12)	<i>Socialization:</i> attention to pre-school and school children <i>Division of work</i> in the home <i>Reproduction</i> <i>Affective and recreational care</i> for family members	Coverage of pre-school and basic education Mother and child health coverage Family planning services Family allowances and pre- and post-natal leave Legal advice Services for the protection of battered women and children
Families at stage II of their life cycle (eldest child aged between 13 and 18)	<i>Socialization:</i> attention to school children <i>Reproduction</i> <i>Affective and recreational care</i> for family members <i>Care of the elderly</i>	Coverage of basic and secondary education Mother and child health coverage Family planning services Family allowances and pre- and post-natal leave Legal advice Services for the protection of battered women and children
Families at stage III of their life cycle (eldest child aged 19 or more)	<i>Production</i> <i>Affective and recreational care</i> for family members <i>Care of the elderly</i>	Coverage and subsidies for higher education Employment opportunities for young people Subsidies and training for young unemployed persons Services for the protection of battered women and children
Families at the "empty nest" stage	<i>Improving the quality of life</i> <i>Care of the elderly</i> <i>Community participation</i>	Social security coverage Old age pensions Health coverage Day care centres for the elderly Cultural and community recreation centres

diverse structures and probably with new changes in its functions. It is worth asking ourselves, however—in these modern times in which there is an increasing effort to broaden not only the economic and political options but also those of a social and cultural nature— what tensions and alternatives the

family will have to face and in what ways we can strengthen the family's role in society and support family projects of a more democratic nature in which the rights of all the members of the family are respected.

(Original: Spanish)

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Free trade agreements *and female labour:* the Chilean situation

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This article analyses the relations between economic integration processes, employment and equality of opportunities between men and women. To this end, the case of Chile is considered, where simultaneous processes of internationalization of the economy, the pursuit of economic integration agreements and the growing incorporation of women into the labour force are taking place. The relation between integration agreements and the labour situation of women derives from three factors. Firstly, the new trade flows affect employment and wages, and there may be a differential effect by sex if the female labour force is concentrated in particular sectors of production. Secondly, free trade agreements may explicitly incorporate items of labour legislation concerning women. Finally, the different labour laws and working conditions in countries entering into integration agreements have given rise to accusations of social dumping by developed countries against developing nations. Section I of the article analyses the effect of trade agreements on employment and wages and describes the situation of the female labour market in Chile. Section II looks at the provisions of trade agreements regarding the female labour force and summarizes the arguments put forward about social dumping and the way this relates to legislation concerning women. Section III analyses the instruments which could be used to regulate the labour and social impacts of integration on the women's labour market. Finally, section IV presents some concluding comments.

I

Labour effects of trade agreements

The increase in trade flows due to economic integration processes is leading to an intrasectoral and intersectoral reallocation of physical and human resources. Consequently, the integration of Chile into a trade agreement should affect sectoral levels of employment and wage differences between different sectors of production.

This section looks at the effects that the incorporation of Chile into a trade agreement like NAFTA could have on the women's labour market. Basically, it sets out some features of female employment in the Chilean economy and then goes on to review previous studies which have quantified the impact of free trade agreements on employment and wages.

1. The labour situation of women in the Chilean economy

Chilean women have been playing an increasing part in the labour market in recent years. The main features of this situation have been i) an increase in the rate of female participation; ii) a rate of participation which is still low in spite of the upward trend of recent years; iii) concentration of women's activities in certain sectors and occupations; iv) significant differences in wages between men and women, and v) the fact that the economic sectors in which the female employment is concentrated are likely to be "sensitive" to a free trade agreement.

The growing incorporation of women into the world of work is directly reflected in female rates of participation (see Mizala and Romaguera, 1996), which have risen from close to 25% in the mid-1970s to nearly 34% in 1995 (table 1).

The increase in female participation is a worldwide phenomenon which is linked with economic growth, development, cultural changes, and changes in the standards of living which accompany these processes, especially women's greater control over their own reproductive capacity.

□ This article is partly based on a report prepared for the Chilean National Women's Service (SERNAM). The authors wish to acknowledge the support received from the Chilean Scientific and Technological Development Fund (FONDECYT), Project No. 1960705.

TABLE 1
Chile: Rates of labour force participation, by gender, 1976-1995

Year	Total	Men	Women
1976	47.1	70.2	25.2
1977	45.9	69.5	23.6
1978	48.5	71.2	27.1
1979	47.3	69.7	26.1
1980	48.4	70.3	27.6
1981	47.8	69.9	26.8
1982	47.2	68.3	27.4
1983	47.5	68.0	28.3
1984	48.1	68.9	28.7
1985	51.9	74.2	30.5
1986	50.9	73.5	29.6
1987	51.1	73.8	29.7
1988	52.5	75.2	31.2
1989	53.0	75.8	31.6
1990	52.8	75.1	31.8
1991	52.6	75.2	31.3
1992	53.8	75.5	33.4
1993	55.3	77.0	34.9
1994	55.2	76.6	35.0
1995	53.9	75.2	33.9

Source: National Institute of Statistics (INE), Survey for the October-December quarter.

On the basis of international comparisons, however, it may be concluded that the level of female labour participation in Chile is still low and it is therefore reasonable to expect that there will be an ongoing tendency towards growing incorporation of women into the world of work. It should be noted that the rate of female participation in Chile is low not only compared with the developed countries but also compared with the recently developed Asian countries such as South Korea and Singapore, where this rate exceeds 60% in the younger segments of the population.¹ This fact is partly explained by the differences in the type of production structure of these countries –specialization in labour-intensive industries or specialization in natural resources.

¹ Data from the World Bank Atlas (World Bank, 1997) indicate that the rate of female participation in Chile was 32% in 1995, compared with 48% in Sweden, 46% in the United States, 45% in South Korea, 43% in England, 40% in Indonesia and Uruguay, and 37% in Colombia.

TABLE 2

**Chile: Employment and average income,
by type of economic activity and gender**

Type of activity	Employment				Income
	Total		Sectoral		Percentage differential, men/women
	Men	Women	Men	Women	
Agriculture and hunting	18.2	5.6	87.2	12.8	-21.5
Forestry and lumbering	2.1	0.2	96.2	3.8	19.6
Fisheries	1.7	0.6	85.4	14.6	-29.6
Coal mining	0.4	-	94.3	5.7	
Crude oil and natural gas	0.1	-	97.0	3	
Metallic minerals	2.1	0.3	94.2	5.8	-14.4
Non-metallic minerals	0.4	-	97.2	2.8	
Foodstuffs, beverages and tobacco	3.7	2.6	74.7	25.3	-36.1
Textiles, clothing and leather goods	3.1	9.1	41.9	58.1	-48.3
Wood, cork and furniture production	2.2	0.6	87.9	12.1	
Paper products, printing and publishing	1.2	0.6	80.1	19.9	
Chemical and related products	1.6	1.2	73.3	26.7	-14.7
Non-metallic mineral products and petroleum products	0.8	0.4	80.8	19.2	
Basic iron and steel industries	0.5	0.1	94.5	5.5	
Metal products, machinery and equipment	3.4	0.8	90.4	9.6	-20.9
Other manufacturing industries	0.5	0.4	72.5	27.5	-52.4
Electricity, gas and steam	0.8	0.1	92.4	7.6	30.9
Water works and water supply	0.2	0.1	83.7	16.3	
Construction	12.3	0.9	96.5	3.5	
Wholesale trade	1.9	1.3	75.7	24.3	-25.1
Retail trade	11.6	18.2	57.3	42.7	-28.8
Restaurants and hotels	1.6	3.6	48.1	51.9	17.5
Transport and warehousing	8.1	1.6	91.3	8.7	13.5
Communications	1	0.7	74.9	25.1	5.7
Financial establishments	1.2	1	71.3	28.7	-8.5
Insurance	0.5	0.9	54.6	45.4	-30.9
Real estate and business services	2.3	2.8	62.7	37.3	-18.9
Public administration and defence	3.4	2.2	76.0	24.0	-11.8
Sanitation and related services	0.4	0.5	63.1	36.9	-64.9
Social and community services	4.8	18.4	35.4	64.6	-44.1
Entertainment and recreational services	1.2	0.9	74.4	25.6	-35.9
Personal and household services	6.1	23.3	35.4	64.6	-48.1
International organizations	0.1	0.1	61.6	38.9	-38.3
Others	0.7	0.7	66.6	33.4	0.6
Total	100.0	100.0			-29.2

Source: Prepared on the basis of CASEN 1992. The data on income correspond to income from the main occupation.

Chilean women's place in the world of work is in a transitional stage, with a slow but rising rate of incorporation into the labour force. Their participation is very sensitive to market conditions such as levels of unemployment and wages, and this may be noted from the difference in the wage elasticities between the sexes: the elasticity of women's wages is 1.88 while in the case of men it is 1.07. Furthermore, the changes in the supply of female labour take place through entry into or withdrawal from the labour force, whereas those of the male labour force take place through variations in the number of hours worked, with the participation in the labour force remaining more stable (Mizala, Romaguera and Henríquez, 1998).

When analysing the potential effect of free trade agreements on employment, it is important to bear in mind the high concentration of female labour in particular sectors of production, according to the data on employment and wages prepared on the basis of the National Economic and Social Profile Survey (CASEN). Chilean female employment is concentrated in agriculture (5.6%), textiles and clothing (9.1%), retail trade (18.2%), social and community services (18.4%) and personal and household services (23.3%); in other words, five sectors of production account for 75% of total female employment (table 2).

The figures reveal that women's income is 29% below that of men, which is due to two factors: i)

women receive lower pay in every one of the different branches of industry, and ii) they are concentrated in low-wage sectors.² In the agricultural sector, for example, women's incomes are 21.5% below those of men, while in the textiles sector the difference amounts to 48.3%, and both these sectors have a high concentration of female labour and have low average wages compared with other sectors of the economy. These figures are only an aggregate indicator of the differences in income by sex, since a more precise indicator should take account of the human capital composition of the workers. In view of the information which exists on the high level of schooling of women, however, the differences observed seem to be due both to a phenomenon of discrimination (wage discrimination and occupational segregation) and to the negative effect of discontinuous working experience.³

The concentration of female employment in low-wage sectors may also be seen from figure 1, where the vertical axis shows the proportion of female labour and the horizontal axis shows average income. There are no observations registered in the upper right quadrant (over 50% participation in employment and high wages); most of the data are concentrated in the bottom left quadrant (less than 50% participation in total employment and low wages). In actual fact, the only sector in which average income is high (379,351 pesos) and female participation is close to 40% is "international organizations": a phenomenon which may be considered as marginal, with virtually no incidence in total employment (0.1%).

2. The labour impacts of trade agreements

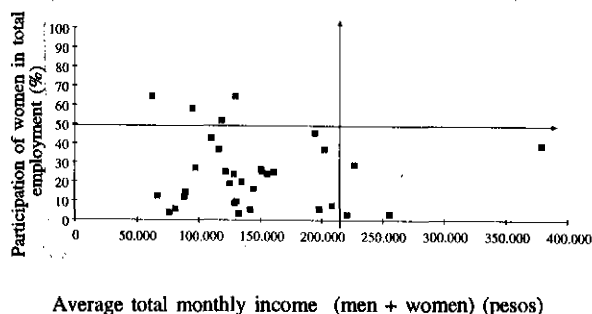
The question of the labour impact of a potential trade agreement has been analysed for Chile by Valdés (1992), Coeymans and Larraín (1992), Muchnik and others (1992), Brown and others (1994), and Yaksic (1994). Among more general studies on the impacts of free trade agreements are those by Butelmann and Meller (eds.) (1992), Butelmann and Frohmann (1992) and Erzan and Yeats (1992). One of the few

² Extensive analyses have been made at the international level to determine whether the female labour force itself tends to depress wages in an industry, but it is not possible to examine this phenomenon with the information available for the present study.

³ For more details of the rise in female participation rates in Latin America and women's high educational levels compared with men, see López, Pollack and Villareal (eds.), 1992; Valdés and Gomáriz (eds.), 1995, and World Bank, 1995.

FIGURE 1

Chile: Average income vs. participation of women in total employment, by branches of activity



studies that analyses this question at the gender level is that by Joeques (1993), but this study refers to the general effects of increased trade rather than the specific effect of a free trade agreement.

The most extensively studied case is that of the possible effects of the integration of Chile into such an agreement with the United States. Generally speaking, the studies conclude that those effects would be quantitatively limited for Chile in view of the high degree of integration of the Chilean economy into the world economy and its current low tariffs.

Indeed, it is estimated that the average tariff affecting Chilean exports to the United States is only around 2%, basically because the goods involved are largely natural resource-based (Butelmann and Frohmann, 1992). However, United States tariffs increase in proportion to the degree of processing of products, especially in the agricultural sector, where tariffs range from 0% to 35% (Campero and Butelmann, 1992).

On the other hand, it is estimated that the benefits of a free trade agreement for Chile will come not so much from access to markets for products with higher added value, but above all from the positive effects of greater stability of trade rules, more transparent regulations and incentives for investment in the country.

a) Effects on employment and wages

The studies on the labour impact of trade agreements have used various methodologies, including general equilibrium models, partial equilibrium models and analyses of specific sectors.

In general, the studies indicate with regard to Chile that the impact on employment and/or wages

TABLE 3
Chile: Effects of a free trade agreement
between Chile and the United States
(Percentage changes)

Sectors	Employment		Real wages	
	Short term	Long term	Short term	Long term
Agriculture	0.26	-0.39		
Mining	0.15	6.86		
Industry	-0.51	2.60		
Fisheries	0.05	-0.16		
Services	-0.02	-0.57		
Total	0.00	0.00	1.35	11.36

Source: Coeymans and Larraín, 1992.

would be quite low (Coeymans and Larraín, 1992; Valdés, 1992; Brown and others, 1994).

Coeymans and Larraín anticipate that the results of a free trade agreement would be a decline in employment in the short term of 0.51% in industry and 0.02% in services, which would be offset by an increase in employment in the other sectors of production (table 3). The increase in the demand for labour would be reflected in an increase of 1.35% in real wages. In the long term, there would be a slight reduction in employment in the agricultural, fishery and services sectors, with declines of 0.39%, 0.16% and 0.57% respectively, while there would be an increase in employment in the mining and industrial sectors.

The Coeymans/Larraín model assumes that the labour force and the rate of unemployment remain constant, so that there would not be changes in employment but in real wages. This is an important restriction, since the low rates of female participation mentioned earlier give grounds for thinking that the supply of female labour is likely to increase in the future. Although the assumptions of this model limit its usefulness for the purposes of the present study, its results do serve to highlight the fact that the sectors which should "provide" labour in the long term are agriculture and services; these sectors must reduce their level of employment in order to allow growth in employment in the mining and industrial sectors.

In the article by Brown and others (1994), a general equilibrium model is developed to assess the effects of the successive incorporation of four Latin American countries into the North American Free Trade Agreement (NAFTA): Chile, Argentina, Colombia and Brazil. Each of the countries entering the Agreement would increase its own well-being (as

TABLE 4
Chile: Effects of a free trade agreement
(Percentage changes)

Sectors	Product
<i>Tradeables</i>	
Agriculture	-0.2
Mining	5.2
Foodstuffs	-1.7
Textiles	-6.9
Clothing	-4.3
Leather goods	-2.6
Footwear	-0.3
Wood products	-4.1
Furniture	-6.1
Paper products	-4.3
Printing	-1.4
Chemicals	-8.9
Petroleum products	1.4
Rubber products	-7.9
Non-metallic mineral products	-0.4
Glass products	-9.0
Iron and steel	-11.7
Non-ferrous metals	24.0
Metal products	-0.7
Non-electrical machinery	-38.2
Electrical machinery	-17.2
Transport equipment	-81.2
Miscellaneous	-6.7
<i>Non-tradeables</i>	
Gas, electricity and water	2.1
Construction	-0.6
Wholesale trade	-0.5
Transport	-0.5
Financial services	-1.1
Personal services	-1.3
Total	0.9

Source: Brown and others, 1994.

represented by GDP), and the well-being of each of them would also be increased by the incorporation of a new member into the agreement, except for Argentina, whose product would be reduced by the incorporation of Brazil. This model—like that of Coeymans and Larraín—assumes that aggregate employment remains constant and focuses on variations in the product and sectoral changes in employment (table 4). In Chile, because of the assumptions of the model, the effect on employment is nil, while a decline of 0.9% in wages is estimated. This decline takes place because—according to the model—NAFTA would cause a sharp concentration of production in the sectors offering comparative advantages, especially the copper mining and copper products sectors, which are capital-intensive. In contrast, it is expected that labour-intensive sectors such as clothing, leather and footwear would suffer a decline in production.

TABLE 5

Chile: Effects caused on employment by the expansion of exports and imports generated by a free trade agreement between Chile and the United States
(Number of jobs; base: 1990)

Sectors	Exports	Imports	Net effect
Agriculture and fisheries	1 279	103	1 176
Mining (copper and iron ore)	17	-	17
Oil and gas	-	-	-
Coal	-	241	-241
Other minerals	1	27	-26
Foodstuffs, beverages and tobacco	1 308	155	1 153
Textiles	257	409	-152
Clothing	744	61	683
Leather and footwear	275	17	258
Wood (excluding furniture)	40	41	-1
Furniture (other than metal furniture)	70	14	56
Paper	1	36	-35
Printing and publishing	3	42	-39
Chemicals and chemical products	87	848	-761
Petroleum refining and products	-	11	-11
Rubber products	21	163	-142
Plastic products	3	283	-280
Earthenware, pottery and glass	134	144	-10
Basic iron and steel industries	1	126	-125
Non-ferrous metals (copper)	-	10	-10
Metal products	13	520	-507
Non-electrical machinery	25	3 934	-3 909
Electrical machinery and equipment	7	881	-874
Transport equipment	23	483	-460
Professional and optical equipment	2	360	-358
Other industries	21	101	-80
Total	4 330	9 010	-4 680

Source: Valdés, 1992.

The Valdés model (1992) is a partial equilibrium model, and its results indicate that integration into a free trade agreement with the United States would lead to an increase in well-being of the order of 1% of GDP in Chile, while the impact on employment would be only small. It estimates that a maximum of 4330 jobs could be generated through the increase in exports, while a maximum of 9010 jobs could be displaced by the increase in imports, so that the net effect would be negative. In the sectors making intensive use of female labour (such as the agricultural and clothing sectors) there would be a positive effect on employment (table 5).

In addition to these studies of a global nature, sectoral studies have also been made, such as those by Muchnik and others (1992) and Yaksic (1994) for the agricultural and agroindustrial sectors; by COCHILCO (1995) for the mining sector, and by Escobar and others (1992) for the textiles sector.

The agricultural and textiles sectors have two features which are important for the purposes of this

article: both of them have a significant concentration of female labour and they will suffer a relatively substantial reallocation of labour, according to the studies analysed earlier.

b) *The agricultural sector*

Agriculture is the sector which appears to be facing the biggest para-tariff barriers to its exports, such as quarantine requirements, marketing orders and import quotas, while processed goods of agricultural origin are subject to increasing tariffs.

The study by Muchnik and others (1992) uses a partial equilibrium model to analyse the employment situation in the agricultural and agroindustrial sectors in the event of a trade agreement between Chile and the United States. The results indicate that employment would go down by 10.4% in the case of importable agricultural goods, while it would increase in the case of both exportable agricultural goods (2.5%) and agroindustrial goods (28.3%). The overall effect would be an increase of 1.5% in em-

ployment (table 6). In other words, although the net effect is small, significant reallocations would be required within the sector.

Lowering tariffs from the present level of 11% would lead to a reduction in the area planted with uncompetitive products such as wheat and oilseeds: a process which has been taking place already even without trade agreements. In the case of exportable goods, since the products currently exported are subject to relatively low tariffs or do not pay duty at all, the effects would come from the elimination of para-tariff barriers; from an increase in exports of more highly processed products subject to high tariffs, such as canned goods (14%) and prepared foodstuffs (21%); and from the possible incorporation of products such as jam and preserved fruit, which are subject to tariffs of 20% to 35% and are basically not exported by Chile at present.

In short, the anticipated effects on the agricultural sector are: a drop in employment in the importable products sector and an expansion in exportable agroindustrial products, which are those subject to the highest tariffs in the United States.

The study by Yaksic (1994) concentrates on the qualitative impacts of a free trade agreement with the United States and gives a description of the present working conditions in the agricultural sector. First of all, it highlights the importance of seasonal labour in the agricultural and agroindustrial sectors which could be affected by free trade with the United States; according to this author, 67% of the workers in these sectors are employed on a seasonal basis. The study also highlights the importance for the agricultural sector of a parallel labour agreement and the possibility of accusations of social dumping in this context (as we shall see in section II below).

According to this study, the importance of the question of social dumping for the agricultural sector lies in the fact that situations which are not in line with the labour legislation are rife in that sector; for example, workers do not have written contracts of employment, the employers do not pay social security and health insurance contributions for them, there are problems of safety and unacceptable environmental conditions in their work, etc. The study claims that working conditions are relatively poor and that an improvement in these aspects would obviously have an impact on the costs of the sector.

On the other hand, it is noted that the mere existence of a parallel labour agreement would generate

TABLE 6
Chile: Effects caused on agricultural and agroindustrial employment by a free trade agreement between Chile and the United States
(Number of jobs and percentages)

Products	Initial employ- ment	Change in employment	
		Jobs	% ^a
Importable agricultural goods (wheat, maize, sugar beet, oilseeds, etc.)	74 403	-7 709	-10.4
Exportable agricultural goods (fresh grapes, tobacco, wine, etc.)	79 215	1 982	2.5
Exportable agroindustrial goods (tomato paste, raisins, canned peaches)	30 079	8 517	28.3
Total	183 697	2 790	1.5

Source: Muchnik and others, 1992.

^a Percentages are with respect to initial employment.

pressures for greater compliance with the labour legislation. Thus, Yaksic asserts that, insofar as it would demand certain minimum working and wage conditions, the free trade agreement would probably result in substantial advances, including the right to collective bargaining and to participation in joint health committees.

In our view, however, it is not so clear that a parallel labour agreement would have such a strong impact on the agricultural sector. As we shall see in section II below, NAFTA-type agreements do not impose common rules on the various countries but basically merely oblige each country to comply with its own labour legislation.

c) *The textiles sector*

In the textiles sector, the tariff structure affecting Chilean exports is also highly progressive, depending on the added value of the product, so that the effective protection is probably greater than might be suggested by the present tariffs. Moreover, there have also been other forms of protection for the United States textile industry, ranging from anti-dumping measures to countervailing duties.

The studies which have been made so far emphasize how difficult it is to predict the future evolution of the sector, which is highly competitive, subject to rapid and constant technological progress, and does not enjoy intrinsic competitive advantages

TABLE 7

**Chile: Summary of effects on employment of a
free trade agreement, according to various studies**

	Studies			
	Coeymans and Larraín (1992) ^a	Valdés (1992)	Brown and others (1994)	Sectoral studies ^b
<i>Agriculture</i> ^c	-	+	-	+
Importable agricultural goods				-
Exportable agricultural goods ^c				+
<i>Fisheries</i>	-			
<i>Mining</i>	+		+	+
<i>Industry</i>	+			
Foodstuffs		+	-	
Textiles ^c		-	-	+
Clothing ^c		+	-	
Leather and footwear		+	-	
Wood		-	-	
Furniture		+	-	
Paper and printing		-	-	
Chemicals		-	-	
Petroleum products		-	+	
Rubber products		-	-	
Plastic products		-	-	
Non-metallic minerals, glass, iron and steel		-	-	
Non-ferrous metals		-	+	
Metal products, machinery and transport equipment		-	-	
<i>Electricity, gas and water</i>			+	
<i>Construction</i>			-	
<i>Services</i> ^c			-	
Financial services ^c			-	
Personal services ^c			-	
<i>Transport</i>			-	
<i>Commerce</i> ^c			-	

^a This study deals with the long-term effects.

^b Correspond to studies by Muchnik and others (1992) for the agricultural sector and Escobar and others (1992) for the textile sector.

^c Sectors or branches where there is a major share of female labour.

in the case of Chile. According to Escobar and others (1992), a free trade agreement would speed up the process of technological modernization of the textiles sector and lead to a slight increase in imports and a somewhat larger increase in exports, so that the sector would grow faster than if there were no agreement and the current decline in employment in it would be checked to some extent.

d) *Summary of sectoral impacts*

By way of summarizing the foregoing analysis, a list is given below of the sectors which would be affected by an integration agreement, indicating whether the expected effect on employment is positive or negative and noting the sectors where there is a high proportion of female labour (table 7).

In general, the studies conclude that a sectoral reallocation of employment would be needed, and they expect that a free trade agreement would have a positive effect on wage levels. The studies which use equilibrium models tend to predict a lower growth rate of employment in the activities where female labour is currently concentrated. A positive impact on employment in mining is expected and a negative impact on employment in service activities, while the expected effect in the areas of agriculture and industry is varied and depends to a large extent on the degree of disaggregation of the analysis.

There are studies on the agricultural sector which highlight the potential positive and negative impacts of the agreements. As the female labour force is mostly in export agriculture and agroindustry, however, the

net effect for this labour force could be more positive than is indicated by the global analyses.

In the case of textiles, the three empirical studies found that there would be a negative impact, while the study of a more qualitative nature estimated that a free trade agreement would ease the negative tendency which the sector has been displaying. In this sense, the tendencies of both the textile and clothing sectors are uncertain, and a process of labour reconversion will probably be needed within the various subsectors of the textile industry.

From the gender point of view, there are two issues which it would be important to take into account in future research. Firstly, the fact that the main labour impact of a free trade agreement is reflected in wage increases is the natural result of the fact that most of the studies assume that the labour force remains constant. However, the incorporation of women into the labour force is precisely the most important potential source of employment growth in Chile, and the increase in the supply of labour is obviously a factor which will moderate the growth of real wages.

Secondly, sectoral employment is heterogeneous not only in terms of skills but also in terms of gender. Thus, assuming full mobility from the sectors which dispensed with workers into the sectors which should absorb them also means assuming that women working in the services sector can be absorbed by the industrial and mining sectors, which is highly improbable in view of the prevailing occupational segregation by gender.

Consequently, it is necessary to progress towards studies with a higher degree of disaggregation at both the sectoral and the gender level. Studies which take into account the fact that the labour force is heterogeneous and that mobility is not perfect will give a better idea of the wage impact of sectoral reallocation due to an integration agreement than the models applied so far.

3. Some consequences for female employment

Female employment is highly concentrated in certain sectors of production, and many of these appear to be sensitive to the impact of a potential free trade agreement. This would be the case, in particular, in the agricultural, agroindustrial, textiles and clothing sectors, although there are branches within each sector where employment levels could either rise or fall.

Although the information on the impact of an integration agreement on the labour situation of women is still somewhat unreliable, this exploratory study seeks to highlight three factors which would affect the result:

i) It is expected that a free trade agreement will have a significant impact on the agricultural, agroindustrial, textile and clothing sectors. Because of the high concentration of female labour in these sectors and the fact that the diversification of the pattern of women's employment seems to be a slow business, what happens in these sectors will naturally influence the female labour situation. Moreover, within each of these sectors there are subsectors which could be either benefited or adversely affected by integration, with the effects being negative in the case of the more traditional or technologically backward activities.

ii) The effect of free trade agreements on the services sector is very important, because this sector employs a great deal of female labour. The studies which have been made consider that this sector will have to reduce its level of employment so that the surplus workers can be absorbed by the expanding sectors. The differences between production activities in terms of their composition by gender, however, leads us to believe that the intersectoral mobility of labour will be lower than assumed in the studies made so far. One of the criticisms levelled at this type of analysis is that it underestimates the new production niches or opportunities created by trade. It could be held that there has been a tendency to overlook the fact that the growing integration of the Chilean economy as a supplier of services to the rest of Latin America—in such areas as financial activities, insurance, computation, etc.—could have a positive effect on female employment.

iii) At the same time, economic growth will naturally help to expand the employment opportunities of women. In view of their current rather low rates of participation in the labour force, the main source of growth of employment will be women, unless there are massive phenomena of international migration or the incorporation of part-time young workers or there is a very intensive process of technification.

Finally, the greater international integration that accompanies trade agreements, the closer links with countries which have made more progress in improving the relative situation of women, and the very fact that the agreements address such issues as discrimination against women should also be positive demonstration factors in the case of Chile.

II

Free trade agreements and labour legislation affecting women

1. What do the agreements say with regard to women?

In general, the actual texts of the agreements signed by Chile do not make any explicit reference to women. So far, the only agreement which has specifically included this matter is the labour cooperation agreement annexed to the free trade agreement with Canada,⁴ which basically follows the NAFTA model.

When the NAFTA negotiations began in 1990, the prevailing view was that trade agreements should only deal with matters of trade and investment and should not include social, labour or environmental matters. However, pressures by trade unions and non-governmental organizations, together with the victory of the Democratic candidate Bill Clinton in the 1992 Presidential elections, led to the preparation of two supplementary agreements, one on environmental matters and the other on labour matters.

Women are referred to, although only indirectly, in the supplementary agreement on labour matters signed by Canada,⁵ the United States and Mexico as an annex to NAFTA; this supplementary agreement mentions gender-based matters in two of the 11 guiding principles which the three countries undertake to promote, subject to the national legislation of each country, but without laying down minimum common standards. These two principles are the elimination of discrimination in employment on account of race, religion, age, sex or other reasons, and equal pay for men and women (according to the principle of equal pay for equal work in the same establishment). These concepts are only general principles, and failure to comply with them does not involve any direct trade sanctions.

The agreement seeks above all to ensure compliance with the respective national legislation: the machinery for appealing to the Trilateral Labour Commission and setting up expert assessment committees is extremely unwieldy and hard to implement.

Rather than using supranational norms or standards based on universally recognized principles, such as the ILO conventions, for example, the United States has promoted the concept of compliance with the labour legislation of the respective countries.

In the event of Chile's accession to NAFTA, it seems unlikely that the country's prevailing rules on women workers will be at variance with the general principles contained in the provisions of NAFTA. If there were a trade dispute or a conflict of a political nature, however, the gap which still exists in Chile between the legislation and its practical application in the case of some labour rights of women could be brought up by the other members of NAFTA.⁶

There are also differences of approach between the Chilean and United States rules on female labour. Thus, for example, the legislation which exists in Chile for the protection of women—the most obvious case is protection of working mothers—does not exist in the same form in the United States legislation, while on the other hand Chile does not have the legal mechanisms that exist in North America for taking legal action against an employer in cases of discrimination.

In the European Union, many instruments have indeed been developed for the promotion and special training of women; the legislation on equality of opportunities is impressive,⁷ but the levels of implementation still leave much to be desired.⁸ In the other examples of integration (MERCOSUR, Andean Pact,

⁴ Labour Cooperation Agreement between the Government of the Republic of Chile and the Government of Canada.

⁵ It is interesting to note that in the case of Canada more women were against the free trade agreement between Canada and the United States (only 44% were in favour) than in the case of men (60% in favour). See Gidenhil, 1995.

⁶ With regard to working conditions in some export sectors, see Mizala and Romaguera, 1997.

⁷ See Nielsen and Szyszczak (1991), Prechal and Burrows (1990) and Blanpain (1991).

⁸ This is shown by the statistics (European Union, EUROSTAT, 1992) and also by the most qualitative analyses (Coyle, 1995).

CARICOM, Central American Common Market) the gender dimension is almost completely absent, although there have been moves by some social actors, especially those connected with women's movements, to raise this issue.

2. The debate on social dumping

One of the issues which has come up again recently in connection with free trade is the effect of differences in wage levels, social security, and workers' protection and safety between trading partners with different economies and economic and social conditions.

For some authors, and above all for the workers in the most highly developed countries, this would amount to "social dumping", an unfair trade practice and a kind of subsidy for producers, since it would increase the competitive advantages of the less developed partner due to the lower cost of the labour factor and "over-exploitation" of workers, while it would also encourage capital flight by offering lower labour costs to producers from the developed countries themselves.

A classic example which has been mentioned as an illustration of this type of situation is that of the in-bond assembly operations in the northern border areas of Mexico, where Mexican workers (especially female workers) with low levels of skills, low wages and unsatisfactory working conditions assemble components and carry out simple processing operations on inputs brought in from the United States in order to manufacture final goods for re-export to that market.

This line of argument has been used on innumerable occasions by United States trade unions and also by candidate Ross Perot in the 1992 Presidential campaign (Doherty, 1992). Indeed, the Generalized System of Preferences and the United States Super 301 International Trade Act include measures providing for unilateral protection against this kind of situation. The concept of social dumping has also been used to explain the deterioration in labour conditions in the developed countries as a result of a kind of "race to the bottom" (see Kapstein, 1997). These arguments, which were already being put forward with regard to the traditional kinds of trading partners (especially from Southeast Asia and Latin America), were expressed much more forcibly in the debate on NAFTA when a free trade agreement was being negotiated with Mexico.

The question of the problems caused by the integration of economies of markedly different types also arose in the course of the formation of the European Economic Community, and in fact when Spain and Portugal –relatively less developed countries– were incorporated into the EEC special measures were taken to deal with this problem. Labour and social standards had to be officially approved and financial support was given in order to form a common labour market.

We nevertheless consider that the arguments questioning the concept of social dumping are quite convincing (ILO, 1994; Albuquerque, 1994):

i) The accusation of social dumping involves an intrinsic error, since dumping means the placing of products on foreign markets "at less than the normal value of the products" (article VI of GATT). The "normal value" is generally defined in terms of the value on the domestic market, and consequently it would not be possible to speak of dumping if a product is exported at a value corresponding to its domestic cost.

ii) Differences in labour costs frequently reflect differences in levels of productivity between different countries.

iii) The quality of life of workers has a positive effect on levels of productivity, and there is a virtuous circle between quality of life and productivity which favours the international competitiveness of the economy in question.

iv) Although in the short term disparities in labour costs may be very great, free trade makes it possible in the medium and long term, with increasingly integrated economies, for the wage levels of the relatively less developed country to draw closer to those of the more highly developed countries.

v) The interests of workers in countries with unequal levels of economic and social development do not necessarily coincide, and the argument of social dumping is often used as a means of protectionism by developed countries which fear foreign competition and capital flight.

The images and associations of social dumping which are put forward, especially in the press of the developed countries, often depict a situation where female workers, with low wages and no social security, take the place of workers with good jobs in a developed country. There are no solid proofs which back up this allegation, however, and in view of the occupational segregation affecting women it is highly unlikely that such a situation would exist.

The validity of the social dumping argument, including its gender dimensions, is thus quite doubtful, and it would appear to be necessary to explore other

ways of analysing and, in time, regulating the effects of international trade liberalization and economic integration processes on workers.

III

Instruments for regulating the labour and social impact of integration

Chile is seeking to establish free trade arrangements with NAFTA, the European Union, the member countries of the Asia-Pacific Economic Cooperation Forum (APEC) and the Western Hemisphere, and it is very probable that labour issues will be included in some way in some of these negotiations. What, then, should be the mechanisms to be adopted for establishing and supervising the labour standards governing these agreements?

In the industrialized countries, the insistence on supranational labour standards is often due more to defensive considerations than to a vocation of international solidarity. This attitude has grown stronger as trade liberalization and globalization have gradually eliminated other more traditional protective barriers, such as tariffs and para-tariff mechanisms.

In the developing countries, which are interested in the inflow of foreign investments and the stimulation of their external sector, this matter is viewed rather ambiguously. On the one hand, some sectors are interested in taking advantage of the situation provided by the negotiation of trade agreements in order to raise national labour standards. On the other hand, there is a feeling in governments and among employers that the establishment of supranational standards could mean the introduction of protectionist mechanisms, promoted by the industrialized countries, which would adversely affect development.

This variety of approaches was reflected recently in the Singapore Declaration of the Meeting of Ministers of Trade of the World Trade Organization (WTO) in December 1996, at which it was agreed that the ILO should be the organization responsible for promoting compliance with basic labour standards, thus avoiding, at least for the present, the inclusion of this issue on the agenda of the WTO. In spite of the resistance of many developing countries, however, it seems clear that social and labour issues, and their

linkages with international trade, have already become a part of the international agenda.

It is in the interests of a developing country like Chile to address and study these issues to avoid their being used as an instrument of protectionism, rather than refusing to consider them at all. Furthermore, it is important to take them into account in order to give social and political legitimacy to the agreements.

The question of gender has been largely absent from this debate until very recently. There had been some mention of women, as a particularly vulnerable and discriminated group, and it had been noted that there was a need for special protection—above all for working mothers—as well as for some special training and promotion measures. It is only recently that this protective and rather paternalistic view has begun to be replaced by a new approach based on the concept of gender, in which equality of opportunities for both men and women and the elimination of the social and cultural barriers which prevent this have moved into the spotlight. This perspective is not easy to incorporate in the traditional trade union and labour demands. Some pioneering efforts have come from countries where equal opportunity plans have been put into effect and from the work of the ILO in this field.⁹

The basic starting-point is provided by the Conventions of the ILO: the international organization specially created to deal with these matters. Moreover, the ILO's tripartite method of operation and of consensus-seeking—workers, employers and governments are all represented in its assemblies—provides a guarantee that the interests of all sectors will be represented.

⁹ See Ulshoefer (1994) and other ILO studies cited therein.

In this respect, it has been suggested that there are some basic international standards –embodied in the ILO's Conventions– which may be considered as prior requisites if trade is to be able to contribute to improvements in the living conditions of workers (Adamy, 1994): Convention 87, on freedom of association; Convention 98, on the right to organize and collective bargaining; Convention 135, on the protection of workers' representatives; Conventions 29 and 105, on the elimination of forced labour; Convention 138, on the prohibition of child labour; Convention 111 on the prohibition of discrimination in employment; and Convention 100, on equal remuneration for men and women for equal work.

These Conventions have been ratified by most of the countries in the world and their principles enjoy at the very least considerable international legitimacy. Nevertheless, there are also different views on what these basic international standards and the mechanisms for implementing them should be.¹⁰

The use of these Conventions as basic rules for international trade is not as simple as it might at first appear. The Conventions and procedures of the ILO do not enjoy the same acceptance and political legitimacy in all countries. There are some countries, some of them with great weight in the international concert, which consider labour legislation as a strictly domestic matter of national sovereignty.

The United States, for example, has ratified only 11 of the 174 Conventions in the 60 years between 1934 and 1994. Most of the Conventions ratified are of minor importance, and several of them deal with technical matters. The United States has not ratified such fundamental Conventions as No. 87 (freedom of association) and No. 98 (right to collective bargaining), even though its own legislation provides for those rights (Cowie and French, 1994). In some cases, Conventions are not signed or ratified because the countries do not recognize certain rights (this is very evident, for example, in the United States, in the case of protection of working mothers and maternity leave). Generally speaking, however, what is involved is a different philosophy regarding the establishment of general rules; a reluctance to enter into the supranational labour regulations developed within the ILO; and a view that these mechanisms are too bureaucratic, unwieldy and not in keeping with specific national conditions.

¹⁰ See French (1996), Freeman (1996), Golub (1997) and Langille (1997).

In the case of the United States, instead of supranational rules based on universally recognized principles, the government has promoted the concept of compliance with national labour legislation in the respective countries with which it has trade agreements. This is based on the principle that the national legislation best reflects the level of development of labour rights and the special conditions of each country, and that it is the disparities between labour rules and actual practice that should disappear. Insofar as trade agreements cause the labour practices of each country to be studied in greater detail, this should at the same time promote a higher level of control and supervision and the elimination of those disparities in the field of labour rights.

In the case of the European Community –later the European Union– initiatives such as the 1974 and 1984 Social Action Programmes, the establishment of the European Social Fund, and the Maastricht Treaty were designed to level out and consolidate the social policies of the member countries, some of which were fairly backward in this respect. The balances being drawn up in the 1990s, however, indicate that social advances have not been as rapid as economic progress. The promotion of social policies in each country would appear to be connected more with the needs arising from the consolidation of the great European market than with the application of binding Community standards (Santillán, 1995).

In the Community instruments, women form part of a long list of vulnerable and discriminated sectors of society with regard to which special policies need to be developed. Some general instruments have been established for creating greater equality of opportunity (Weinberg, 1992), but the scanty changes which have taken place in female employment and the maintenance of the wage gap between men and women (European Union, EUROSTAT, 1992), at least in the 1980s, would appear to indicate that it has not yet been possible to promote significant changes.

The European Social Charter has been seen as a model mechanism for regulating the labour and social impacts of integration. It is important to bear in mind, however, that several of these mechanisms have been promoted mainly by the most solid and prosperous Welfare States. Although it is important to learn from the European experience, it would appear to be very difficult to imitate it.

We believe that there is no reason why gender issues should be caught up in this debate. They are

based on a different concept –equality of opportunities between men and women–, which means that rather than putting forward a set of demands (although they do also include specific demands) the real aim is to do away with the social and cultural mechanisms which cause and reproduce discrimination. In the case of the issues connected with motherhood, for example, it is not just a question

of obtaining more day nurseries and better maternity leave, but of securing the recognition of social responsibility for the upbringing of children, which should be reflected, among other things, in parent leave. In order to achieve these purposes, both the pragmatic Anglo-Saxon concept and the more principle-oriented approach based on international labour standards are valid means.

IV

Final comments

The debate on the labour effects of integration agreements and, in particular, their effects on the female labour market is still at an incipient stage (see Yáñez and Todaro, 1997).

In Chile, women's participation in the labour market is growing but is still quite low by international standards, while female employment is concentrated in certain sectors of production.

The estimates made using different models to analyse the labour effects of a potential free trade agreement in the case of Chile indicate that the net effect in terms of employment and wages would be quite small. In general, the studies made so far have not taken into account the gender dimension, which is important for at least two reasons: firstly, although the net effects may be quite small, it is anticipated that it will be necessary to reallocate employment between production sectors which have very different employment structures by gender. Secondly, some of the sectors which are most sensitive to a free trade agreement are those where much of female employment is concentrated.

In this sense, the changes in the employment demands of the different sectors due to integration processes would represent a major challenge for female integration into the labour force, since they would have to run counter to the tendency towards segregated occupations currently displayed by the Chilean economy.

At the same time, it is expected that regional integration, links with countries where the relative situation of women is better, and the fact that the agreements include some gender considerations may also be positive demonstration factors for developing countries like Chile.

Although women's issues have been present in some trade agreements, they have been dealt with in a relatively indirect manner. In the agreement between the United States, Mexico and Canada, the guiding principles include non-discrimination in employment and equal pay for equal work between the sexes, although failure to comply with these principles does not involve direct trade sanctions. The agreements do not seek to establish supranational regulations or standards but basically merely to ensure compliance with the respective national legislation.

If Chile enters NAFTA, it seems unlikely that the prevailing Chilean rules will be at variance with the general principles of that agreement, although the gap which exists in Chile between the legislation and its practical application in the case of some labour rights of women could be brought up as an issue by developed countries.

It is precisely the developed countries which have been responsible for accusations that some developing countries are guilty of possible social dumping, because of the differences in working conditions and legislation.

Although there do not seem to be any solid arguments behind these allegations, the developing countries must realize that the linking of economic integration matters with their labour effects has become a part of the international agenda, and it would be preferable to address this question in order to avoid it being used as an instrument of protection, rather than refusing to consider it at all.

With regard to specific gender issues, it must be acknowledged that there is very little information for evaluating the differential effect of economic integra-

tion. At the same time, in order to secure a positive impact on the situation and rights of women workers, the discussion must be taken away from matters involving specific demands, and it is also necessary to get away from the habit of viewing women merely as a vulnerable group requiring special protection. In this respect, it is important to emphasize the principle of equality of opportunities in the international debate, because this will make it possible to gradually eliminate the mechanisms that reproduce discrimination. Likewise, it seems necessary that each country's legislation, rather than emphasizing and expanding the labour rights of working mothers, should try to secure more general acceptance of the concept of parental rights.

Finally, a great deal of attention has been given to the question of integration seen as a threat (from the point of view of social dumping), but in fact integration also presents challenges and opportunities for the world of female labour, including not only the challenge of breaking the occupational/sectoral segregation of female employment in a situation of reallocation of employment, but also the demonstration effect deriving from integration with countries which display greater relative progress in gender matters and the effect that can be exerted by the mere fact that the agreements may include general principles relating to non-discrimination and equality of opportunities.

(Original: Spanish)

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Macroeconomic trends in *Paraguay from 1989 to 1997:* consumption bubble *and financial crisis*

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This article looks at macroeconomic trends in Paraguay since 1989: a critical date, because it marks the return to democracy and a move towards liberalization of the economy. The stabilization process embarked upon at that time resulted in favourable evolution of the monetary variables, but not of investment or of growth of the product. The combination of heavy inflows of capital and an excessive increase in aggregate demand gave rise to a growing external imbalance reflected in a domestic consumption bubble. Trade transactions which are not officially registered – a special feature of the Paraguayan economy – have affected the evolution of the macroeconomic situation and appear to have contributed to the worsening of the trends in question, since there was also a deficit on this type of trade up to 1994. In the financial sector, the liberalization process was not accompanied by the strengthening of banking supervision. In this permissive context, the financial sector has contributed to the consumption bubble of the 1990s, through the proliferation of high-risk activities, loans to enterprises linked with the lenders themselves, and the rapid growth of an informal or “black” financial sector. The resulting increasingly fragile situation of many financial establishments explains why a combination of domestic and external upsets led in 1995 to a financial crisis which had recessionary effects on the whole economy. Failure to take care of elements of such fundamental importance as the monitoring of excess spending and the modernization of banking supervision, and the mistaken option for a model based on imports and informal trade, facilitated the procurement of quasi-privilege rents by certain interest groups and the formation of consumption bubbles which contributed to the crisis. What is needed, then, is a sustainable macroeconomic policy aimed at promoting growth on the basis of a process of genuine innovation.

I

Introduction

The economic evolution of Paraguay since the return to democracy in 1989 has displayed favourable features. Throughout the 1990s, the country maintained a satisfactory fiscal balance; inflation was gradually brought down, reaching a single digit in 1996; the level of the international reserves rose; and the external public debt went down until in 1996 it only represented around 14% of GDP: the lowest relative level in Latin America. On the other hand, however, the product grew only slightly and per capita GDP did not increase at all.

At the same time, various problems were arising, as in other countries of the region. At the macroeconomic level, the lower inflation was achieved through a policy of control of the money supply and an exchange rate anchor, accompanied by a fiscal austerity strategy, but not enough attention was paid to such fundamental aspects as aggregate demand, which registered high growth rates during the period. This situation gave rise to growing external imbalances, with an average annual growth rate of imports which was much higher than that of exports. Moreover, the imports were increasingly made up of consumer goods.

As a corollary to this, there was a growing inflow of volatile capital in the first part of the decade. In these circumstances, in which domestic demand was rising but domestic saving was falling and being progressively replaced by external saving, gross fixed capital formation stagnated and it became impossible to keep up the level of absorption reached.

Section II of this article analyses this evolution and the behaviour of the main macroeconomic variables and shows how the elements in question helped to form a consumption bubble which made future contraction inevitable, as occurred in 1995.

Section III looks at the theory according to which the excess of imported goods and the apparent difference between domestic expenditure and GDP is really the result of Paraguay's traditional re-export trade, in which the goods imported for subsequent sale abroad are registered but not the actual re-exports. It is shown that the various available estimates largely disprove this explanation and that there may even have been a deficit on this unregistered trade too,

because part of the unregistered imports remained in the country instead of being re-exported, thus feeding the domestic consumption bubble.

Section IV examines the state of the financial system after the liberalization begun in the early 1990s. This liberalization was carried out in a context of feeble prudential regulation rules and ineffective supervision of their application, with a Central Bank which had little *de facto* autonomy. In this context, fraudulent practices and administrative mismanagement abounded because of the lack of supervision by the responsible authorities. At the same time, the dichotomous situation of the financial system, in which sound and efficient establishments operated side-by-side with others whose practices were not in keeping with the rules of good management, was reflected in the persistence of high interest rates throughout the period and the rationing of credit to the detriment of part of the production sector, namely, small and medium-sized enterprises which were not linked with some banking group.

The consumption bubble was reflected in the financial sphere in a credit boom (without pretending to identify the direction of the causality between the two phenomena) which extended to the whole financial system, although most markedly to the domestically owned banking sector. The situation was made worse by big capital inflows attracted by the high prevailing interest rates. Because of the weakness of supervision, these flows fed the boom in loans for consumption, speculative and short-term financial activities, operations in the informal sector, and real-estate speculation, etc., which led to an excessive concentration of economic activity in high-risk sectors generating little value added. This accumulation of high-risk portfolios, facilitated by the implicit State guarantee on deposits and the scale attained by malpractices, seems to have been responsible for many of the banking failures which took place from 1995 onwards.

To the extent that the net worth of firms was weakened by numerous risky unregistered operations—generally carried out at very high interest rates—, by loans made to their own associates, etc., they were

the first to be affected by a series of events in 1995 which included the decline in international soybean prices, the partial reversal of capital flows, and a domestic financial scandal. The financial crisis which began in 1995 is seen as a process of correction in which an external shock subjected the banking system to excessive tensions and led to the breakage of its weakest links: in this case, the high-risk and/or illegal activities. Through its impact on the informal credit system, this financial crisis had repercussions on the whole economy and gave rise to a major recessive adjustment.

In the light of the foregoing, by way of conclusion, the concluding section sets forth some guide-

lines for a sustainable macroeconomic policy programme for Paraguay aimed not only at stabilization but also at growth. Finally, it is noted as a basis for future analysis that the bubble phenomenon observed may be ascribed to the exploitation of what Nochteff (1996) calls "quasi privilege rents": a system in which dominant interest groups take advantage of their influence on institutions to perpetuate those rents at different levels (importation and re-export of smuggled goods, financial and real-estate speculation). In many cases this phenomenon impeded the pursuit of quasi-technological rents which would have propelled development based on innovation and the generation of genuine competitive advantages.

II

The macroeconomic scene in the 1990s

The evolution of the macroeconomic indicators in Paraguay between 1989 and 1997 shows the results of the stabilization policy undertaken in the new context of liberalization and sound management which accompanied the return to democracy. In particular, during this period fiscal management was satisfactory (the central government deficit never exceeded 0.8% of GDP, while the non-financial public sector maintained a surplus throughout the period) and inflation was brought down steadily from the peak level reached in 1990 (table 1).

Various sectors of the economy were liberalized. The exchange rate, which had previously had multiple rates and was subject to political manipulation, was replaced by a single floating exchange rate. Interest rates were freed and foreign currency operations were authorized. Monetary policy management was placed on a sounder basis, and after 1990 the automatic rediscounting granted to certain sectors¹ (especially cotton) and the possibility of monetary financing of the public sector were eliminated. During the period, there was an increase in the international reserves, which amounted to US\$ 1062 million

at the end of 1996 (equivalent to 2.4 months of imports of goods and services) and the weight of the external public debt was reduced, so that in 1997 it came to only 14% of GDP: a very low figure by the standards of the region (table 1). In spite of these favourable indicators, however, the real growth of the economy was insufficient: it averaged 3.1%, which was barely higher than population growth (estimated at between 2.7% and 3%), so that per capita GDP remained unchanged.

The monetary policy applied as from 1991 could be described as a "dual anchor" policy based on both the money supply and the exchange rate. The Central Bank's scheme aimed –without very much success– at maintaining moderate growth of the monetary aggregates (table 2), together with an exchange rate managed through a dirty float. This policy ended up by placing greater emphasis on the second element, since it was hard for the monetary authorities to control the money supply in a partially dollarized economy with enormous unregistered financial operations, and without any real possibilities of controlling foreign exchange movements inside and outside the country. Consequently, the partial anchoring of the exchange rate resulted in a substantial difference between the variations in prices of tradeable and non-tradeable goods and in considerable appreciation of the currency (table 3).

¹ The rediscounting was not completely eliminated, however, since as explained in section IV, up to 1994 there was a system of indirect rediscounting through the reduction of the compulsory reserve requirements connected with the financing of cotton.

TABLE 1

Paraguay: General Indicators, 1989-1996
(Millions of dollars at current prices, unless otherwise indicated)

	1989	1990	1991	1992	1993	1994	1995	1996	1997
GDP	4 115	5 285	6 254	6 447	6 841	7 857	8 970	9 686	10 029
GDP (millions of 1982 dollars)	6 614	6 818	6 987	7 113	7 407	7 636	7 996	8 097	8 311
Per capita GDP (1982 dollars)	1 618	1 616	1 612	1 597	1 619	1 625	1 656	1 634	1 634
GDP growth (%)	5.8	3.1	2.5	1.8	4.1	3.1	4.7	1.3	2.6
Central government fiscal surplus (+) or deficit (-)	100	158	-19	-18	-48	75	-25	-76	-0.8
As a percentage of GDP	2.4	3.0	-0.3	-0.3	0.7	1.0	-0.3	-0.8	-0.8
Non-financial public sector fiscal surplus (+) or deficit (-)	79	276	98	60	83	191	228	167	...
As a percentage of GDP	1.9	5.2	1.6	0.9	1.2	2.4	2.5	1.7	...
Monetary reserves	427	675	975	611	698	1 044	1 107	1 062	800
External debt	2 076	1 670	1 637	1 249	1 217	1 240	1 328	1 336	1 413
Debt/exports of goods and services (%)	148	89	81	66	44	36	30	32	37
Inflation (%)	28.5	44.1	11.8	17.8	20.4	18.3	10.5	8.2	6.2

Source: Prepared by the author on the basis of official figures of the Central Bank and the Ministry of Finance of Paraguay.

TABLE 2

Paraguay: Evolution of monetary aggregates and inflation, 1989-1996
(December-December variation, %)

	1989	1990	1991	1992	1993	1994	1995	1996
Monetary base	27.2	21.4	25.7	31.2	16.8	27.4	23.0	3.2
M1	46.1	27.6	27.4	28.5	19.3	32.8	20.3	2.0
M2	41.5	28.1	35.4	28.4	15.3	38.5	34.8	13.3
M3	75.6	36.0	41.1	39.8	28.7	28.7	22.9	21.9
Inflation	28.5	44.1	11.8	17.8	20.4	18.3	10.5	8.2

Source: Prepared by the author on the basis of figures from the Central Bank of Paraguay.

TABLE 3

Paraguay: Evolution of relative prices, 1990-1996
(Tradeable/non-tradeable goods; 1990=100)

1990	100
1991	95.2
1992	93.8
1993	91.1
1994	88.6
1995	87.4
1996	80.0

Source: Prepared by the author on the basis of data from the Central Bank of Paraguay.

Fiscal policy was used mainly as a support for the monetary strategy, with compulsory surpluses frozen in the Central Bank, thus explaining the good budgetary results. However, this was achieved at the cost of systematic cuts in infrastructural investments, which became the adjustment variable of fiscal expenditure. As the country had not adopted a decisive policy of privatization of public works or their trans-

fer to the private sector, the lag in terms of infrastructure became still greater, which probably helps to explain the slow growth observed so far in the 1990s.² At the same time, the process of renewed access to external financing observed throughout the region extended to Paraguay too (Ffrench-Davis, 1996; Aninat and Larraín, 1996) and from 1990 onwards there were substantial inflows of capital, mostly short-term (table 4, line 9). There was a simultaneous marked reduction in domestic saving (especially by households), with heavy growth of consumption expenditure, marked by a high imported component.

Part of this inflow of capital helped to increase the reserves. The rate of investment stagnated around its initial level of 23% of GDP throughout the period, and moreover its composition—in which there was an excessive preponderance of construction activities—

² For an analysis of the infrastructural situation in the continent, see World Bank, 1996.

TABLE 4

Paraguay: Macroeconomic Indicators, 1989-1996

	A. In millions of 1982 Guaraníes							
	1989	1990	1991	1992	1993	1994	1995	1996
1. Gross domestic product	899 500	927 317	950 208	967 312	1 007 377	1 038 547	1 087 409	1 101 158
2. Gross national income	865 321	899 381	913 048	925 581	967 657	1 001 577	1 044 539	1 066 832
3. Consumption (4+5)	669 245	753 036	780 600	836 997	881 575	999 299	1 034 007	1 059 270
4. Public consumption	64 639	66 707	80 047	86 288	90 847	94 382	105 772	116 349
5. Private consumption	604 606	686 329	700 553	750 709	790 728	904 917	928 235	942 921
6. Investment	200 747	219 175	238 030	222 482	227 557	237 699	254 588	254 311
7. Excess of expenditure over GDP (3+6-1)	-29 508	44 894	68 422	92 167	101 755	198 451	201 186	212 423
8. Excess of expenditure over GNI (3+6-2)=11	4 671	72 830	105 582	133 898	141 475	235 421	244 056	246 749
9. Net inflow of capital	36 437	111 342	151 037	81 823	154 169	278 748	238 549	241 671
10. Variation in reserves	31 766	38 512	45 455	-52 075	12 694	43 327	5 782	-5 078
11. External saving (9-10)=8	4 671	72 830	105 582	133 898	141 475	235 421	244 056	246 749

	B. As a percentage of GDP							
	1989	1990	1991	1992	1993	1994	1995	1996
1. Gross domestic product	158	100	100	100	100	100	100	100
2. Gross national income	96.2	97.0	96.1	95.7	96.1	96.4	96.1	96.9
3. Consumption (4+5)	74.4	81.2	82.2	86.5	87.5	96.2	95.1	96.2
4. Public consumption	7.2	7.2	8.4	8.9	9.0	9.1	9.7	10.6
5. Private consumption	67.2	74.0	73.7	77.6	78.5	87.1	85.4	85.6
6. Investment	22.3	23.6	25.1	23.0	22.6	22.9	23.4	23.1
7. Excess of expenditure over GDP (3+6-1)	-3.3	4.8	7.2	9.5	10.1	19.1	18.5	19.3
8. Excess of expenditure over GNI (3+6-2)=11	0.5	7.9	11.1	13.8	14.0	22.7	22.4	22.4
9. Net inflow of capital	4.1	12.0	15.9	8.5	15.3	26.8	21.9	21.9
10. Variation in reserves	3.5	4.2	4.8	-5.4	1.3	4.2	0.5	-0.5
11. External saving (9-10)=8	0.5	7.9	11.1	13.8	14.0	22.7	22.4	22.4

Source: Prepared by the author from national accounts and balance of payments figures.

meant that the efficiency of gross fixed capital formation was low, as shown by the high incremental capital/product ratio of 9.5 for the period 1990-1996 (or 6.9 if the two years of lowest growth are excluded) (Moon, 1997), which is almost the same as that of developed countries.³ It may be noted that the big institutional investors (the Social Security Institute and the other pension funds) have traditionally placed most of their funds in real-estate enterprises, thus helping to limit the resources available for productive investments.

It is highly probable that the stabilization policy and the bias against the local production of tradeable

goods resulting from the tendency to over-valuation of the exchange rate not only hindered fixed capital formation but also led to serious under-utilization of the existing production capacity, partly explaining the mediocre growth rates of the secondary sector during the period.

Another characteristic feature of the stabilization process was the failure to monitor the evolution of aggregate demand and, hence, of the expenditure-product gap in recent years. This latter indicator displayed big fluctuations in relation to GDP and also in relation to gross national income, which is a variable representing the total amount of money available to the agents in a country for spending in a given period.

The rapid increase in the expenditure-product gap in the 1990s indicates that insufficient attention was paid to the evolution of domestic expenditure and its compatibility with the economic policy of the country. Thus, between 1990 and 1995 domestic con-

³ A high incremental capital/product ratio means that greater gross capital formation is needed in order to raise GDP growth by a given amount. The value observed in the case of Paraguay is higher than that of other countries with a similar level of income.

TABLE 5

Paraguay: Composition of Imports, by type of goods, 1990-1996
(As percentages of the total)

	1990	1991	1992	1993	1994	1995	1996
Consumer goods	26.4	32.1	42.5	42.5	43.4	46.8	44.6
Non-durable	20.6	25.1	29.2	29.5	30.9	34.3	36.4
Durable	5.8	7.0	13.3	13.0	12.5	12.5	8.3
Intermediate goods	26.0	24.8	24.9	23.0	21.3	18.1	23.0
Capital goods	47.6	43.1	32.6	34.5	35.3	35.0	32.3

Source: Prepared by the author on the basis of figures from the Central Bank of Paraguay.

sumption increased by 37.3% (a figure resulting from weighting the growth in private consumption (35.2%) and public consumption (58.6%)), whereas the GDP grew by only 17.3%.⁴

As a consequence of exchange rate appreciation and the big increase in demand, there was a growing deficit on registered trade. Over the period 1989-1995, imports grew by an average of 23% per year, whereas exports registered a trend decline of 2%. This phenomenon is similar to that observed in Latin America in general, since much of the recovery in demand in the region in the 1990s was satisfied with bigger imports. Indeed, the countries which did not make the timely corrections needed, such as Argentina and Mexico, subsequently suffered traumatic recessive adjustments (Ffrench-Davis, 1996).

III

The external deficit and unregistered trade: an appraisal

Paraguay's external trade has been marked in recent decades by the substantial share of unregistered trade. The appearance of this type of trade is explained not only by the country's special landlocked geographical situation but also by other factors: for example, its close relations with Brazil, high tariff levels which are not accompanied by an import substitution policy, multiple exchange rates, and political

Even more interesting is what happened with regard to the composition of imports. This composition changed substantially as from 1990, with the share of imports of capital goods going down from 47.6% in that year to 32.3% in 1996, while the share of imports of consumer goods rose from 26.4% to 44.6% over the same period (table 5).

The special features of Paraguay's external trade, however, which included a growing proportion of unregistered trade in the 1990s, caused many observers to underestimate the effects of this situation on the macroeconomic performance of the country. There was a general belief that the excessive expenditure observed or, what amounts to the same thing, the trade and current account deficits,⁵ were only apparent and were actually offset by a surplus on unregistered trade.

authorities which, under the dictatorship, were very indulgent to certain interest groups (Masi, 1995). Unregistered trade, which consisted mainly of imports smuggled in from Brazil in the 1970s and 1980s, expanded towards the middle of the latter decade with the appearance of the so-called re-export trade based on the high protective tariffs applied in Brazil and Argentina to imports of finished goods such as

⁴ In this case, we have taken the sub-period 1989-1995, because the financial crisis which took place in May 1995 changed consumption and investment tendencies and led to a drop in overall growth in 1996.

⁵ The accounting identities in the national accounts show that the trade deficit is equal to the excess of expenditure with respect to GDP, whereas the current account deficit corresponds to the excess of expenditure with respect to gross national income.

TABLE 6

Paraguay: Registered and unregistered trade

	A. In millions of current dollars								
	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Registered exports	1 009.4	958.7	737.1	656.6	725.2	816.8	919.3	1 043.4	1 088.6
2. Registered imports	660.8	1 193.4	1 275.4	1 237.1	1 477.5	2 140.4	2 782.2	2 850.5	2 957.1
3. Unregistered exports	170.6	407.5	372.4	397.6	1 103.4	1 464.9	2 111.1	1 723.3	1 554.8
4. Unregistered imports	355.1	442.4	592.2	688.2	1 240.3	1 411.3	1 689.0	1 345.1	1 080.0
5. Deficit on unregistered trade (3-4)	-184.5	-349.9	-219.8	-290.6	-136.9	53.6	422.1	378.2	474.8

	B. As a percentage of GDP								
	1989	1990	1991	1992	1993	1994	1995	1996	1997
1. Registered exports	24.5	18.1	11.8	10.2	10.6	10.4	10.2	10.8	10.9
2. Registered imports	16.1	22.6	20.4	19.2	21.6	27.2	31.0	29.4	29.5
3. Unregistered exports	4.1	7.7	6.0	6.2	15.5	17.8	23.3	17.8	15.5
4. Unregistered imports	8.6	8.4	9.5	10.7	18.0	17.9	19.2	13.9	10.8
5. Deficit on unregistered trade (3-4)	-4.5	-0.7	-3.5	-4.5	-2.5	-	4.2	3.9	4.7

Source: Central Bank of Paraguay, on the basis of IMF, "Directions of Trade".

liquors, cigarettes, electronic items, perfumes, sports footwear, etc. This led to a new triangular trade flow of products from the Asian countries and, to a lesser extent, from the United States, which are re-exported to neighbouring countries. Likewise, because of the high taxes imposed within Brazil, goods such as cigarettes or clothing are brought into Paraguay from Brazil for subsequent re-export by *sacoleiros* to that same country.⁶

In 1989, the informal "re-export" model was given official recognition by establishing tariff reductions for the so-called "tourist goods", and in 1991, as part of the tax reform, such goods were granted preferential VAT treatment (VAT of 2% instead of the uniform regular 10% rate). Finally, in 1995 a large number of these "tourist goods" were included in the lists of goods excepted from the MERCOSUR common tariff, which, in the case of Paraguay, consist of 399 products on which the tariffs are to converge towards the 10% common external tariff within a period of 5 to 10 years.

With regard to the macroeconomic impact of this situation, an estimate of the trade flows represented by unregistered trade may be attempted by taking the

estimated figures prepared by the Central Bank of Paraguay on the basis of figures from the International Monetary Fund's "Directions of Trade" statistics (table 6). When the unregistered trade balance is isolated in the official source it may be seen that, contrary to what is usually believed, this item registered deficits between 1989 and 1993 and only registered a clear surplus from 1995 on.

This is a controversial conclusion, since the prevailing belief is that unregistered trade has traditionally shown a surplus. In addition to the estimates in question, however, there are two other facts which support the idea that unregistered trade showed a deficit up to 1994 which was only reversed as from 1995. Firstly, 1995 marked the beginning of the recessive cycle in Paraguay (i.e., the moment when domestic demand went down and, with it, the demand for imports) and of the application of the Plano Real in Brazil, which gave rise to a consumption boom (including consumption of imported goods) through the stabilization of prices and appreciation of the local currency. Secondly, it is a well-known fact that much of the unregistered imports from Brazil consist of "smuggled" foodstuffs, toilet articles, construction inputs, etc. for domestic consumption, and that this trade prospered mainly up to 1994 because of the favourable exchange-rate conditions but went down appreciably after the adjustment of the Brazilian currency under the Plano Real (see annex).

⁶ The name *sacoleiros* is applied to the persons who cross the Puente de la Amistad between Ciudad del Este (Paraguay) and Foz de Iguacu (Brazil) carrying goods in big bags. The incessant to and fro movement of the *sacoleiros* accounts for a large part of the "re-exports" to Brazil.

If it is true that part of the unregistered imports were consumed within Paraguay instead of being re-exported, this would be in keeping with the theory of a consumption boom arising from the analysis of other macroeconomic data. Thus, if unregistered trade showed a deficit throughout the first part of the 1990s, then the economic authorities' decision to endorse the import model (with its additional re-export component), especially through tariff and fiscal advantages but also through over-valuation of the national currency, helped to aggravate the macroeconomic imbalances generated by the growth in consumption and excessive domestic absorption. Furthermore, the over-emphasis on exploiting the competitive disadvantages of neighbouring countries (protectionism, high domestic taxes) by particular interest groups took place at the expense of the exploitation of Paraguay's own comparative advantages, thereby contributing to the sluggish performance of local production units.

The exhaustion of the import-based model as from 1995 with the entry into force of MERCOSUR and the process of tariff convergence, as well as the

progressive blockage of cross-border trade by the Brazilian and Argentine authorities, has faced the country with the challenge of radically changing its economic policy lines towards a scheme compatible with the promotion of an export-oriented strategy.⁷ This process must be actively promoted by the main economic agents, because it will not be automatic. It seems inevitable that the tariff convergence process begun in 1995 will lead to the disappearance of unregistered re-export trade, by reducing the differences in the tariffs levied on finished goods in the various MERCOSUR countries. Nevertheless, Herken Krauer (1995) argues that in view of the relatively erratic characteristics of the integration process (such as the continued existence of non-tariff barriers and special modifications in the common external tariff) the factors responsible for such trade will continue to be the real exchange rate, non-tariff barriers and the financial and monetary instability of the member countries, so that Paraguay's re-export trade is likely to continue to have a firm basis, even though its profit margins may go down.

IV

Macroeconomic evolution and the financial system

Between 1988 and 1992, a financial reform programme was carried out in Paraguay which was aimed at liberalizing the system but which involved only some of the measures applied in other reform processes in Latin America (table 7).

Two aspects are particularly noteworthy in this respect. Firstly, out of the eight measures listed in table 7, the only ones applied were the liberalization of interest rates and the reduction of compulsory reserve requirements. Secondly, the sequencing of the measures was clearly unsuitable:⁸ whereas these fi-

ancial variables were liberalized (together with the exchange rate and the possibility of effecting operations in foreign currency), no progress was made in the correction and supervision of a financial system hitherto marked by serious structural distortions, including the custom of operating without the slightest risk, thanks to the automatic rediscounts granted by the Central Bank, and the formation of big cross-linked portfolios in the main financial-industrial-commercial groups (Duarte-Giménez, 1997). This context of rapid liberalization without the concomitant strengthening of prudential supervision sowed the seeds of the future financial crisis of 1995.⁹

The weak supervision exerted by the Office of the Superintendent of Banks in the period in question

⁷ The integration commitments undertaken by the country obviously include the obligation to apply policies aimed at checking illicit activities, since continuing to favour a model based on informal trade would give rise to the opposition of Paraguay's partners in MERCOSUR and make it impossible to develop such an export-oriented model.

⁸ For an analysis of financial reform processes in Latin America since 1988 and an assessment of the proper sequence of such reforms, see IDB, 1996.

⁹ The second financial crisis, in 1997, is viewed here as a continuation of that which occurred in 1995, because timely corrective measures were not taken.

TABLE 7

Paraguay: Financial reform measures, 1988-1995

Liberalization of interest rates		Changes in compulsory reserve requirements ^a		Percentage of managed credit	Privatization of loan market (State banks)
Deposits	Loans	Local currency	Foreign currency		
Yes	Yes	Reduced	Unchanged	Maintained in part	No
Greater independence of Central Bank		Improved regulation of capital market		Improved regulation of banks	Improved supervision of banks
No ^b		Yes ^c		No ^d	No ^e

^a Compulsory reserve requirement in national currency was gradually reduced from 42% in 1989 to 25% in 1994 (18% for banks which undertook to use the differential to provide credits for the cotton sector). This level was maintained until 1996.

^b The Central Bank does not currently have legal or technical independence.

^c It should be noted that although legislation does exist and some 60 firms are currently quoted on the stock market, the activities of this market essentially involve money market instruments.

^d The new banking law was only adopted in 1996, after the 1995 financial crisis.

^e According to the assessment made by the IDB (IDB, 1996), banking supervision requires a major overhaul. This assessment still holds good today.

permitted a big rise in the level of risk of the portfolios of most banking institutions, as reflected in the rapid growth in the number of entities and in the total amount of private sector credit. Between 1989 and 1994, 13 new banks and 38 finance companies were opened, attracted by the high profits promised by free interest rates.¹⁰ In the first years of this period, there was an excessive concentration of risks in the soybean and cotton export sector, which led to a serious deterioration in loan portfolios when there were three consecutive years of poor harvests and depressed international prices, further complicated by the growing over-valuation of the local currency with respect to the dollar. The necessary reorientation of credit activities towards other sectors was retarded by a perverse practice of the Central Bank, which, although it had officially done away with *ad hoc* rediscounts, introduced a system of reduced compulsory reserve requirements on cotton sector financing, thus perpetuating the former system.

¹⁰ The excessive growth of the financial system is even more evident when it is considered that in 1994 there was one financial institution (bank or finance company) for every 47,000 inhabitants. At that time (i.e., before the financial crisis) there were 34 banks and 65 finance companies, as well as various savings and loan cooperatives, savings and loan companies for housing loans, etc.

The banks which did reorient their loan portfolios did so by concentrating on activities that were at once more lucrative and more risky: consumer credit and credit cards, thus contributing to the consumption bubble of the 1990s. The "black" financial system also grew apace, thanks to the scant control exerted by the banking supervisory body and the tax authorities. An increasingly large proportion of the deposits received went to high-yield illicit activities such as smuggling, or to loans made at usurious interest rates to firms operating in illicit ("black") activities. As a result, there were big rises in interest rates on both deposits and loans because of the need to procure more and more deposits to finance those high-risk activities. The implicit State guarantee on deposits further encouraged this.

This behaviour was observed in the case of the majority of domestically-owned banks and finance companies. Their bad management practices (including both mere inefficiency and operations outside the law) led them to seek clients – of an increasingly risky nature – at higher and higher interest rates, thus reducing the quality of their loan portfolios. Furthermore, part of the resources was lent to persons or firms directly linked with the owners of the banks concerned, without applying proper project evaluation criteria, so that many of these financial institutions ran up heavy losses.

The banking system was marked, however, by a clear situation of duality, since on the other hand there were institutions –mostly branches of foreign-owned banks –which were able to adapt to the circumstances thanks to better management and in any case had traditionally restricted their supply of credit to top-level clients (big firms, external trade operations with their home countries). This fact, together with the concentration of the local banks on speculative activities or consumer loans, meant that a large segment of the productive sector –small and medium-sized enterprises, and especially those which were not linked with some financial group– had little access to bank credit during this period.

Economic theory on the functioning of financial markets analyses the reasons why the money market is a complex market in which prices (interest rates) do not always adjust to balance supply and demand and in which balances may be produced through rationing (Stiglitz and Weiss, 1981). They are subject to effects of “adverse selection” and “incitements” which mean that interest rates channel information relating not only to levels of supply and demand but also to the quality of clients. The result is that yields grow in line with interest rates (although more slowly) up to a certain level, after which the expected yield decreases. In keeping with this phenomenon of the “adverse selection” effect –the fact that the clients willing to pay higher rates are also those with the highest risks– rational financial institutions limit their supply of credit even though there is still unsatisfied demand.

Moreover, because of the situation of tacit oligopoly existing in the Paraguayan financial market, the foreign-owned banks did not appreciably reduce their rates but merely set them a little below those of the most inefficient or daring financial intermediaries, thereby obtaining high rates of return. Thus, average annual interest rates remained very high during the period: negative rates on deposits, and rates on loans which fluctuated between 10% and 20%, with differences of between 15% and 20%.

Because of this dichotomy of the financial system and the specialization of banking institutions, credit to certain sectors was rationed, while there was a big increase in credit to other higher-yield activities such as commerce, finance and various kinds of in-

TABLE 8

Paraguay: Ratio of growth rate of credit to growth rate of GDP, 1989-1995

Locally-owned banks	10.4
Foreign-owned banks	4.6
Public-sector banks	4.7
Total banking system	6.2

Source: Prepared by the author on the basis of data from the Central Bank of Paraguay.

formal activities. Between 1989 and 1995 there was thus a rapid but not exaggerated increase in total credit, from 10.8% to 19.7% of GDP. The sustainability of this growth may be better appreciated when it is compared with the degree of penetration of financial activity. In real terms, the ratio of the growth rate of credit to the growth rate of GDP during the period was 6.2 (table 8): a somewhat higher ratio than those registered in other countries with a similar degree of penetration, such as Argentina and Colombia (*The Economist*, 1997, p. 19).

As already noted, however, the growth in credit was more pronounced in the case of the locally-owned private banks than in that of the foreign-owned banks and the public banking system, the respective average annual growth rates being 32.2%, 14.4% and 14.7% in real terms. Taking only the locally-owned private banks, the ratio was 10.4: comparable to that of Mexico in the same period, and much higher than the level considered to be sustainable.

At the same time, the very big inflows of capital registered in the period were only partially sterilized and fed the boom in short-term credit to high-yield activities, as well as providing a steady flow of resources to the real estate sector.¹¹ A number of poorly-timed economic policy decisions, especially the decision to free the funds belonging to public bodies which had previously been deposited in the Central Bank, without properly regulating the use to be made of them, helped to aggravate the situation still further, since these resources simply went to the activities offering the highest interest rates.

¹¹ For an analysis of the relation between capital flows and the financial sector, see Folkerts-Lindau and others, 1995.

V

Conclusion: Consumption bubble and financial crisis

In 1995, a combination of events subjected the financial bodies with the highest exposure to excessive tensions, including the unfavourable evolution of international soybean prices, which caused heavy losses in some firms over-involved in the financing of the harvest, and the decline in capital inflows after the Mexican crisis. Another event which helped to set off the crisis, at the domestic level, was the discovery of a serious case of embezzlement of funds from the vaults of the Central Bank through the diversion of funds corresponding to the compulsory reserves of the commercial banks, with the complicity of representatives of those private bodies.

Banks which had run up losses exceeding their net worth (in some cases by several times that figure) as a result of unregistered operations, speculative activities and loans to related enterprises found themselves in a state of illiquidity and had to face runs on their deposits. The fact that the situation reached this level was due largely to shortcomings in supervision, since the annual balances of some banks which then had to be officially intervened had not been approved for several years, without anyone doing anything about this.

Gavin and Hausmann (1995) see the financial crises of many Latin American countries as the result of a macroeconomic upset coinciding with conditions of weakness of the financial system, so that the "chain" (the system) breaks at its weakest "link" (the affected banks). In the case of Paraguay, the weakness in question was due mainly to high-risk or illicit ("black") activities and loans to enterprises linked with the banks themselves. In the light of what was set forth earlier in this article, however, the 1995 financial crisis may be said rather to be a symptom of the bursting of a consumption bubble largely connected with the growth of the informal sector and illicit financial activities and fed by big capital inflows.

The breakage of the chain of payments and credits which followed the financial problems of 1995 was due essentially to the sudden blockage of the use

of post-dated cheques as instruments of commercial transactions and informal credit. Post-dated cheques, which were illegal at the time, had become the main instrument of alternative credit, because of the means of enforcement imparted to them by the fact that the issue of cheques without funds was punishable by imprisonment. At the same time, the financial institutions had developed a black market for rediscounting these instruments through their associated finance companies. The collapse of several banks which were active in this business and public mistrust in the banking system were then reflected in the abrupt termination of these operations, which further aggravated the recessionary impact of the crisis.

With regard to the prevailing macroeconomic context, it would appear that bad policies, in the sense of permitting an exaggerated increase in spending on the one hand and neglecting proper supervision of the banks in a context of financial liberalization on the other, prepared the ground for the crisis. Finally, the ill-advised option for an import-based model and three-way trading, with a permissive attitude to unregistered trade, helped to worsen the imbalances in question, resulting in the need for a severe recessionary adjustment after the 1995 financial crisis. The economic policy flaws shown up by the behaviour of the variables between 1989 and 1995 points to the need for a sustainable and growth-oriented macroeconomic strategy (ECLAC, 1995).

As well as placing the financial system on a sound basis and strengthening banking supervision—prior requisites for any sustainable macroeconomic strategy—it is also necessary to watch domestic spending more closely and impose suitable regulation of capital flows. The economic statistics (specifically those on the external sector) also need to be improved: an unavoidable condition closely linked with the adoption of a different economic model.

With regard to the bubble phenomenon analysed here, a more detailed analysis of its organizational-institutional aspect is called for (see Nochteff, 1996), for in each of the markets in question this phenome-

non is linked to the exploitation of quasi privilege rents by groups enjoying various kinds of protection. Thus, the persistence of an import-based model with important smuggling and re-export components—in contradiction with the declared liberalization and export-oriented strategy—was due to the preservation of the benefits of some particular agents, at the expense of greater use of the country's own compara-

tive advantages (Herken Krauer, 1995). Likewise, for a number of years numerous inappropriate practices were tolerated in the financial sphere although their existence was well known, thus giving rise to fat profits for certain economic groups and the excessive growth of loan portfolios connected with unsustainable activities, all of which finally culminated in the 1995 financial crisis.

Annex

The problem of statistics in Paraguay, with special reference to the external sector

The unreliability of economic statistics in Paraguay is an obstacle to systematic analysis of the performance of the Paraguayan economy, since it makes it necessary—as in the present article—to use multiple sources, not all of them consistent with each other, and to fill some gaps with estimates.

Data are relatively abundant in the monetary sector. However, the high percentage of unregistered activities, which became evident after the 1995 financial crisis, leads one to believe that the monetary indicators only reflect a part of the real situation. It is known, for example, that many financial institutions were receiving three types of deposits: "white" (with an official receipt, and duly recorded in the accounts of the bank); "grey" (with an official receipt, but not recorded in the accounts), and "black" (without any official receipt or record in the accounts), which were likewise reflected in three types of accounts corresponding to each class of deposit (World Bank, 1996). It may be assumed that this situation has improved since 1995, due to the disappearance of various banks which were very active on the black market. The most reliable indicator is probably the consumer price index, whose base was renewed in 1995. The same cannot be said of the indicators on the monetary aggregates, because of the problems of registration in the financial system sources.

With regard to the real sector of the economy and the national accounts, there are systematic records, but they are very inaccurate because of approximations in their preparation. The unregistered activities of many economic agents, as described earlier in this article, partly explain their reluctance to provide data to the public authorities. Consequently, although the system of national accounts is governed

by the appropriate procedures—since 1997 the procedures used are those of the United Nations System of National Accounts, 1993, version 4—in many cases it lacks reliable inputs in the form of empirical data. It is estimated that the gross domestic product has traditionally been greatly underestimated by amounts varying—according to the sources used—from 30% to 60%.

The data which must be viewed with the greatest caution, however, are undoubtedly those of the external sector, because of the country's long tradition as a centre of unregistered trade in the Southern Cone of Latin America. The problems stem from both the non-registration and the under-registration of the true values of goods. The only sources available for trying to correct these shortcomings are the "Directions of Trade" estimates of the International Monetary Fund, published by the Central Bank of Paraguay (table 6). The methodology consists of cross-checking the official Paraguayan information (customs registers) with official data on exports to and imports from Paraguay by the country's main trading partners (Brazil, Argentina, the United States, Japan, Taiwan, etc.) in order to estimate possible omissions and under-estimates from the discrepancies observed. These data are used in the preparation of the national accounts. In the process, however, they undergo adjustments which mean, for example, that the external deficit (calculated with respect to both GDP and GNI) does not coincide with the corresponding balance of payments figures or those of the national accounts.

Table 4 presents a set of calculations by the author which seek to overcome these methodological difficulties. The lower part of the table has been adjusted by estimating the variation in the reserves in

constant-value guaranies on the basis of their value in current dollars (at the current exchange rate and the implicit price index of the GDP) and then deducing the total capital inflow from that value and from the external saving given by the national accounts (upper part of the table). This is necessarily an approximation, since it is not feasible to use the preferred method, which would be to compute the two parts of the table separately in order to check their degree of coincidence.

With regard to the magnitude of unregistered trade, the first conclusion to be drawn from these estimates is that unregistered trade in Paraguay amounts to almost unbelievable levels: in 1994, for example, the estimated unregistered exports and imports represented 179% and 66% of registered exports and imports.

At the same time, according to the same estimates, unregistered trade showed a deficit between 1989 and 1993, broke even in 1994, and turned in surpluses as from 1995 (table 6). This result, which is of crucial importance for macroeconomic analysis, may be explained intuitively by a number of factors. Firstly, thanks to the prevailing exchange rate conditions, the "smuggling" of Brazilian products for domestic consumption in Paraguay (foodstuffs, toilet articles, construction inputs, etc.) reached its peak in the period up to 1994 (when the over-valuation of the guaraní with respect to the Brazilian currency came to an end with the introduction of the Plano Real in the latter country), which is in keeping with the fact that part of the unregistered imports remained in the country and were not re-exported. Secondly, 1995

was marked by substantial changes in the Paraguayan and Brazilian economies. In Paraguay, a markedly recessionary cycle began which reduced the country's capacity to absorb imports, while in Brazil the introduction of the Plano Real gave rise to a consumption boom and appreciation of the national currency, and the trade balance, which had been showing a surplus for years, began to register deficits. Obviously, part of Brazil's additional imports came from Paraguay and were not always officially registered. At the same time, however, the exchange-rate-based stabilization plan was accompanied as from 1995 with the scheduled convergence of tariff levels with MERCOSUR, so that the average Brazilian tariffs underwent sharp reductions, probably leading to a considerable increase in imports from outside the area. These factors back up the theory that the macroeconomic conditions prevailing between 1989 and 1994 strengthened the consumption-oriented tendencies of the Paraguayan economy and that there was indeed a deficit which was only reversed after 1994.

In the light of this analysis, both the available estimates and the evolution of the macroeconomic variables suggest that up to 1994 unregistered trade helped to aggravate the excessive domestic absorption described in the present article, backing up the theory that there was a domestic consumption bubble. Finally, it may be noted that after 1995 the surplus on unregistered trade represented only a small fraction of the deficit on registered trade, so that a substantial excess of absorption still persisted.

(Original: Spanish)

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The strategies pursued *by Mexican firms* in their efforts to *become global players*

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Almost 60% of the biggest non-financial groups in Mexico carry on at least two types of activities in transnational markets. This article describes and analyses the various internationalization paths and strategies of Mexican firms. This drive for internationalization is taking place against the background of an open export-oriented economy and growing integration with the United States and Canada. There are various national and international factors, as well as others specific to the firms themselves, which influence the strategies chosen and their results. This article consists of an introduction (section I), followed by six sections analysing the various paths followed by Mexican firms in order to become "global players". Section II identifies the firms which have set up subsidiaries in developed countries. Section III reviews the firms which have resorted to strategic alliances that could convert them into transnational corporations, and some outstanding examples of this are cited. Section IV describes the presence of Mexican firms on the international securities markets and the interaction that this involves with world financial institutions. Section V looks at the strategies followed by some Mexican firms in order to establish global marketing networks. Section VI examines the rapid expansion of the solutions and strategies applied by firms to gain a world-level position, and finally section VII offers some conclusions evaluating the paths and preferences of Mexican firms seeking to become transnationals, the obstacles they have had to overcome, and the consequences of their international activities.

I

Introduction

This article focuses on the processes followed by Mexican corporations in order to become global players: that is to say, to attain a situation where their action is ruled, shaped and modified not only, or not fundamentally, by national processes and in which increasing influence over their organizational structure and corporate action is exerted by the greater interaction and feed-back with transnational institutions and agents operating through manufacturing, financial, trade and corporate networks that have attained a global outreach.

The purpose of this article is to see which Mexican corporations have become global enterprises and what strategies they pursued in order to do this; how Mexican entrepreneurs, by virtue of their transnational action and strategies, become global players and transform the structural constraints that limit the scope of their action and corporate organization; to what extent they overcome such constraints; and why they changed their strategies only late in the 1980s, when other newly industrialized countries (the Asian Tigers, for example) had already made great advances in this direction (Tseng, 1994). In other words, what forces set this process in motion?

The emphasis throughout the article will be on the level of the agent: an agent who is well informed of the significance of the present conjuncture and the opportunities and costs underlying the transition to global status. Other questions will also be addressed at this level: how Mexican entrepreneurs challenge and react to the ways, conditions and rules under which they interact with the global system, and how they articulate and activate a strategic, conscious drive to become global, to interact and compete with global forces, and to plan their action and, increasingly, their very organizational structure.

In view of this emphasis on the level of the agent, the definition of transnational corporations (TNCs) used in this article necessarily underscores the strategic and operational logic underlying global action. Thus, for the purposes of the present analysis a global (transnational) enterprise is defined as a highly complex business organization that has expanded its operations to several countries by at least two of the following means:

i) Operation of subsidiaries: usually acquired in order to gain a global position in certain products, outrank competitors and simultaneously defend the firm's own domestic market from massive and/or dumped imports. This new emphasis on positioning and/or benchmarking will be the main consideration when planning growth. Accordingly, Mexican corporations that reach global status must gauge and improve their competitiveness not in relation to national standards but in relation to their closest global competitors.

ii) Strategic alliances: multiple and diversified combinations with TNCs from advanced or developing countries, entailing segmentation, specialization, sectoral and/or geographic redistribution of markets; combination of distribution networks, technological management and marketing expertise; and exchange of top executives and directors. The nature of the link-up transcends that of the more generalized joint ventures or technology or marketing licensing of the 1960s and 1970s.

iii) Sale of stock and other securities on foreign markets. This requires, on the one hand, sophisticated systems of information and communication with institutional investors, investment bankers, brokers and different specialized agents, and on the other hand, a more open attitude towards the public in general and stakeholders in particular (creditors, management, clients, consumers, employees and stockholders).

iv) Networking: distribution and marketing networks strategically developed by the corporation to promote and commercialize its own or other Mexican exports, particularly in the United States or other industrialized countries. In this way, the corporations no longer rely on agents or brokers to export their products and they considerably diversify their sources of revenue.

Many large and medium-sized Mexican companies are exploring new avenues for opening new markets, and it is difficult at this point to assess whether they will be successful or not. Using the criterion of a more diversified presence in foreign markets (in at least two types of activities), I have attempted to determine that they have a firm footing in the global

economy and are more deeply involved in the global rules of the game.

All these activities presuppose intense interaction and collective planning with global agents from advanced capitalist countries. Information exchange and communication with customers, suppliers, investors, creditors, partners and allies make collective planning and decision-making increasingly complex, but necessary. This interaction, in turn, influences the enterprises' course of action and promotes strategies and patterns of behaviour like those widely used in the advanced countries. However, it also provokes, as we shall see, difficulties and contradictions that demand sophisticated responses, short-and long-term planning, and meticulous monitoring of all the enterprises' activities in Mexico and abroad. In other

words, spontaneous reaction to market signals and to public policies gives way to an increasingly complex process of strategic planning and decision-making. Without this process it would not be possible to integrate national and transnational activities, nor to coordinate internalized and externalized¹ alliances and corporate networks. It would not even be possible to follow up all the enterprises' activities, much less to comply with the standards of their new global status. This process of strategic collective planning underlying their global action is in my view the main difference with respect to any previous participation by these firms in international markets and not, as Peres Núñez (1993, p. 56) claims, a shift from foreign trade and debt towards foreign direct investment.²

II

Establishment of affiliates

Ever since the 1970s, many Mexican corporations have extended their operations to other Third World markets, in predominantly defensive strategies designed to protect export markets, alleviate the contraction of demand in Mexico, diversify sources of foreign income, or at least reduce dependence on one country. In the 1990s, however, the new global players have penetrated industrialized markets and have rapidly achieved a very strong position and high ranking in their specific areas of operation. Table 1 shows that of the 60 largest non-financial groups,³ only 13 have operating affiliates (i.e., value-adding activities) in industrialized countries, though many more have prospects, or are looking for prospects, of growth through mergers and acquisitions.

It would be difficult to trace the evolution of every case. I have chosen to examine three key cases in more detail (Vitro, Cemex and Televisa) for several reasons: (1) they all explicitly revealed the drive

to become global and the courses of action followed in order to advance in that direction; (2) they have all pursued very aggressive strategies to expand their activities to other countries, gain a global position and integrate their operations in order to profit from firm-specific advantages and synergies; and (3) a very large proportion of their revenue and value-added originates abroad.⁴

Vitro started making forays into the United States market with the acquisition of Anchor Glass and Latchford Glass, so that in 1989 it became the second-largest producer of glass containers in the United States, with this market accounting for approximately 40% of Vitro's total sales in 1990, 59% in 1992 and 56% in 1993. The transaction exposed the group to new, sophisticated rules of the game. In Mexico's business environment acquisitions usually

¹ That is, links with firms which do or do not belong to the corporation.

² As we shall see, participation in international trade has dramatically changed the nature of Mexican corporations' involvement in the international markets. Although foreign investment was not altogether absent before, it was oriented either to other less developed countries or, as indirect or real-estate investments, to advanced capitalist countries.

³ In order to examine the main avenues of development of big business and the strategies employed in order to become global, I constructed a list of the 60 largest non-financial groups and a list of the 15 largest financial groups according to sales and assets (the main criteria used to rank non-financial and financial groups, respectively). The list was prepared on the basis of sales revenue and assets in 1994 as reported by *Expansión 500*, the Mexican Stock Exchange and the firms' annual reports.

⁴ Unless otherwise specified, the information comes from interviews (see the list of interviews at the end of this article), Annual Reports and Offering Circulars.

take place through friendly deals. This was the first time a Mexican corporation had attempted a hostile takeover of a United States concern and, according to Wall Street analysts the price paid was "overly generous", particularly considering that Anchor had reported losses the year before and that the glass industry was in crisis, facing strong competition from plastic containers.⁵ Throughout the negotiations Vitro's top executives exhibited the will to go global: "If we want to continue to be a glass company, as we have been for 80 years, we can no longer be satisfied with having a strong domestic base and some export activity", said Ernesto Martens, Chief Executive Officer, before the deal was over (*The New York Times*, 1989 and *Wall Street Journal*, 1989). By 1997, however, this venture had failed and Vitro had to sell its investments in Anchor Glass and retreat back to the Mexican market.

Cemex's expansion into the international market has also been achieved primarily through acquisitions. In 1995 sales generated outside Mexico (considering exports and international operating income) represented almost half of its total revenue. In 1989 the group bought several companies in Texas and California which gave it a tenth of the United States sunbelt market. In 1992 Cemex paid US\$ 1.85 billion for Spain's two largest cement firms—La Valenciana and Sansón—which represented 28% of the Spanish cement market.

The international stock market community—particularly those closely watching Latin American stock—considered these acquisitions a very risky move for several reasons: the company had little experience managing overseas operations; the acquisitions increased its long-term debt by US\$ 760 million, and they increased the company's immediate borrowing by US\$ 1.35 billion.

United States and European investors who had recently acquired Cemex stock resented what they considered an arbitrary, unilateral decision about which they had not been properly informed in previous prospectuses and presentations. Two days after the deal was announced the price of Cemex's shares dropped by 17%.⁶ The decision by security market

agents to dump Cemex's stock led the company's top management to organize several presentations in order to demonstrate that their strategy was sound and promising. The market community, however, remained sceptical for some time about the Cemex management's capability to operate in European markets (Interview 2).

Despite all the uneasiness and opposition from the market community, Cemex's top management pursued an aggressive strategy. From 1993 to 1996 the group expanded considerably to South and Central America, and by 1996 its sphere of influence included 20 countries (see table 1). Underneath this aggressive strategy was Cemex's decision to become global and to simultaneously defend its market inside and outside Mexico. "The global cement business is becoming increasingly concentrated and we need to stay with the leaders", said Lorenzo Zambrano, Chief Executive and controlling shareholder (*Financial Times*, 1992). The spectacular demand for Cemex bonds in May 1993⁷ demonstrated that the group's strategy was finally approved by the global financial community.

Televisa, the television and media company, also had to fight its way into the United States market. The first two forays—Spanish International Network (SIN) and The National—were not successful, and in 1986 the group was accused of illegal practices and had to undergo a complicated legal dispute. The Federal Communications Commission found that the firm was violating restrictions on foreign ownership⁸ and Emilio Azcárraga Milmo sold the stations to Hallmark Cards Inc., who agreed to continue with the same management structure. The group was forced to retreat, partially and temporarily at least, from the Spanish television network in the United States.

Soon after that, Televisa tried to penetrate the United States television market once again, but this time with a different ally. In association with Jerrold Perrenchio from California (who was to share 75% of the television stations and 50% of the network) and Gustavo Cisneros (President of Venevisión), who was to have a similar share to that of Televisa, approval was finally obtained from the Federal Communications Commission (FCC) (*Expansión*, 1992).

⁵ The original offer was for US\$ 251.4 million and the final cost was US\$ 390 million for the capital and US\$ 460 million for the debt (US\$ 900 million altogether, including Latchford Glass).

⁶ See *Euromoney* (1993) and *Financial Times* (1992).

⁷ See the section on global securities markets.

⁸ United States legislation prohibits more than 20% foreign ownership of television stations.

TABLE 1

Mexico: Foreign subsidiaries of Mexican companies

Group	Subsidiary	Country	Year	Procedure	
VITRO	Anchor (100%)	United States	1989	Hostile takeover	
	Latchford (100%)	United States	1989	Acquisition	
CARSO-Global	International Wireless	United States	1996	Merger and acquisition	
Telecom	Prodigy	Spain			
CEMEX (20 countries)	Sunbelt	United States	1989	Acquisition	
	Pacific Coast	United States	1989	Acquisition	
	La Valenciana	Spain	1992	Acquisition	
	Sansón	Spain	1992	Acquisition	
	Vencemos	Venezuela	1994	Acquisition	
	Bayano	Panama	1994	Acquisition	
	Diamante	Colombia	1996	Acquisition	
	Samper	Colombia	1996	Acquisition	
	VISA	Coca-Cola (51%)	Argentina	1994	Acquisition
	ICA	Rodio	Spain		
TELEVISA	Univisión	United States			
	Galavisión	United States			
	Televisión Española	Spain			
	Cfa Peruana	Peru			
	Telev. Argentina	Argentina			
	Telev. Bolivia	Bolivia			
	Telev. Chile	Chile			
	Venevisión	Venezuela			
BIMBO	Baird's, QFS(50%)	United States	1994	Acquisition	
	Alimentos Alesa				
	Bimbo	Chile			
	Bimbo	Costa Rica			
	Bimbo	Argentina			
	Bimbo	Honduras			
	Marinela	El Salvador			
		Venezuela			
	Central America				
GRUMA	Maseca	United States		New plant	
IMSA	Acumulad. Fulgor	Venezuela	1993	Acquisition	
	Acumulad. Indust.	Venezuela	1993	Acquisition	
	Durex Indust.	Brazil	1994	New plant	
	Stabilit	Argentina			
	IMSA	Chile			
	Enermex	Brazil			
DINA					
SYNKRO	Kayser-Roth	United States	1993	Leveraged buy-out	
	Modecraft	Argentina	1993	Acquisition	
Iusacell					
Herdez	Festin Food	United States	1990	Acquisition	

Sources: *América Economía* (1993-1994), Infotel, Reuters and Annual Meeting Reports of companies quoted on the Mexican Stock Exchange.

Univisa controls the international distribution of Televisa's Spanish programmes, which means that the group bypassed the ownership restrictions on foreigners in the United States by selling its programmes to a group of stations over which it exercises management control. Thus, although it was partially and temporarily prevented from operating stations itself, the group manoeuvred in such a way that it ultimately recovered and strengthened its position in the United States Spanish television market.

Today, this media empire covers 90% of the North American Spanish network, plus 18% of that of Spain, and it has expanded through a series of joint ventures to Chile, Peru, Argentina and Venezuela (see table 1), now leading the world in the production of Spanish-language television programmes (Interview 7).

Other Mexican corporations have operating affiliates in the United States or other industrialized countries but have not yet gained an important posi-

tion. Those that have become global players had to struggle to make headway and defend their space in the domestic and foreign markets. They had to use different investment strategies; to play by different bargaining rules; to learn different financial, legal and fiscal practices, and to operate in a much more aggressive and strictly regulated institutional framework.

III

From conventional joint ventures to strategic alliances

There is no broad agreement yet as to a basic definition of strategic alliances. Since these represent one of the new practices most characteristic of global action, some key traits must be identified in order to be able to assess the degree to which Mexican corporate alliances have become truly strategic.

The literature tends to underscore cooperation, collaboration and complementarity as the principles guiding the formation of this type of corporate alliance. Strategic alliance networks are assumed to be non-hierarchical and self-regulating, conflict is by and large absent, and when it is present it is considered deviant and rare (Alter and Hage, 1993, pp. 189-195). The scant attention given to conflict in the literature may in part stem from the fact that these and other scholars have focused on strategic alliances involving TNCs based in advanced capitalist countries. These corporations are more likely to have similar levels of strength. Consequently, it would be difficult at this point to arrive at a definition that would also embrace the particularities of alliances between corporations based respectively in advanced and in newly industrialized countries, since this kind of alliance is a relatively new and rapidly changing phenomenon which involves corporations of different size and strength. However, some of the most important traits of strategic alliances which ought to be present are: i) a combination of strengths and assets; ii) a gradual, intense and often multi-stage process of deliberation which develops consensus, a strong sense of common interest and active collective management practices; and iii) a need for local business control and adaptation to the national, economic

Even when they relied on specialized teams of consultants and financial advisors, the undertakings have been complex and dangerous. The new ventures have demanded very little (and sometimes no) real new Mexican investment, but, as Vitro's failure in the United States glass industry shows, the new players are gambling with resources accumulated over a long historical period.

and cultural environment (Alter and Hage, 1993; Lorange and Roos, 1992).

In the particular case of strategic alliances involving Mexican corporations, the network of allied firms is very dynamic and contradictory, as we shall see below. However, the need for complementary assets draws the national and foreign corporations closer together: the Mexican partner usually wants to become more active in the international arena and gain access to foreign markets and state-of-the-art technology, while the foreign partner aims at gaining access to the Mexican growth potential (Jurgensen, 1993).

Some of the most outstanding strategic alliances recently undertaken by Mexican firms reveal not only the scope of the relation but the strength—and, as we shall see, the weaknesses as well—of the emerging Mexican global players. They also show a sectoral redistribution and segmentation of markets that become increasingly important in the light of the North American Free Trade Agreement (NAFTA) and the formation of a North American regional market.

As may be seen from table 2, the number of alliances has grown rapidly in the past few years. However, only a few have a clear-cut strategic profile as a multipurpose agreement combining manufacturing, distribution, marketing, investment and/or organizational resources. Among the most important are Vitro-Corning, Cifra-WalMart and Modelo-Anheuser Busch.

Even though it collapsed after two years, the Vitro-Corning alliance may be considered a paradigmatic case for several reasons: it was conceived in

TABLE 2

Mexico: Strategic alliances of Mexican companies

Mexican group	Partner(s)	Origin	Date	Sector
Telmex	Southwestern Bell ^a	United States	1991	Communications
	France Telecom ^a	France	1991	Communications
	Sprint ^a	United States	1996	Multimedia
Cifra	Wal-Mart ^a	United States	1991	Retailing
Vitro	Ford	United States		Glass
	Pilkington	United States		Glass
Famosa	Owens	United States		Equipment
Vitrocrisa	Corning ^{a,b}	United States	1991 ^a	Elec. appliances
Vitrocrisa	WTT ^a	United States	1992	Houseware
Acros	Whirlpool ^a	United States	1992	Aluminum cont.
	American Silver	United States	1991	Petrochemicals
Cydsa	Pechiney	France	1994	
	BF Goodrich	United States		
	Royal Plastics			
	Mitsubishi			
	Bayer			Environment
San Marcos	Allied Signal			
	Dora Olver			
Carso	Crown Crafts	United States	1993	
Nacobre	Modine			
Cigatam	Philip Morris	United States	1993	Tobacco
Euskadi	General Tire	Germany	1993	Tires
	Continental AG	Canada		Tires
Frisco	Placer Dome			Mining
Cemex	Mobley Environ't		1992	Energy
	Scancem		1993	Cement distribution
ALFA	MANGHH	United States	1980	Technology
	Shaw	United States	1994	Carpets
	AT&T	United States	1995	Communications
	Payless Cashways	United States	1993	Retailing
	Oscar Mayer	United States	1993	Distribution
Sigma	Sodima	France	1993	Yogurt
	Himont	United States	1992	Petrochemicals
Petrocel	Eastman Chemical		1995	Chemicals
	Akzo	United States	1975	Synthetic fibres
	Dupont	Denmark	1976	Synthetic fibres
Alpek	Basf	Germany	1975	Petrochemicals
	Celanese	Mexico		Petrochemicals
	AMOCO	United States	1987	Petrochemicals
	Worthington		1994	Steel
Hylsa	Metecno	Spain	1993	Steel
	Bekaert	Belgium	1993	Metals
Ademsa	Flemming	United States	1992	Retailing
	Carrefour	France	1994	
Radio Shack	Tandy	United States		Retailing
Visa				
Femsa	Coca-Cola ^a	United States	1993	Soft drinks
Femsa	Miller Brewing	United States	1993	Beer
Comercial Mexicana	Price Club	United States	1991	Retailing
Ica	ABB			
	Knoll Int	United States	1993	Construction
	Fluor Daniel	United States	1992	Engineering
	General Electric	United States	1992	Hydroenergy
	Con Perini ^a	United States	1992	Water storage
	O&G Ind.	United States		
	GEC Alsthom	France	1992	Thermoenergy
	Duro Felguera	Spain	1992	Capital goods
	WMX Tech	United States	1992	Environment
	Gral Des Eaux	France		Environment
	Soletanche	France	1994	Construction
	Bechtel	United States		Construction
	Florida Roads ^a			
	Sheraton	United States		Hotels

TABLE 2 (concluded)

Mexican group	Partner(s)	Origin	Date	Sector	
Televisa	Megavisión	Chile	1991	TV media	
	Venevisión	Venezuela	1991	TV media	
	Cfa Argentina	Argentina	1992	TV media	
	Cfa Peruana	Peru	1992	TV media	
	TCI	United States	1993	Cable TV	
	Discovery Comm. ^a	United States	1993	TV programming	
	Sociedad Europa ^a		1993	Transmission	
	News Corp	Australia	1993	TV programming	
	Hearst ^a	United States	1993	Magazine publishing	
	Pan Am Sat ^a	United States	1992	Satellite	
	QVC Network		1993	Telemarketing	
	Fox Broadcasting		1994		
	Aeroméxico	Air France ^a	France	1993	Transport
GModelo	Anheuser-Busch ^a	United States	1993	Beer	
Bimbo	Bambrini ^a	United States		Distribution	
	Sara Lee ^a	United States	1992	Distribution	
Desc Spicer	Baird's Bakeries	United States	1994	Food products	
	Dana Corp. ^a	United States	1970-1993	Auto parts	
	Kelsey Hayes			Metal	
	GKN			Auto parts	
	GM			Auto parts	
	TRW			Auto parts	
Liverpool	Cabot				
	K-Mart	United States	1993	Retailing	
Tmmsa	JB Hunt ^a	United States	1992	Transport	
Imsa	Nicholas Plastics	United States	1993	Auto parts	
	Durlex Ind.	Brazil	1994	Auto parts	
Aty Ahmsa	Car Sprint				
		Holland			
Ggnex	Pepsico	United States		Soft drinks	
	Natural Beverage	Canada	1993	Distribution	
	Seagrams	Canada	1993	Soft drinks	
Sidek Situr	Holiday Inn	United States	1992	Tourism	
	Diamond Resorts	Canada	1992	Development	
	Club Robinson	Germany	1992	Tourism	
	Caribbean Villas	Dominican R.	1992	Tourism	
	Bel-Air	United States	1992	Tourism	
	Thomas Cook	U.K.	1993	Tourism	
	Trafalgar House	U.K.	1992	Construction	
	Gmd	Benito Roggio	Argentina	1993	Construction
	Elektra	Western Union	United States	1994	Services
	TV Azteca	NBC	United States	1994	TV programming
BI	Underwater Inv.	United States	1994	Petroleum	
	Lyonnaise Eaux	France		Water treatment	
	Kellog ^a	United States	1989	Construction	
Iusacell	Bell Atlantic	United States	1993	Telecommunications	
Herdez	Gilroy Foods		1992	Transport	
	Heinz	United States	1994	Food products	
Geupec	Pepsico	United States	1992	Soft drinks	
San Luis	Triangle Springs	United States	1993	Auto parts	
	Cambior	Canada	1993	Mining	
	Teck	Canada	1993	Mining	
	Hillsborough	Canada	1993	Mining	
Banacci Accival	Swiss Bank Corp.	Switzerland	1993	Brokerage	
	MCI		1995	Telecommunications	
	Aegon NV	NVS	1995	Insurance	
GFB	GTE			Telecommunications	
GSERFIN	GE	United States	1992	Leasing	

Source: Jurgensen (1993); *América Economía* (1993-1994); Annual Meeting Reports and offering circulars of corporations, and journals listed in the Bibliography.

^a Alliances that enabled Mexican groups to expand their operations to global markets.

^b This alliance aborted in December 1993.

more egalitarian terms, it soon became a case which other Mexican corporations tried to emulate, and it entailed a gradual process of negotiation which lasted months and was preceded by an intense interaction and previous, more traditional, links.

A closer look at its characteristics reveals that, in contrast with the traditional joint ventures of the 1970s, which generally gave access or facilitated the entry of First-World TNCs to the Mexican market, the Vitro-Corning alliance was a double joint venture. The two companies exchanged assets in their consumer glass interests. The transaction would enhance Vitro's position in the United States market, and the alliance was complementary in other respects as well. There was not much overlapping of similar products, allowing a segmentation of markets according to the income-levels and preferences of consumers, and the combination of distribution networks and marketing skills was supposed to benefit both of the parties. Neither of the companies had developed distribution systems in the other country, due to the trade barriers prevailing until the 1990s. Last, but not least, a reshuffle of Directors and top executives was also agreed.

Although Vitro has become involved in at least two other strategic alliances under the concept of a double joint venture and nine joint ventures of a more traditional kind, the failure of Vitro-Corning SA reveals some of the great difficulties in attempting to gain access to the global corporate network. According to Corning's top officials the separation was due to different management philosophies (*Business Mexico*, 1994). But Adrián Sada G., Chairman of Vitro's Board at the time, attributed the failure to the fact that "NAFTA does not ... favour Mexican manufacturers of glassware products for the kitchen and table." (Vidro, 1993, p. 4). The alliance was therefore redefined to cover only marketing.

Bleeke and Ernst (1991, p. 129) anticipate problems for strategic alliances between companies of disparate size and strength:

When one partner is weak, managing the alliance seems to be too great a distraction from improvement needed in other parts of the business. When unbalanced partnerships do succeed, it is usually because the strong partner brings the capability that is crucial to the venture; it pulls the weaker partner along for a while before acquiring it or finding another partner.

While it is important that partners have complementary skills and capabilities, an even balance

of strength is also crucial. This is especially true in product-for-market swaps. When one partner brings a product or technology and the other brings access to desirable markets, there is often a certain amount of suspicion. Each partner fears that the other will try to usurp its proprietary advantage.

The fate of both the Vitro-Corning and the Cifra-WalMart alliances seem to confirm this opinion. The first-named case has already been examined above. In the latter case, the stronger partner (WalMart) took over the weaker partner around six years after they started the link-up. In 1991 Cifra, Mexico's largest retailer, teamed up with WalMart, the largest retailer in the United States. The link-up covered several projects in both countries (Interview 5). In 1997 the Mexican partners agreed to sell the controlling share, arguing problems of family generational turnover.

Modelo and Anheuser-Busch, the leading brewers in Mexico and the United States, respectively, joined forces in April 1993. The link-up included four areas: i) the acquisition by Anheuser-Busch of 17% of the equity of Modelo, with the option to buy up to 30%; ii) Modelo will remain the exclusive importer and distributor of Budweiser and other brands of the United States brewery; iii) Anheuser-Busch will be given three seats on Modelo's board of directors and a Modelo representative will be appointed to the Anheuser-Busch board; and iv) there will be rotation of executive and management personnel between these corporations, particularly in the areas of marketing, planning and finance.⁹ The fate of this alliance has not been decided, but many fear that Anheuser will eventually buy out full control.

Table 2 shows the growing number of associations Mexican groups have formed, each of which may involve different arrangements. The cases examined in more detail, however, shed light on the nature of the global network. Strategic alliances link up two or more global firms in a corporate network. Each may fulfil, however, a different function. Some organizations may hold central positions, whereas others remain marginal, particularly when overall decisions are being taken affecting the articulation and dynamics of the network. Thus, collaboration

⁹ See *Business Mexico*, 1993, p. 14, and *Latin American Newsletters*, 1993.

and integration of the manifold and extremely differentiated functions take place only after a complex process of negotiation ruled by a global institutional

framework. Not all the global players participate to the same extent in the formulation of the global rules shaping and constraining strategic choices.

IV

Expansion to global securities markets

During the 1980s, most Latin American corporations could not participate in international financial markets, except to renegotiate debt, swap debt for equity capital and, later, buy back their own paper at discount rates. All of these negotiations, however, entailed a process of learning how to manoeuvre in the global financial circuits, paving the way for the more aggressive and sophisticated undertakings of the 1990s.

Before the groups could pursue any negotiations, however, the Mexican Government had to bail them out. Through a very complex mechanism –Ficorca¹⁰ the government underwrote the private foreign debt.¹¹ Most of the largest groups –especially those from Monterrey– would have defaulted if the government had not intervened.¹² The second half of the decade offered private corporations the opportunity of buying public debt paper at attractive discounts. In April 1987, the Mexican Government allowed Mexican private investors to buy Mexican sovereign debt in the secondary market and to use it to redeem their own foreign debt. The Mexican foreign debt was purchased at 50%-60% of its value and was redeemed in pesos by the government at around 90% of its value. If it was used to prepay foreign debt in Ficorca it was taken at its face value (i.e., 100%). Some groups

profited enormously from this situation and from other debt-reduction innovations.

The opening of the Mexican economy and, later, the negotiations to form NAFTA forced many corporations to strengthen their position. To be able to defend their markets in Mexico they had to become larger, competitive, more efficient and more productive. The new wave of mergers, reshuffles and investments in the new modern technology needed to cut costs also meant the reorganization of the capital structure and greater access to the international securities market. This, in turn, meant greater familiarity with transnational standards of disclosure, accounting and information.

The first incursions in the global securities markets, from 1989 to the beginning of 1992, were aimed at the equity markets. From April to June 1992 most Mexican stock issues circulating in the global markets through American Depositary Receipts/Global Depositary Receipts (ADR/GDR)¹³ plummeted because the market was saturated, according to some analysts. But by the end of 1992 a great variety of complex debt and equity instruments were being used. Participation in international roadshows and presentations to market analysts and fund managers became part of the new function of financial promotion and planning. Specialized management teams for financial promotion were often created in the corporate structures.

Table 3 shows that between 1989 and 1992 over 35 Mexican corporations entered the international stock market with ADRs or GDRs. Only 20 of these companies were fully registered with the United

¹⁰ This trust –Ficorca– provided a mechanism whereby, once they had reached an agreement with foreign credit institutions to defer the terms of redemption, corporations registered under the Ficorca programme would be eligible to buy the foreign currency needed to pay the debt interest and principal at subsidized, fixed rates. The Ficorca programme offered different options for buying the foreign currency needed to pay interest and principal.

¹¹ Garrido and Quintana (1987) have assessed the total transfers of funds made by Ficorca to private groups.

¹² Alfa and Moctezuma did indeed default because it took them a very long time to reach agreement with their creditors. Alfa had 170 creditors when it started renegotiations, and the sheer number of agents involved slowed down the process considerably.

¹³ ADRs/GDRs are receipts circulating on international stock markets which represent stock in a company. The stock is deposited in a neutral trust, usually Nafinsa, which then issues receipts representing that stock. The holder of such a receipt has the right to receive profits, but no voting rights.

States Securities and Exchange Commission (SEC).¹⁴ The remainder of these issues trade "Over the Counter" in the institutional markets (pension and insurance funds), where they are more protected from hostile takeovers, leveraged buy-outs and other aggressive investment strategies (MacKee (ed.), 1989).

Several Mexican groups (Femsa, Vitro and ICA) used ADRs/GDRs to finance acquisition or investment programmes, while other groups used them to reorganize proprietary interests. During the process of reprivatization of the banks, bridge loans were partially paid with proceedings from secondary or primary offers (of ADRs/GDRs), and the government also used this device to complement Telmex's privatization programme (Salas-Porras, 1997).

Most of the expansion into international markets, whether through acquisitions, joint ventures or strategic alliances, has been undertaken with little or no new investment. Very sophisticated financial operations, including debt swaps at heavily discounted prices, had to be engineered to reshuffle proprietary interests on a global level,¹⁵ and certain Mexican companies had a favourable position for several reasons: i) NAFTA had remarkably changed the perception of risk for Mexican issues; ii) international investors began to demand Latin American paper because it offered, on average, better returns; iii) most Mexican groups trading in global markets achieved low levels of leverage in the 1990s; and iv) some groups had large cash flow potential.

In 1993, many analysts and investors considered Mexico more favourably than the rest of Latin America. The very good reception of almost all Mexican debt issues launched between 1992 and 1993 con-

firms this perception. Most of the issues shown in table 4 had to raise the original offering because they were over-subscribed and were priced at relatively low rates considering the conditions of the markets for high-risk countries. Undoubtedly the largest and most successful issue was launched by Cemex in May 1993. The demand was so great that the offering had to be increased from an original US\$ 600 million to US\$ 1 billion. This and other issues launched in 1991 and 1992 (see table 4) certainly satisfied the financial needs arising from Cemex's recent acquisitions in Mexico (Empresas Tolteca in 1989 and Cementos Hidalgo in 1993) and Spain (La Valenciana and Sansón in 1992) and the new investment prospects mentioned above.¹⁶ Cemex would not have been able to engage in these multi-million-dollar global transactions if its leverage had been high and its cash flow potential low. However, the opposite was true. In spite of all the debt paper issued during 1993, at the end of the year its leverage (total liabilities/total assets) was only 50% and its cash flow represented 30% of sales (cash flow from net earnings/net sales).

The shift from private negotiations and credit contracts with foreign banks and financial institutions to the issue of different and complex equity and debt instruments as a means of obtaining foreign funds took a whole decade (1982-1992). The multiple relations and contradictions with numerous agents of the global securities market—leading agents, institutional investors, investment bankers, fund managers, brokers, etc.—put pressure on the groups and forced them to rapidly change their corporate structure, practices and strategies. Disclosure, accountancy and information practices became more open. Some groups reorganized their corporate structure by sectors to respond to the needs of certain pension funds focusing their investments by economic sectors. The short-term strategy of the international market community forced Mexican groups to offer quarterly information and results.

¹⁴ Only those companies which are fully registered can trade directly on the New York Stock Exchange (NYSE). Not all Mexican groups can meet the disclosure requirements demanded by the SEC, i.e., more frequent and more complete reports, history of operations for the last five years, and use to be made of proceeds when offering new stock or paper. Companies listed on the NYSE are more closely regulated, implying less risk for individual investors who cannot trade over the counter (OTC). Therefore, fully registered companies have access to funds from individual investors, who give the institutional markets much greater marketability. Only institutional investors operate in the OTC market, which has lower liquidity. In the OTC markets transactions are conducted through a telephone and computer network connecting stock and bond dealers (brokerage houses or investment banks), rather than on the floor of an organized exchange (Downes and Goodman, 1995).

¹⁵ According to Michalet (1991, p. 43) the process of globalization is different from the multinational process, among other things because "... the reshaping of world industry is not giving rise to an economic process of capital accumulation. In contrast to the previous period, foreign direct investment mainly constitutes a shift in the ownership and control of existing companies."

¹⁶ For the Spanish bid, J. P. Morgan negotiated a bridge loan worth US\$ 1.6 billion from Citibank.

TABLE 3

Mexico: International securities issues by Mexican companies

Name	ADR/GDR ^a	Neutral Fund	New York Stock Exchange	NASDAQ ^b
Telmex	X	X	X	
Cifra	X	X		X
Vitro	X	X	X	
Carso	X	X		
Cemex	X	X		X
Visa			X	
Alfa	X	X		
Comercial	X			
Gigante	X			
ICA	X	X	X	
Televisa	X		X	
G. Modelo				
Bimbo		X		
Desc	X	X	X	
Soriana		X		
Gruma	X		X	
Aeromex	X			
Gimmex		X		
Kimberly	X	X		
La Moderna	X		X	
Liverpool	X			
TMMSA	X	X	X	
IMSA				
Aty	X		X	
Nadro				
Tribasa	X		X	
GMD	X		X	
Cydsa				
Ahmsa				
CMA	X			
Chedraui				
Sidek	X		X	
Dina	X		X	
Pefioles		X		
Apasco	X	X		X
Ggemex	X		X	
Continental				
Elektra	X		X	
BI	X		X	
Synkro	X		X	
Lala				
Gis				
Bachoco				
P Hierro				
Benavides				
Syr	X			
Copamex				
Hermes				
Gidusa	X		X	
Iusacell	X		X	
GHerdez	X		X	
Tamsa	X			
Argos				
Coppel				
Geupec				
Posadas	X			
San Luis	X			
Ponderosa	X			
Canada				
Ceramic	X		X	

Sources: BMV-AMIB (1995-1996); Banamex-Accival, *Semana Bursatil*.

^a ADR/GDR: American Depositary Receipts and/or Global Depositary Receipts.

^b NASDAQ: National Association of Security Dealers Automated Quotation.

TABLE 4

Mexico: Debt instruments for international securities markets
(Millions of dollars)

Group	Instrument	Amount	Lead broker	Date	Rate
Carso	ECP ^a	300	Citicorp	1992	
Cemex	ECP	425		1992	
Alfa	ECP	100	Lazard	1992	550
Ica	Eurobond	225	Citicorp	1993	200
Televisa	Euronote	100	Merrill	1992	
Desc	ECP	100	Citicorp	1992	
Gruma	Euronotes	125	Lehman	1993	415
Aeromex	Fixed rate notes	100	Citicorp	1992	
Liverpool	ECP	100	Chemical	1992	
Cydsa	Term note progr.	250	Citicorp	1992	
Apasco	Eurobond	50		1992	
Iusacell	Eurobond (3 years)	45	JP Morgan	1992	610

Source: *International Financial Review* (1992 and 1993).

^a ECP: Euro Commercial Paper.

V

Distribution networks

This is perhaps the area of activity in which big Mexican corporations have been working for the longest time. Nevertheless, the degree to which they have been successful in building their own distribution networks in other countries varies a lot. Success depends not only on the quality of the products but on the administrative muscle needed to coordinate increasingly complex production, promotion, marketing and distribution tasks. Moreover, very specialized professional teams are required to tackle foreign and transnational legal and institutional frameworks (World Trade Organization (WTO), NAFTA and other trading agreements).

Until the 1980s, manufacturing exports depended predominantly on the situation of the domestic market. If demand was depressed, companies looked for other channels to orient surplus production. From the second half of the 1980s on, foreign trade strategies became increasingly aggressive among manufacturing groups. A greater part of production capacity was deliberately oriented towards foreign markets and a closer interaction of producers with customers—particularly TNCs in the automobile

and electronic sectors—led the former to expand their distribution networks and follow their customers to other countries.

As may be seen from table 5, several Mexican corporations have considerably increased the proportion of exports in their total revenue. Very few groups, however, have articulated a global system of distribution encompassing transportation (ships, trucks, terminals, distribution centres, etc.), warehouses, marketing, promotion agents and legal representatives. Among the most important are Televisa, Cemex and Modelo. From the point of view of the agent, the experiences of Cemex and Modelo are particularly enlightening since they tackled powerful global players who were trying to prevent them from growing in the United States and European markets. To do so they had to learn a variety of procedures, ranging from the very sophisticated anti-dumping laws and GATT institutional rules to more informal rules and trading tricks.

In 1988, seven cement producers from Texas, New Mexico, Florida and Arizona, apparently led by a subsidiary of the Swiss TNC Holderbank, com-

TABLE 5

Mexico: Exports, distribution networks and market agreements

Group	Exports/Sales 1993 (%)	Trading networks and market agreements
Telmex	20.3	
Vitro	22.0	ICI America, Pilkington Bros, Agreement with GM
Carso	16.2	
Cemex	11.5	Sunbelt, distribution centres, marine terminals and ships
Visa	2.7	Representatives in United States
Alfa	21.4	Eastman Chemical, Just-in-Time agreement with Ford
Ica	6.8	ICA Tech, ICA Construction, Tremec Trading Co
Televisa	22.5	Galavisión, Sociedad Europea
GModelo	8.8	Moctezuma Imports, Gambrinus
Bimbo	1.1	Sara Lee
Desc	21.3	Chemtech, Housmex, Just-in-Time agreements with GM, Ford
GMexico	55.4	Minera Mexico International, Western Copper Supplies
Kimberly	3.1	Intercompany trading with parent
La Moderna	20.0	Mid and Far East
Celanese	32.3	Intercompany trading with parent
Tmmsa	40.3	The Texas-Mexican Railway Co., Cardiff, Marine terminals and ships
Imsa	12.2	Representatives
Tribasa	1.0	
Cydsa	26.1	Rayon Yarn, Intermex, Jansen, Veratec (fibres & textiles)
Ahmsa	3.9	
Cma	61.7	Agreements with travel brokers
Sidek	3.3	Pacific Steel Inc., Agreements with travel brokers
Dina	30.8	Agreement with Mercedes-Benz
Peñoles	41.0	General Products Co., Peñoles & Chemicals
Bi	13.0	Agreement with Kellogg and representatives in the United States
Synkro	66.0	Subsidiaries in the United States and representatives in Latin America
Gis	15.4	Representatives
Bachoco	20.4	
Herdez	3.0	Festin Food
Tamsa	71.4	ITL, TAMSA Inc., Tamtrade
Argos	8.4	
Posadas	12.1	
San Luis	74.5	Market agreements

Source: *Expansión* (1994); BMV (1994).

plained to the United States Federal Trade Commission that they were being unfairly affected by low-priced Mexican cement imports. The Trade Commission imposed antidumping duties ranging from 50% to 58%. Mexican cement exports to the United States dropped from 3.5 million tons to less than 1 million and Cemex was badly hurt, since it accounted for around 90% of that amount. Several attempts to overturn the ruling were unsuccessful, until in July 1992 an international panel found that the United States had violated the GATT antidumping code. United States trade representatives offered to do away with the antidumping duties if Mexico withdrew its GATT complaint, kept exports to the United States within certain limits and prices, and opened its own cement market to imports. The punitive duties have gradually been reduced, but not eliminated (Interview 2).

Cemex's geographic proximity to the United States represented a competitive advantage—particularly when transport costs were considered—which no doubt troubled the adversaries who promoted this legal fight (the Swiss TNC Holderbank and the French Lafarge, ranked first and second in the world, respectively). During the legal dispute, which lasted more than two years and has still not completely ended, Cemex has been forced to find new markets in Japan, Singapore and other Southeast Asian countries, Europe and Latin America, diversifying its network of trading representatives and agents.

The case of Modelo also highlights the new strategies Mexican corporations had to develop to expand to First-World markets. Between 1986 and 1987, a brand of beer produced by Modelo—Corona Extra—became the second-best-selling imported beer in the United States, displacing Heineken as the

number one in California, Texas and Colorado. Very soon after Corona had been recognized as the second-best-selling imported beer, a persistent rumour began to spread across the United States saying the beer was contaminated. This rumour affected certain regional key markets. After trying other strategies, Modelo's representative in the United States filed a US\$ 3 million lawsuit against Luce & Sons, Inc., the

Heineken distributor responsible of spreading the rumour. The dispute was settled when Luce agreed to state publicly that Corona was not contaminated. From 1986 to 1987 Corona increased its share in the United States imported beer market from 11% to 18% (whereas Heineken's share dropped from 29.3% to 25%). In 1992, Modelo accounted for 69% of all Mexican beer exports, with sales in 59 different countries.¹⁷

VI

Global strategies

The cases examined in this article all reflect a deliberate effort to adopt global strategies and become global actors. This is broadly considered as a condition for overcoming, or at least lessening, the inefficiency, lack of competitiveness and chronic shortage of financial resources characteristic of closed, protected and underdeveloped economies. At least four of the interviewees (2, 3, 4 and 8, representing Cemex, Carso, Alfa and Vitro, respectively) explicitly linked competitiveness and the possibility of defending their markets (national and sectoral) to the adoption of global strategies. According to Vitro's management, for example, "As the Mexican economy opened up, the only alternative was to expand towards foreign markets and, simultaneously, protect national markets, but on the basis of the rules of the game of the international market." (Interview 8).

The drive to become global is thus the strategy adopted in order to survive and overcome some traditional limitations and constraints characteristic of the national bourgeoisie, particularly inefficiency and widespread dependence on the State. To become global, Mexican entrepreneurs had to adopt a more active, aggressive, conscious and even self-analytical position. This strategic orientation presupposes that this segment of the national bourgeoisie takes a step back from the role it has been playing in the economy, examines it critically and tries to transform it.

My interviews demonstrate that this strategic planning—different actions logically connected together in order to produce a specific outcome—is now deeply rooted as a corporate practice. Global strategies—that is, sets of deliberate actions aimed at gaining or maintaining a position in the global market—have transformed the predominantly inward

orientation of corporate metapreferences into a predominantly outward orientation.

The global strategies formulated and implemented by Mexican groups are quite comprehensive. They include different combinations of the turnaround strategies¹⁸ worked out by TNCs based in advanced capitalist countries in the 1980s; new forms of growth by acquisition (privatization operations, hostile takeovers, leveraged buy-outs and management buy-outs); positioning or benchmarking on a global scale; strategic alliances and networking, and the use of new financial instruments (commercial paper, Eurobonds, buying options and other financial devices).

Operations on a transnational scale broaden the scope of action not only because top management has to coordinate activities in different countries but also, and particularly, because competitiveness and performance have to be evaluated on a global scale: i.e., in comparison with the results of global competitors. This new emphasis on positioning permeates corporations' growth and turnaround strategies. Positioning on a global scale thus becomes one of the main objectives in almost all areas of corporate action.

¹⁷ See *Wall Street Journal*, 1987; *Journal of Commerce*, 1988, and *Latin American Newsletters*, 1993.

¹⁸ By turnaround strategies I understand a comprehensive corporate organization which acts on all levels of the corporation: financial, technological, organizational, etc. These strategies were first formulated in the 1970s but the different financial and corporate measures have changed considerably since that time. Among the most important new elements we find the use of leveraged buyouts, the issue of junk bonds to finance acquisitions, strategic alliances, and so forth. See Bibeault (1982) and Slatter (1984).

Presentations to agents from the global market community¹⁹ invariably give a special space to positioning on various accounts (net income, productivity, return on assets, etc.). Annual Meeting Reports, offering circulars, road shows, presentations and other financial promotion instruments cannot evade the problem. Most of my interviews show that positioning has deeply transformed the logic of strategic management among large Mexican corporations. One of the most important considerations which encouraged Cemex to buy Sansón and La Valenciana in Spain was that the group would achieve a return on assets much greater than that of their competitors in Europe (Interview 2). Lorenzo Zambrano, Cemex's CEO, considers that in order to compete with TNCs from industrialized countries Mexican management must know them in detail, understand their strategies, follow their development in different countries, identify their vulnerable areas and anticipate their next moves (IMEF, 993, p. 10).

However, firms do not necessarily adopt *all* the components of the global formulas, because their sectoral and/or specific situation may involve different problems and constraints. The possible combinations of strategies are thus manifold. They depend on the firm's financial situation and the characteristics of the core business, cost structure, historical strategy and so forth.

Before the opening-up of the economy, most big Mexican companies could have been considered stagnant businesses: firms with under-utilized assets and ineffective management, by transnational standards. Under the conditions of a closed protected market, these firms survived in spite of their poor performance, but as the economy opened they had to adapt to the international production environment if they were to stay in business. Among the most popular courses of action adopted to overcome their competitive weakness are those prescribed by classical turn-around specialists (Bibeault, 1982 and Slatter, 1984): i) Product-market reorientation,

adopted by Alfa, Desc, San Luis and to a lesser extent VISA; ii) Cost reduction, adopted in particular by Alfa, Cemex, Carso and Vitro; iii) Improved marketing (Bancomer, Modelo); iv) Asset reduction (Alfa, Cemex, Carso), and v) Constitution of professional senior management and boards (Alfa, Carso, VISA-Bancomer).

Turnaround strategies rapidly spread throughout the corporate milieu, becoming a buzzword among top executives. Turnaround specialists or "artists" emerged, sponsored and guided by transnational agents, consultants and investment bankers as both the external and internal environment and management constraints created a turnaround situation for most Mexican corporations.²⁰ The expectations of success are closely related to previous development and to the support of other agents who may benefit from the process.

Carso, like Kohlberg Kravis Roberts (KKR) and Fortsmann Little in the United States (Useem, 1993, p. 318) and Trafalgar House Ltd. in England (Bibeault, 1982, p. 87), has made a practice of taking part in privatization operations and buying out large firms facing difficulties of different sorts. Privatization of State firms has spurred quite a number of turnarounds, since State companies were generally very poorly managed. Carso was one of the groups which benefited most from this process. The group has proved quite successful in turning these ailing firms around through a combination of devices—stronger management, financial instruments, cost-cutting and asset redeployment strategies—very often used in turnaround situations. Another successful turnaround specialist is Lorenzo Zambrano, Chairman and CEO of Cemex, who has restructured Empresas Tolteca and implemented a similar cost-cutting and asset reduction strategy in the recently acquired Spanish companies Sansón and La Valenciana.²¹

¹⁹ By global market community I understand all the agents involved in buying and trading securities in the transnational markets.

²⁰ The role these agents played in the process of corporate restructuring in the United States and other countries is controversial. Whereas some authors (Vedder, 1989, p. 14) consider they helped to make corporations more efficient and productive, others (Bruning, 1989, p. 53 and Brock and Adams, 1989, pp. 34-35) think they fostered speculation and destroyed productive capacity and jobs.

²¹ He is planning a similar strategy for Cementos Samper and Diamante, two Colombian companies acquired in May 1996.

VII

Conclusions

The compounded effects of national and international factors between 1982 and the early 1990s decisively helped to promote the globalization of Mexican corporations. The most important national factors were i) the recession of the 1980s, which forced groups to look for and open new markets for their products; ii) the negotiation of foreign debt, the operations of Ficorca, and the depreciation of Mexican debt which linked them to new, modern and more sophisticated financial circuits and agents; iii) the opening-up of the economy and Mexico's entry into GATT and NAFTA, which meant less protection and fewer subsidies and transfers; iv) the revaluation of Mexican corporations in the light of the expectations generated by NAFTA; and v) the debt overhang, which created financial opportunities.

Among the international factors, the most important were the globalization of a growing number of industrial sectors, clusters and networks, which opens new spaces and niches for transnational corporations from developing countries; the fact that many TNCs from advanced capitalist countries are shifting their attention from traditional to leading-edge activities; the technological development in the area of communications and information, which makes possible complex combinations of productive, marketing and financial operations; financial agents looking for and creating more attractive (speculative) options for investment in emerging markets, given the general fall in interest rates; and a global regulatory framework more concerned with quality and ecological standards.²²

As may be seen from table 6, of the 60 largest non-financial groups in Mexico, 37 (that is, almost 60%) have become global corporations according to the definition proposed at the beginning of this article, i.e., with at least two types of activities in transnational markets (see introduction).

²² Although these problems are beyond the scope of this article, there has been a great deal of discussion of these issues since the expansion of the maquilas, the opening-up of the economy and the negotiations on NAFTA.

Strategic alliances have become the most common strategy. An exhaustive survey of the business literature reveals that 29 of the 60 largest non-financial groups in Mexico have formed strategic alliances in the past five years. Only in a few cases do these alliances enable Mexican groups to expand their operations to global markets, however, either by facilitating exports or in value-adding activities.

Expansion to the securities markets is a very popular strategy too, since credit contracts are gradually disappearing and the Mexican capital market cannot satisfy the capital requirements of these large groups. However, not all Mexican corporations have the organizational capacity to quote in the international securities markets, especially the New York Stock Exchange (NYSE). Of the 60 largest industrial-retailing corporations as of 1994, 55 are listed on the Mexican Stock Exchange, 35 trade American Depositary Receipts or Global Depositary Receipts (ADRs/GDRs) on international markets, only 20 are listed on the NYSE, and 13 offered other types of debt instruments from 1992 to 1993 (see tables 3 and 4).

Only 13 groups have operating subsidiaries and therefore value-adding activities in their core business abroad (table 1). A total of 24 groups have developed their own trading, manufacturing and marketing agreements with global corporate clients (see table 5). Of the motives identified by Fujita and others (Taylor (ed.), 1993, pp. 11-14) for promoting foreign direct investment (FDI), Mexican corporations are particularly keen on upgrading technological skills and increasing efficiency through rationalized operations and cost reduction strategies (Cemex and Vitro). However, market-seeking and export-oriented FDI tend to become more important for companies operating in saturated national markets (Televisa, Synkro, Bimbo-Baird's). Resource seeking is considerably less important for Mexican firms.

In sum, the most common trajectory is a combination of two strategies: expansion to the global securities market and the formation of strategic alliances. As may be seen from table 6, of the 60 groups in our sample, 37 have become global. Of these 37 global Mexican firms, 25 combine these two

TABLE 6

Mexico: Paths followed by Mexican companies to become global players

Group	Sector ^a	Subsidiaries	Securities ^b	Strategic alliance	Exports
Telmex	Communications		X	X	X
Cifra	Retailing		X	X	
Vitro	Glass	X	X	X	X
Carso	Highly diversified	X	X	X	X
Cemex	Cement	X	X	X	X
Visa	Beer, soft drinks	X	X	X	X
Alfa	Steel, petrochemicals		X	X	X
Comercial	Retailing		X	X	
Gigante	Retailing		X	X	
Ica	Construction	X	X	X	X
Televisa	Television	X	X	X	X
GModelo	Beer		X	X	X
Bimbo	Food products	X		X	X
Desc	Highly diversified		X	X	X
Soriana	Retailing				
Gruma	Food products	X	X		
Aeromex	Airlines		X		
GMexico	Mining				X
Kimberly	Paper		X		X
La Moderna	Tobacco	X			X
Liverpool	Retailing		X	X	
Tmmsa	Transport		X	X	X
Imsa	Auto parts	X		X	X
Aty	Retailing		X	X	
Nadro	Petrochemicals				
Tribasa	Construction		X		X
Gmd	Construction		X	X	
Cydsa	Petrochemicals		X	X	X
Ahmsa	Steel		X	X	X
Cma	Airlines		X		X
Chedraui	Retailing				
Sidek	Steel, tourism		X	X	X
Dina	Automobiles	X	X		X
Peñoles	Mining				X
Apasco	Cement		X		
Ggemex	Soft drinks		X	X	
Elektra	Retailing, television			X	X
Bi	Construction		X	X	X
Synkro	Textiles	X	X		
Lala	Food products				X
Gis	Auto parts				X
Bachoco	Agroindustry				
P Hierro	Retailing				
Benavides	Retailing				
Syr	Retailing				
Copamex					
Hermes	Metals				X
Gidusa	Wood products				
Iusacell	Communications	X	X	X	
Herdez	Food products	X		X	X
Tamsa	Steel tubes		X		X
Argos	Soft drinks				X
Coppel					
Geupec	Soft drinks			X	
Posadas	Tourism				X
San Luis	Mining			X	X
Canadá	Footwear				
Tablex	Food				
Ceramic	Construction		X	X	X

Source: Previous tables

^a Core business(es).^b ADRs and/or debt instruments

strategies in some way. Six groups limit their global action to these areas. Although value-adding activities are not involved in this trajectory, the interaction with global partners and securities agents can be very intense, deeply transforming corporate strategies and organization. Most large retailing groups have followed this trajectory. Only six Mexican groups combine all four of the global strategies (table 6).

If we compare Mexican global corporations with the multinational enterprises of the Third World in the sixties, as analysed by Khan (ed.), 1986, some major differences may be found with regard to investment strategies, location, mechanisms of expansion and instruments to finance expansion. Whereas the Third World multinationals employ defensive strategies to expand to Third World markets in order to counteract the effect of recessive trends or protective measures, or in order to reduce risk through regional diversification, the Mexican transnationals use aggressive strategies to penetrate First World markets.²³ In other words, the Mexican global players deliberately aim at First World markets in order to become global forces in their respective areas of operation. They do not penetrate those markets through arrangements with governments, handshake deals or joint ventures with Third World investors, as Third World multinationals did before (Khan (ed.), 1986), but rather through complex and aggressive actions comprising acquisitions, hostile takeovers, leveraged buy-outs, buying options, strategic alliances, lawsuits and other legal or financial manoeuvres. They generally do not depend on their own internal financial resources to finance their expansion. Instead, they use sophisticated financial devices engineered by powerful transnational agents who have become a key link in the whole process of globalization. Acquisitions, strategic alliances and other investment projects are carried out with relatively little or no fresh Mexican capital, but rather with bridge loans in combination with ADR/GDR offerings, Eurobonds, and other instruments which presume the low-leverage financial positions achieved by Mexican groups throughout the 1980s, and also high cash flow potential.

The drive to become global constitutes a survival strategy in the context of an open export-oriented

economy and increasing integration with the United States and Canada. The national and international conditions favour those groups whose competitive edge lies in goods demanding mature and standardized technology, where they have achieved high productivity, primarily through cost-cutting strategies (Vitro, Cemex) (Taylor (ed.), 1993). In other cases, globalization is achieved where, for cultural reasons, it would be very difficult to replace the services in question (retailing, television programmes). And this is precisely the main similarity with the multinational enterprises from the Third World analysed by Khan (ed.), 1986.

Thus, even when they become global, these corporations from less developed countries exhibit weaknesses and shortcomings. They gain a foothold in non-leading and highly cyclical areas of the world economy (cement, steel, glass, petrochemicals), where they have more potential to compete on a global level. The Vitro-Corning strategic alliance, for example, was confined, even before it failed, to the house-ware industry division and did not include state-of-the-art products such as optic fibres where Corning has become a leading-edge producer. Even in the traditional production of glass containers, however, Vitro suffered a blow in 1996, when the group reported losses for more than US\$ 400 million and withdrew completely from the United States market after selling Anchor Glass.

Very few Mexican global corporations have developed towards more technologically advanced areas. Vitro was producing glass-manufacturing machinery and equipment for its subsidiaries in the United States (Anchor's plants), but as already noted it nevertheless had to withdraw from the United States in 1996. However, Cemex, ICA, BI and GMD are exploring the production of environmentally friendly facilities; Televisa has bought its own satellite, which will force the group to get involved and assimilate the technology contained in that equipment, and in 1996 Carso Global Telecom began an aggressive process of expansion into multimedia activities with the acquisition of Prodigy Services.

The better ranking of Mexican debt issues (Eurobonds, commercial paper, etc.) from 1992 to 1994 has been dramatically adjusted after the devaluation and collapse of December 1994. Much higher rates have had to be offered from 1995 onwards to compensate for the much higher risk. Moreover, these newcomers to the global scene are more vulnerable

²³ A United Nations study (Taylor (ed.), 1993) likewise notes the greater proportion of FDI channelled from Third World to First World countries.

to the financial strategies of the open market and even to institutional investors and transnational financial engineers who are permanently monitoring their decisions and performance and can provoke instability in the price of their shares and their financial

situation. Since these agents are usually interested in short-term returns they also exert pressure on the corporations to sacrifice long-term investment strategies, fostering speculative practices.

(Original: English)

Interviews

1. Bufete Industrial
Lic. Luis de la Mora
Subdirector of Financial Resources
2. Cemex
C.P. Víctor Naranjo
Director of Finance and Investors Relations
3. Grupo Carso
Eduardo Valdés
4. Grupo Alfa
Ing. Enrique Flores
Director of Investors Relations
5. Grupo Cifra
Ing. Federico Casillas
Director of Investors Relations
6. Grupo ICA
Ing. Gerardo Sáez
Director of Investors Relations
7. Televisa
Manuel Abud
Director of Investors Relations
8. Vitro
Hugo Sánchez García
Director of Investors Relations

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Regulating the private *provision of drinking* water and sanitation *services*

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Ever since the 1970s, the governments of the region have been transferring public companies and other State institutions to the private sector in one manner or another. Privatization has now spread to all sectors of the economy, including drinking water supply and sanitation services. Private sector involvement in the provision of these services offers potentially significant efficiency gains, but it will not, in itself, guarantee lasting welfare improvement unless these services are provided in a competitive market. If not, the results will depend on the regulatory regime within which the industries operate, and the effectiveness of this regime will be determined by the ability of governments to seek and create institutional and regulatory conditions that oblige suppliers to be efficient and responsive to the needs of their customers. This article focuses on the issues to be confronted in preparing a suitable regulatory framework for the drinking water supply and sanitation sector.

I

Introduction

The provision of drinking water and sanitation services has been marked in Latin America and the Caribbean by enormous deficiencies or faulty management on the part of the government. This is the main reason for the present widespread adoption of measures to increase private sector participation. Such participation could be expected to bring potentially large efficiency gains, but it will not in itself be sufficient to guarantee lasting welfare improvement, because drinking water and sanitation services tend to be natural monopolies when their provision by a single firm results in lower costs than if they were provided by two or more firms. In this case, competition is either not possible or would entail inefficient and prohibitively costly duplication of fixed assets, as well as failing to take advantage of economies of scale.

Unless there is a competitive market, results will depend on the ability of governments to find adequate institutional and regulatory solutions which oblige suppliers to be efficient and responsive to their customers' needs. It is therefore important to identify the features which contribute to the success or failure of such efforts. This is particularly important because the regulation of private monopolies is no easy matter: "effective regulation is necessarily a complex

business, and to pretend otherwise is likely to have damaging long-term consequences for the industries concerned. Undue simplification of the initial framework of regulation for privatized monopolies will ... very frequently lead to the emergence of much more serious difficulties in the longer term" (Vickers and Yarrow, 1988). Furthermore, governments in the region have little experience in this field, since most companies in this sector used to be State-owned and regulatory systems for them were never developed.

A sudden shift from public ownership and bureaucratic control to a regulated private monopoly completely changes the demands made on the management institutions of the sector and also requires a thorough reconsideration of the management policies adopted for drinking water and sanitation services in the past. Privatization demands not only that the State should withdraw from many activities, but also that it should take on some new ones which are often of a very different nature and require different skills and knowledge on the part of public sector personnel. With regard to drinking water and sanitation services, experience shows that privatization does not simply end with the transfer of the assets concerned but requires continuing regulatory action by the public sector.

II

Regulatory system design

Two broad modes of regulation may be distinguished: structure regulation, which determines which organizations or types of organizations can engage in which activities, and conduct regulation, which concerns the permitted behaviour of organizations in their chosen activities (Vickers, 1991). Thus, conduct regulation exercises direct control over the objectives of the regulated firm, while structure regulation exercises direct control over the structural environment of the firm, but not its behaviour (Perry,

1984). The regulation of natural monopolies will usually require a combination of the two.

The nature of conduct regulation is largely dictated by structure regulation. In order to minimize the scope for government failure, there should be as little conduct regulation as possible.

Regulators should seek to create a reward structure which confronts firms with strong incentives to adopt socially optimal choices rather than simply engaging in micro-management, which is not much

different from the management of State-owned enterprises; there is little merit in converting a public monopoly into a heavily-regulated private monopoly. The creation of such a structure involves identifying the precise sources of market failures, using structure regulation to isolate the activities with which they are associated and focusing conduct regulation directly on the areas where market failures are most pronounced. If structure regulation fails to achieve this end, conduct regulation may be ineffective in restraining monopoly power and may induce productive and allocative inefficiencies. Thus, appropriate regulatory design maximizes the benefits from removing market failures, in relation to the cost of government intervention, because the marginal benefits of regulation decline linearly as intervention increases, while the costs rise exponentially (Jones, 1994).

To what extent should public authorities rely on structure or conduct regulation? This is an empirical problem which necessarily depends on industry-specific conditions, such as the scope for new entry and competition afforded by the underlying technological and market conditions and the degree of asymmetry of information.

III

Asymmetric information

Adequate information is of paramount importance for effective regulation, but regulators are fundamentally constrained by the lack of information on the utilities they regulate: "the problem of regulation is essentially a problem of control with incomplete information" (Laffont, 1994). The regulated company's management always has better information than the regulatory agency about both industry costs and demand conditions, including the effects of the incorporation of new technologies and the most efficient means of operation, and also about the firm's own behaviour, particularly the level of its efforts to reduce costs. Asymmetric information allows a firm to extract rents from its monopoly of information and obtain supernormal profits, resulting in overall welfare loss or allocative inefficiency.

There are sectors where market liberalization and restructuring can be counted on to supply the beneficial pressures of competition which will avoid monopolistic forms of conduct. In others, however, there are industries, including drinking water and sanitation services, where potential entry and competition are limited by the current technology in transmission and distribution activities. In these industries, even if all barriers to entry were removed, new entrants would not materialize except at the expense of productive inefficiency related to the prohibitively costly duplication of fixed assets. In industries with a high degree of natural monopoly, conduct regulation, rather than structural reform and the promotion of competition, is the appropriate policy response.

Other important factors are the nature of the infrastructural components which define a firm as a natural monopoly and the speed of changes in the underlying technological and market conditions (Beesley and Littlechild, 1989). Systems of a local nature, where the rate of change is slow, such as drinking water and sanitation services, offer the most promising conditions for conduct regulation. If the system is of a national scale and the rate of change is rapid, however, such regulation will be more difficult.

Asymmetric information has three major implications:

i) the prospects of generating information for regulatory purposes should be an important consideration in a government's decision about the nature of the regulatory regime and the structure of the industry (Beesley and Littlechild, 1989).

ii) instead of using command-and-control methods: i.e., instructing the firm on every aspect of its operation and requiring it to follow the orders it is given and relying on micro-management, the regulatory goal should be to design incentive mechanisms for the regulated firm that will motivate it to use its superior information to maximize society's objectives while pursuing its own self-interest, rather than merely extracting rents from its

monopoly of information (Acton and Vogelsang, 1989; Sappington, 1994).

iii) regulators should have a legal right to have access to the inside information of the regulated firm, as for example through audits, and they should also ensure the transparency of information. Transparency of accounts is a very important feature of regulation in the United States, where a "Uniform System of Accounts" is used that classifies all utility accounts under a common system (International Energy Agency, 1994).

In order to overcome asymmetric information, regulators must also have adequate, although suitably restricted, discretionary powers and considerable administrative and financial resources.

There are several information-extracting mechanisms by which a regulator can reduce the information advantage that the regulated industry enjoys.

One of these is the issue of licenses (franchising), or competition for the market. Where direct market competition is not possible within an industry, franchising, or competition for the right to be the monopolist, is another information-extracting mechanism. When many interested parties facing the same technology and production costs present non-collusive bids for the right to be the monopolist, the competition for the market among the *ex-ante* producers will hold in check the potential informational advantage of the *ex-post* supplier through the competitively determined terms of the franchise contract. This approach is being increasingly used in Latin America and the Caribbean, examples of it being the concessions and related arrangements in Argentina and Mexico. Despite their many interesting features, however, franchising arrangements suffer from serious limitations (ECLAC, 1997; Williamson, 1976), and the activities of the drinking water and sanitation sector are particularly subject to these difficulties. The most important obstacles include the danger that bidding for the franchise will cease to be competitive; problems connected with the visibility and transferability of investments, which may distort both the incentives to invest and the nature of the competition for franchises; and difficulties in specifying and administering the contracts.

The most promising attempt to formally address the problem of asymmetric information in privatized water supply and sanitation services seems to be through benchmark or yardstick competition, also known as competition by comparison or competition by example. This method promotes competition in cost minimization between monopolists indirectly, via the regulatory mechanism, by replicating comparisons with the performance of similar firms elsewhere. The basic principle behind this proposal is to decouple the utility company's price structure from its own reported costs and hence limit its opportunities to distort its cost data. The opportunities for the use of benchmark competition in the drinking water and sanitation services industry derive from the fact that—as a result of the common regulatory structure and many common features in the operational environment and the input and output markets of the service providers—when setting prices or target service quality levels for one firm, the performance statistics of other firms usually contain information signals concerning the underlying economic trade-offs faced by the given firm's management (Vickers and Yarrow, 1988). It is not easy to implement benchmark competition, however. Regulators have found it difficult to incorporate it explicitly in regulatory frameworks (Cowan, 1993; Helm, 1994), but in spite of the problems it raises it is being increasingly used in the regulation of both the price and the quality of the services provided.

The advantages of benchmark competition are part of the case for having horizontally separated companies rather than a single national company in natural monopoly industries (Vickers, 1995). Mergers, takeovers, joint management arrangements and other changes in the industry structure can affect the regulator's ability to make effective use of benchmark competition. This does not rule out mergers, but since the loss or degradation of comparators, particularly among bigger or more efficient companies, adversely affects the efficiency of benchmark competition, regulators should seek to create new and improved comparators and to link this with immediate benefits to customers, notably in the form of lower prices (OFWAT, 1995a).

IV

Conduct regulation

Although as a general rule the most suitable policy for promoting efficiency is the adoption of structural reforms designed to encourage competition, the special features of drinking water and sanitation services, especially in relatively small countries or those with a low level of economic development, limit the possibilities of such restructuring. In situations like these, conduct regulation becomes the most important if not the only instrument.

Conduct regulation is concerned with different aspects of the behaviour of regulated firms, such as their pricing policy, the quality of the products and services they offer, investments, etc. The aim of this type of regulation is to reproduce, in a monopoly industry, the same kind of outcome as would be found in a competitive situation and to create the same incentives as competitors would have generated in a competitive market.

Conduct regulation has traditionally focussed on activities such as monitoring, control and auditing. It is very similar to the relation which exists between a State-owned monopoly and the ministry which oversees it. The more modern approach to conduct regulation emphasizes economic incentives that compel regulated companies to operate efficiently.

1. Price regulation

a) *Explicit price regulation*

Perhaps the most visible form of conduct regulation is price regulation. There are many price regulation mechanisms, but all fall somewhere along a continuum between the extremes of rate-of-return regulation (the traditional method of regulating public services in many countries, especially the United States) and price-cap regulation, which was applied in England and Wales in the mid-1980s.

In recent years, traditional rate-of-return regulation has been criticized for two main reasons: i) because it provides poor incentives to minimize costs and innovate, and ii) because it encourages firms to use an inefficiently high capital/labour ratio for their level of output: the so-called Averch-Johnson effect (see Averch and Johnson, 1962). A series of empiri-

cal studies of the United States drinking water and sanitation industry have been unable to find significant differences between the relative efficiency of private utilities subject to rate-of-return regulation and public utilities, which would appear to confirm the low incentive properties of rate-of-return regulation (see Feigenbaum and Teeple, 1983; Byrnes, Grosskopf and Hayes, 1986; Lambert, Dichev and Raffiee, 1993).

Apart from the criticisms made regarding its limited capacity to provide incentives, however, rate-of-return regulation does have some advantages. By providing a solid guarantee of a fair rate of return, it offers a type of long-term commitment which is crucial for investments with a high sunk cost component, as in the drinking water and sanitation sector (Laffont, 1994). It also defines a feasible procedure which gives investors guarantees against the risk of bankruptcy and provides for a strong system of checks and balances. Furthermore, rate-of-return regulation is likely to have a downward impact on the cost of capital (Grout, 1995). Although it may provide weaker incentives for cost reduction, it generally performs well in the presence of cost uncertainty and asymmetric information about the capabilities of regulated firms, and it reduces the ability of the regulated firm to profit from regulatory ignorance or favourable cost shocks (Schmalensee, 1989).

Price-cap regulation attempts to avoid the problems associated with rate-of-return regulation (particularly its tendency to put upward pressure on costs), while at the same time limiting the scope for regulatory failure and reducing the burden of regulation. It is argued that regulation of prices rather than profits provides strong incentives to improve efficiency and make innovations in production technology and the supply of services, helps to promote competition, and also focusses regulation precisely on the particular services where market failure and public concern are greatest, so ensuring that consumers are effectively protected against monopoly abuse.

Perhaps the most serious drawbacks of this option have to do with the difficulty of establishing

price adjustment factors and the uncertainty surrounding the process, which can translate into higher capital costs and discourage investment. Even more serious is the fact that under this system a regulated firm's profits may diverge considerably from normal or reasonable levels, which suggests that it might be difficult for governments to opt for regulation based exclusively on price caps. Inevitably, in a monopolistic and highly capital-intensive industry like drinking water and sanitation services, the regulatory authorities quickly came to the conclusion that price controls must be complemented with an assessment of capital expenditure requirements, including recognition of the financial implications of capital expenditure for price adjustments (Jeffery, 1994). This blurs the difference between the price-cap approach and rate-of-return regulation.

Nevertheless, there are strong reasons for preferring price-cap regulation initially following privatization, mainly because productivity gains are potentially larger at the time of privatization than subsequently, so that the improved incentive properties of price-cap regulation are particularly important during that period (Beesley and Littlechild, 1989). In industries with a decentralized industrial structure, the reasons for preferring price-cap regulation initially are reinforced by the regulator's possibility of generating superior information and overcoming the asymmetry of information through benchmark or yardstick competition. Furthermore, since price-cap regulation can effectively control the prices charged by dominant firms when the competitive marketplace controls the profits, it has been suggested that this form of regulation is probably most effective and appropriate as a transitory step on the path towards total deregulation and full competition (Braeutigam and Panzar, 1993; Schmalensee, 1995).

Although, in their pure forms, these two mechanisms may appear very different, their characteristics in terms of incentives to reduce costs and invest efficiently are very similar in the real world, where either mechanism usually includes aspects of the other, with the result that their strong points and weaknesses tend to be very similar. For instance, regulatory lags and automatic price adjustments reinforce the incentives under rate-of-return regulation and cause it to more closely resemble price-cap regulation, while the need to guarantee private investors a reasonable rate of return on their capital brings price-

cap regulation closer to rate-of-return regulation and introduces the same flaws. What matters is not what the system is called, but rather such factors as the length of the regulatory lag and the expectations that the system generates among investors as to how and on what basis prices are to be readjusted (Jones, 1994).

The tariff-setting process currently used in Chile for drinking water supply and sanitation services is a good example of a process incorporating aspects of several different approaches.

First, rates are determined on the basis of a simulation of a "model firm", which is defined as a firm whose aim is to provide drinking water and sanitation services efficiently, within the prevailing regulatory framework, taking into account the geographical, demographic and technological constraints under which the firm must operate. This represents a form of benchmark competition, since the costs considered in the pricing process are those which the model firm would incur rather than those of its real-world counterpart, and this, at least in theory, prevents the institutionalization of inefficiencies and encourages regulated firms to improve productivity. The drawback of this approach arises out of the basic problem of asymmetric information: if the regulatory agency uses the actual costs of the real-world firm, it validates any of the firm's possible inefficiencies and gives it an incentive to manipulate the information it provides to the regulator. Accordingly, the regulator will be obliged to use other sources of information which are not perfect either.

Second, maximum rates are fixed for a period of five years. In order to make this relatively long regulatory lag feasible, rates are indexed in order to maintain their real value. These characteristics introduce some features of price-cap regulation into the set-up, since regulated firms stand to benefit from any cost-cutting they implement before the next periodic review.

Third, the system incorporates some elements of rate-of-return regulation, since the rates are calculated in such a way as to generate a return on assets of not less than 7%. Moreover, if before the next periodic review it is shown that the basic assumptions used for pricing have changed significantly, then the rate-setting formulas may be modified by mutual consent of the regulator and the firm in question.

b) *Implicit regulation of prices or other aspects of conduct*

Commercial code regulation, also known as "potential" or "implicit" regulation or "regulation-by threat", does not require a sector-specific regulatory framework. Firms operate freely without specific regulation, but regulators monitor and evaluate their performance on the basis of principles established by competition or anti-trust legislation in general; furthermore, there is a credible threat of regulatory intervention if firms engage in anti-competitive behaviour, if prices rise too much or if quality becomes compromised or customers are not reasonably satisfied.

Studies of the behaviour of firms threatened with regulation (Glazer and McMillan, 1992) suggest that:

i) Their behaviour is determined by the marginal effect of changes in price on the probability of regulation;

ii) An unregulated monopoly will consider the effect of its pricing policy on the probability of regulation;

iii) Because under the threat of regulation a monopoly lowers its prices to prevent regulation, the actual imposition of regulation may have little effect on its prices or expected profits; and

iv) Firms may alter their prices more in response to changes in the perceived probability or strictness of regulation than its actual imposition.

Commercial code regulation is relatively simple to implement, it is very inexpensive, and it provides a means to institute regulation gradually: all factors which are particularly important in countries with little experience in formal regulation. It is particularly suitable where the cost of errors is low and as a temporary measure to protect consumers against monopoly power until competition arrives. On the other hand, the rational fear that some future government will impose strict price regulation will force the firm not to increase its profits excessively, which it can achieve by keeping prices low but also by not working too hard and not pursuing every opportunity to reduce costs (Jones, 1994).

2. Service quality regulation

a) *Various means of regulating service quality*

A reduction in product quality or service standards is equivalent to an increase in price. Without adequate regulation of the quality of service pro-

vided, price regulation may be rendered ineffective: "buyers can be exploited just as effectively by giving them poor or unsafe service as by charging them excessive prices" (Kahn, 1988).

At the present time, competition in the basic transport and distribution services of drinking water and sanitation utilities, as well as the possibility of shifting demand, are very limited or non-existent in most cases. In addition, markets for water-related services are typically characterized by informational asymmetries between suppliers and consumers, and the suppliers of the services usually operate as monopolies. For these reasons, it is very unlikely that price control alone can give firms which are seeking to maximize their profits incentives to adopt socially optimal quality options (Shapiro, 1983; Leland, 1979; Spence, 1975). There is therefore a strong case for supplementing price regulation with the regulation of service quality.

The most common methods of quality regulation include the following (Rovizzi and Thompson, 1995):

i) The publication and dissemination of information on service quality is a simple and inexpensive way to put public pressure on any company providing substandard service and may also encourage new competitors to enter the market, but it provides few incentives to improve quality.

ii) Civil liability-based schemes and the like have significant advantages: they can give private firms strong incentives to improve quality, their supervision and enforcement are decentralized, they are flexible because they allow firms to make up for changes in the quality of service by increasing their costs, and customers receive compensation for poor service. They can result in high transaction costs, however, and they are more appropriate when quality failures can be easily verified. They would seem particularly appropriate for supply interruptions, rationing and similar problems. Because they are costly and difficult to implement, civil liability schemes are more suited to bulk consumers.

iii) Customer compensation schemes or guaranteed standards of performance, in contrast, are usually more appropriate for the majority of normal customers, especially when the quality faults are easily observable. They involve the setting of standards of service backed by a system of financial penalties payable in the event of non-compliance either to the government or, preferably, directly to the affected

customers. In England and Wales, for example, the Guaranteed Standards Scheme provides for fixed payments to be made when the company fails to meet certain guaranteed service standards (OFWAT, 1995b). This scheme currently provides for a flat-rate payment of £10 (about US\$15) in respect of each failure to meet the guaranteed standard, except for sewer flooding, where the payment is a refund of the customer's annual sanitation charge. Payments for some service failures are made automatically: if they are not made within ten working days of the failure, the customer is entitled to an additional payment. For other failures, claims must be made in writing by the customer.

iv) In order to be more effective, minimum quality of service standards should be backed by explicit legal sanctions, such as fines or license amendment or revocation, or by an implicit threat to revise the regulated price or to impose enforceable quality of service standards, and in order to be more efficient, standards should be set with reference to the benefits of regulation and its costs. They are appropriate for situations where there are informational asymmetries between suppliers and customers and where small changes in quality can give rise to serious damage (Rovizzi and Thompson, 1995).

v) Finally, there is the possibility of incorporating a measure of service quality explicitly in the price-control formula or taking it into account implicitly at the regulatory review. This mechanism may include action to reduce prices, profits or revenues when a firm fails to meet quality standards or the initiation of a regulatory review in the event of service quality falling below some preset levels. A well-implemented mechanism of this kind would mimic the incentives existing in competitive markets, but it involves a heavy informational burden. In any case, the pricing process should take into account the quality-related aspects of the regulated products and services, and the regulator should therefore monitor the regulated firm to ensure that it meets the quality standards specified in its tariffs.

b) *The common agency problem*

When a firm faces several different regulators for quality of service, pollution and other environmental aspects, and prices, whose preferences in respect of the various possible actions often conflict with each other, what is generally referred to as the common agency problem can arise. This can lead to

tensions between the regulators and create the danger of inefficient outcomes (Baron, 1985 and 1989).

This potential for inefficiency underlines the need for closer cooperation between the regulatory agencies, for institutional procedures that guarantee collective decision-making, for the responsibilities of regulatory agencies to be compatible, and for an explicit duty to be imposed on the environmental regulator to balance costs against benefits, as long as legal obligations are not compromised (Cowan, 1993). In the privatized water industry in England and Wales, the Office of Water Services (OFWAT), as economic regulator, does not decide on environmental policies but it ensures that decision-makers have all the necessary facts, strives to ensure that costing data are available and that sufficient solutions have been considered, and is concerned that companies should be able to plan their investment programmes in a reasonably stable regulatory environment (Booker, 1994). It impresses on the quality-regulating agencies the importance of carrying out adequate economic analysis before they adopt more stringent standards.

3. Regulation of quantity

Many water-related goods and services form a small but indispensable part of the total cost of the wide range of products in which they are used and meet needs that consumers cannot readily forego. As a consequence, the losses from service failure can be very large in financial, social and political terms, relative to the basic cost of provision of the service. For this reason, public service utilities are usually subject to universal service obligations, that is to say, obligations to serve all those who live within their area, apply for service, and are willing and able to pay for it. Without such an obligation, utilities will not have a motivation to provide service when the costs of satisfying demand temporarily increase. For public utility industries, this requirement sometimes means that they must make capital investments in unprofitable areas or must maintain an unprofitable type of service, but more commonly it means that utilities must expand capacity ahead of demand growth (Phillips, 1993).

The universal service obligation means that in the case of an essential public service the public sector can never wholly abdicate its responsibilities for the operation of that service, as it can in some other

industries, without placing the public at risk. Given that the operator of last resort will always be the public sector, governments should probably consider either regulating privatized water-related utilities more comprehensively or foregoing more comprehensive regulation but charging the privatized firm a risk premium for "public insurance" to cover the contingent costs of public sector intervention should the firm enter into a critical operating condition (Devlin, 1993). An alternative, albeit less attractive, would be for the public sector to retain the residual means of providing essential services should the private sector fail to perform its functions.

4. Regulating investment

Many of the benefits of private sector participation in the drinking water supply and sanitation industry result from the fact that such participation protects necessary but politically dispensable investments from unfavourable budgetary pressures. It also provides a means of tapping the greater pool of private capital to help finance them. The direct object of regulation is usually pricing policy, but the effect of regulation on social welfare depends critically on the investment behaviour that price regulation induces in regulated firms (Vickers and Yarrow, 1988). Given the nature and technological characteristics of the water supply and sanitation sector, the advantages of private participation are likely to be small unless there is private participation in investment.

An adequate supply of private finance will only be forthcoming if investors are confident that their investment will not disappear through direct expropriation or through a series of small regulatory actions that are tantamount to a de facto expropriation, and that they will obtain a rate of return on the capital invested which is commensurate with the risk they take. The problem of regulatory commitment "arises from a fundamental asymmetry: the regulated price is flexible but the regulated firm's capital stock is not" (Besanko and Spulber, 1992). Since the economic life of many of the components of drinking water supply and sanitation infrastructure is extremely long and moreover these structures cannot be relocated to other areas or given alternative uses, the profitability of investment depends not so much on the initial regulatory framework as it does on the decisions sub-

sequently taken by the regulator after the investment or privatization has been carried out.

Potential investors need government commitment to respect in the long term their property rights, the rules and regulations governing tariffs, entry conditions, and expansion plans. It is essential, therefore, to develop a stable regulatory environment to encourage and maintain private investment in water-related services. Unless there is such a stable environment, the rational fear of *ex post* opportunism by governments will deter efficient investment in sunk cost assets. The only secure route to private sector confidence is a history of rational government committed to policies encouraging private investment in public services. These considerations underline the importance of ensuring transparent and stable regulatory standards which will uphold the State's commitment to recognize the need for a long-term level of profitability acceptable to the private investor. In addition, the regulatory framework should be flexible enough to adapt to changes in markets, as well as in the economic, institutional, social and technological spheres.

One effect of privatization will be to significantly increase the discount rate applied to investment projects, as the discount factors used by governments are usually low. This means that privatization can affect the choice of technology. If a government decides to use subsidies to encourage the private sector to follow a specific investment path, attention should be paid to the need to ensure that any subsidies are channeled to the most efficient companies and do not affect the play of the market forces too much.

When prices are regulated, regulatory agencies must carefully monitor the capital and maintenance spending of the regulated firms to ensure that they make the investments allowed for in the price limits on time and achieve the expansion, quality and other targets for which the investments had been proposed. The need for close monitoring is underlined by the capital-intensive nature of most drinking water supply and sanitation utilities, which provides scope for evading the constraints imposed by price regulation, by reorganizing their investment profile to enhance short-term financial performance at the possible expense of longer-term efficiency and prospects (Bishop and Kay, 1989).

V

Structure regulation

There may be different reasons for implementing structural reforms, the most important being:

i) In the case of potentially competitive industries, to encourage competition, not for competition's sake but as a means of achieving cost effectiveness or eliminating or reducing the need for conduct regulation; and

ii) In the case of industries such as drinking water and sanitation, where competition is not possible for technological reasons, to improve access to information and facilitate conduct regulation.

When considering structural reforms, it is important to bear in mind that they are by no means a panacea. Attempts to separate closely interdependent activities can impose high costs on the sector, including the loss of economies of scale and scope, the cost of the system coordination machinery, the costs of restructuring the sector, and the possible loss of some internalization of externalities. Such costs need to be carefully weighed against the potential benefits of cost-minimizing behaviour in a situation of competitive pressure. If these factors are significant, there might be justification for continuing with an integrated monopoly.

1. Horizontal restructuring

Horizontal restructuring means integrating or separating identical production processes on a territorial basis or by service categories. A typical example of horizontal separation is the subdivision of national drinking water supply and sanitation companies into regional or municipal units.

In some cases—for example, when the size of the market far exceeds the optimum scale of production and transport costs are insignificant compared with those of production—horizontal separation can create direct competition. This model has been applied in various countries in the electricity sector, but it is not directly applicable to the drinking water supply and sanitation sector, because there are generally no national or regional networks. In some cases, however, it is possible to create competition between regional

enterprises for big industrial or commercial clients or for the right to supply clients located on the edges of the companies' service areas.

Perhaps the main advantage of horizontal separation, even when it leads to local monopolies (unless there is no correlation in the cost conditions among them) is that it enables regulators to have access to information from a group of independent providers of comparable services. This provides a basis for comparisons between firms which are useful for setting incentives based on relative performance and hence creating opportunities for the application of more effective regulatory incentive structures based on comparable yardsticks or benchmarks. In addition, the existence of several companies opens up the industry to competition between them in the capital market.

Horizontal separation can also mean, however, that regulators are faced with the prospect of regulating and monitoring a considerable number of firms, which may cause serious administrative problems.

2. Vertical restructuring

Vertical restructuring concerns the integration or separation of the different processes needed to make the final product or service available to the consumer. A typical example of vertical separation is the division of a State-owned electric power utility into separate generating, transmission and distribution companies.

Although vertical integration in competitive markets often increases efficiency and social well-being, the vertical integration of monopoly firms can be a source of concern for regulators for various reasons:

i) Vertical integration can allow a natural monopoly to extend its monopoly power to non-regulated upstream and downstream markets by discriminating in its own favour or in favour of affiliated firms, increasing barriers to entry, and foreclosing competitors by such means as prohibitive network access charges or discrimination in other aspects of interconnection, and

ii) Vertical integration usually worsens the asymmetry of information between regulators and firms and impairs the quality of the information available to the regulator, thus hindering effective conduct regulation and providing opportunities for circumvention.

These considerations suggest that the regulator should try to identify the component or components of water resource infrastructure which establish a utility as a natural monopoly and attempt as far as possible to isolate those activities that may be described as an intrinsic natural monopoly from other activities or production processes that cannot be described as such. This separation seeks to prevent companies that integrate various production segments from using one of these to obtain undue advantages from others or from concealing inefficiencies by transferring profits earned elsewhere to them.

So far, vertical reforms of this type have been applied more extensively in the electricity sector, but they are not directly applicable to the drinking water supply and sanitation sector, where the scope for increasing competition through vertical structural reforms is extremely limited if not non-existent, because of the strength of the natural monopoly conditions deriving from the established local networks of water mains and sewers. The obstacles are the need for extremely tight coordination between the services, due to the interrelated demand, the high costs of service delivery in relation to the costs of water production or wastewater treatment, and the fact that the experience gained and the equipment used in one activity is useful in the other.

3. Diversification of regulated firms

The diversification of any firm has many advantages, since it makes it possible to spread risks, compensate

for fluctuations in demand, make better use of the firm's capacity, and secure other benefits which can be reflected in lower costs and better service.

In spite of its potential benefits, however, the diversification of regulated firms can be a source of concern for regulators for several reasons (Armstrong, Cowan and Vickers, 1994):

i) Difficulties in the unregulated activity could negatively affect the regulated firm's ability to raise capital and operate its core business;

ii) Diversification of a firm makes estimation of the cost of capital more difficult, and if the firm diversifies into a riskier business this might raise that cost;

iii) The operation of the non-core business might consume excessive amounts of the time and resources of the regulated firm's management.

Diversification of a regulated firm can also worsen the asymmetry of information between the regulator and the firm and reduce the regulator's ability to implement benchmark competition, by reducing the number of available comparators. It also allows scope for cross-subsidization through transfer pricing in intra-company transactions.

For these reasons, the authorities should be alert to the impact of the diversification of regulated firms, although it would not be appropriate to prohibit diversification entirely, since it can give economies of scale and scope and open up the possibility of reducing costs. An important question is how to structure the regulatory system to take advantage of the positive aspects of diversification while avoiding its undesirable effects. The main point is to ensure transparency of transactions between regulated and unregulated activities, to avoid cross-subsidies, and to guarantee access by the regulator to the information he needs to fulfill his objectives.

VI

Regulating public utilities in Latin America and the Caribbean: the present situation

Almost all the Latin American and Caribbean governments have adopted policies to increase private sector participation in the provision of drinking water supply and sanitation services. The actual nature of these policies varies greatly from one country to another. Only a few of them have opted to completely transfer the administration of these services to the private sector, generally in the form of concessions, as in Argentina and Bolivia. Elsewhere, as in Chile and Venezuela, decentralization and regulation within the public sector has been the policy adopted, with private sector participation limited to contractual service arrangements of a more technical nature.

As regards regulatory policy, however, the Latin American and Caribbean countries have two clear priorities: the development of effective regulatory capacity and the establishment of the independence of regulatory authorities, which should be free of direct political interference. At the same time, it is necessary for those defining regulatory policy to be absolutely clear as to what the real objectives of such policy must be.

It is not easy to develop a regulatory system, and it has been necessary to formulate systems which can rapidly incorporate the lessons of experience, since it is impossible to predict all problems from the start. The main obstacles are lack of experience and a relatively steep learning curve. It is for this reason that the functions of the regulator must be clearly defined and strictly limited to the absolutely necessary. In

general, this is why price regulation is the preferred basic approach, leaving other decisions to the managers of the utilities. Regulation of service quality has its own intrinsic importance, however.

Adequate information is of paramount importance for effective regulation. The most promising path for the countries of the region to formally address the problem of asymmetric information seems to be some form of benchmark competition. The advantages of benchmark competition are part of the case for having a horizontally separated rather than national structure in water supply and sanitation services.

The effect of regulation on social welfare depends critically on the investment behaviour that it induces in regulated firms. In general, there is no shortage of capital in the world for investment in this sector; on the contrary, it is perfectly possible to set a flow of investment in motion, as shown by the example of the electric power sector. For this to take place, however, potential investors need government commitment not only to respect their property rights over the long run but also to create a stable regulatory environment that will encourage and maintain private investment in water-related services. As already noted, the only secure route to private sector confidence is a history of rational government committed to policies that encourage private investment in public services.

(Original: English)

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Quality management

promotion to improve

competitiveness

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The author aims to demonstrate the importance of quality issues in national strategies for increased productivity and competitiveness in Latin America. Quality is an important factor in today's increasingly globalized and liberalized markets, and the application of quality management techniques is therefore considered to make a positive contribution to the competitive performance of countries, economic sectors and individual organizations. Since competitiveness contributes to sustainable development, the widespread diffusion and implementation of quality management seems desirable from a national point of view. In recent years, Latin American governments have shown a growing tendency to establish programmes that promote and support the diffusion of quality management techniques. Thus, quality issues will play an increasingly important role in the social and economic development objectives of the countries of the region. The implementation of total quality management (TQM) innovations has not proved to be easy or rapid, however: for example, in Latin America the diffusion of the ISO 9000 standards for quality systems has been less rapid than in most other regions of the world. In the author's view, the level of quality awareness in the region has been limited by market considerations, the difficulties of enterprises in gaining access to resources, traditional management practices, and conditions at the macro level. These obstacles can be associated with market failures that occur within companies, between companies and in factor markets. Various governments have therefore chosen to promote quality management techniques in order to adjust to the relevant market failures. The article concludes with an overview of the activities that have been carried out in selected Latin American countries to enhance the diffusion of ISO 9000 quality management systems.

I

Introduction

Quality refers to the totality of features or characteristics of a product or service that bear on its ability to satisfy stated or implied needs. Therefore the implementation of quality within an organization requires the internalization of the concept of "consumer satisfaction". Moreover, as quality failures and defects can have substantial adverse effects on an organization's resources and performance, the implementation of quality management will involve the "continuous improvement" of all the organization's activities that affect quality. The results of continuous improvement may be improved product quality, less waste or reworking, or improved secondary labour conditions. Furthermore, the provision of quality assurances to clients has become a concept that has evolved from final product inspection, to operational process control, to quality control in the product or process design phase. Therefore, the implementation of quality control involves the overall management of an organization rather than being a secondary problem of specialized departments.

Total quality management (TQM) is a management philosophy that aims to achieve improved enterprise results through the realization of objectives

related to consumer satisfaction and continuous improvement. Among other aspects, TQM emphasizes measurement and monitoring, improved cross-functional communication and external relations, quality assurance and human resources development (Rauter 1995). In order to establish both effective (consumer satisfaction) and efficient (continuous improvement) organization, a wide range of quality management techniques have been developed and applied that incorporate these TQM principles, which can guide the implementation of the different quality management techniques.

Quality has become a major factor among the competitive pressures existing in today's increasingly globalized and liberalized markets, and the application of quality management is considered to make a positive contribution to competitive performance. Competitiveness may be defined as the ability of a country or organization to generate proportionally more wealth than its competitors in world markets, as noted in *World Competitiveness Report, 1995*.¹ In the next two sections, various aspects of quality management and competitiveness will be discussed at the national, sectoral and enterprise levels.

II

Quality management and competitiveness at the national and sectoral levels

At the national level, competitiveness may be analysed according to the approach used in the *World Competitiveness Report*. In the 1995 version of this report, a list of 48 countries is presented, classified by the various factors that influence a country's international competitiveness, such as strength of the domestic economy, appropriate government policies, infrastructure, etc. In accordance with the methodology used in the report, quality aspects are primarily presented within the "management" factor (i.e., the extent to which enterprises are managed in an inno-

vative, profitable and responsible manner), and to a lesser extent within the "science and technology" and "people" factors (scientific and technological capacity, together with the success of basic applied research; and the availability and qualifications of human resources). Therefore, quality may be identified as a factor that contributes to a country's com-

¹ World Economic Forum, International Management Development Institute, 1995.

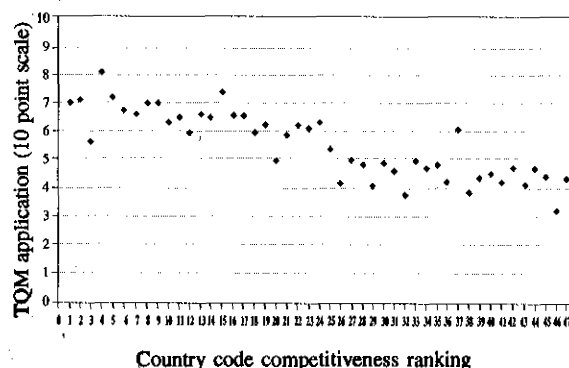
petitiveness.² For example, quality management techniques have been identified as being an important factor in the economic success of Japanese companies, by making their production more flexible, productive and more competitive.

Figure 1 shows the relation between TQM and competitiveness. The numbers on the horizontal axis correspond to the countries' place in the overall competitiveness ranking presented in the *World Competitiveness Report 1995*. Executives in each of the participating countries were asked to rate the use of TQM in their respective country on a scale from one to ten. The results are reflected on the vertical axis. The overall tendency (linear mean) of the relationship between TQM and competitiveness indicates that TQM practices are increasingly applied as the countries are rated more competitive.³ The non-linear relationship between competitiveness and TQM is assuredly due to the fact that TQM is not the only factor that determines international competitiveness.

The improved aggregate competitive performance of the economic sectors of a country is not limited to individual firms in those sectors. It also depends on the application of quality management within entire production and/or commodity chains. For example, the competitive performance of a company will be influenced by the competitive performance of its suppliers and other subcontractors (consisting of backward and forward linkages in the same or connected sectors) and its degree of communication with them. Competitive industrial development theories therefore place emphasis on the promotion of intra-firm reorganization and the establishment of enterprise networks. The Organization for Economic Cooperation and Development (OECD) notes that the economic success of such enterprise networks has not come about through advantageous access to low-cost factors of production, cheap labour, capital and/or land but rather through particularly effective social and economic organization of those networks (OECD, 1993).

² In order to determine how far quality contributes to competitiveness, the author has analysed the tables in the *World Competitiveness Report* and has estimated that factors associated with quality management account for about 12% of the overall calculation of the competitiveness ranking of countries. It should be noted that this figure is the result of a very rudimentary exercise and is purely indicative.

FIGURE 1
TQM and competitiveness



The TQM principles that seem especially relevant for achieving the internalization of quality issues in the production chain are: communication and dissemination of information, measurement and monitoring, and compliance with quality assurance standards.⁴ In order to face increased global competitiveness pressures large companies determine their core business areas (according to their competitive advantages) and then often subcontract or outsource all other activities. Hence, as large companies become more dependent on suppliers they look for reliability, improved communication and long-term relationships with the latter. The internalization of quality management within the production chain can result, *inter alia*, in reduced transaction costs and increased flexibility and quality innovations throughout the economic sector in question, thereby contributing to increased sectoral competitiveness. For example, Xerox (copying machines) trained selected suppliers in statistical process methods and operational quality management techniques. As a result, over a period of two years net production costs went down by 10%, the proportion of products not conforming to specifications decreased by 93%, and the costs and time needed for the development of new products were reduced by 50% (Burnt, 1990).

³ The names of the countries corresponding to the numbers in figure 1 may be found in World Economic Forum, International Management Development Institute, 1995, or in Schuurman, 1997a.

⁴ The contribution of quality issues to the competitiveness of industrial sectors can be determined through the competitiveness analysis methods developed by Porter (1980).

III

Quality management and competitiveness at the enterprise level

The crucial issue determining the competitive success of a company is its ability to integrate the results of quality improvement (crucial for consumer satisfaction) with profitability (the management's concern). In open economies, companies that are relatively more competitive than their rivals expand their market share because consumers are satisfied with specific characteristics of their products or services.⁵ Consumer satisfaction may be associated with (one or more) of the following elements of an organization's products or services (Pandora, 1989):

i) *A reasonable price*: The price of the product should be in line with the need the client has for the product.

ii) *A good product*: The quality of the product needs to be reliable or conform to predetermined specifications.

iii) *A reasonable delivery time*: The client needs to have the product within a certain time frame, otherwise it has no value for him.

iv) *A unique product*: Everybody wants a product or service that is just a little bit different or that exactly meets his individual needs. This requires that manufacturers be capable of meeting this demand for product diversity.

v) *A new product*: Consumers change old products, even though they may have the above characteristics, for products that are better, faster, in fashion, more modern, stronger, contain the latest materials, etc.

Hence, the competitive performance of companies in (global) consumer markets will be determined by their capacity to simultaneously deal with such factors of competition as efficiency, quality, delivery time, flexibility and innovation (Fleury, 1995; Maas,

1992; Pandora, 1989).⁶ As we shall see below, quality management techniques may be applied in each of these areas of competition. To put it simply, competitiveness at the enterprise level may be nothing more than applying the concept of continuous improvement to all those parameters that determine the relevant competition factors.

1. Efficiency: a reasonable price

As a competition factor, efficiency (price) requires that the production function –i.e., the mathematical relationship between quantities of inputs and outputs– operates as cost-efficiently as possible. For example, the optimization of capital and labour productivity has led to economies of scale where maximum efficiency is sought through minimal production costs per unit output. With regard to quality management and efficiency, attention could be given to –among other things– minimizing waste and the amount of products that do not conform to specifications, decreasing material and product waiting times (dead time), and reducing the amount of stocks (materials or products).

Various management concepts have been applied to achieve higher production efficiencies. Those developed at the beginning of the twentieth century, in which the production process is organized through a detailed division of labour, with each employee performing a specific sub-task along the assembly line, are particularly well known and widely used. Although this “Taylorism” or “Fordism” has led to large efficiency increases, it has also established a division between “doing” and “thinking” at the workplace. The organization of “thinking” has resulted in the extensive hier-

⁵ Consumer satisfaction is especially important in markets where supply exceeds demand. Global markets which are literally swamped with products and services put consumers into the position to choose.

⁶ It should be considered that even though the factors are discussed from their chronological evolution, they are highly inter-linked. For example, application of quality techniques and innovations can lead to increased efficiency, and decreased delivery time may be the result of improved flexibility.

archical pyramid of responsibilities and power relations that characterizes traditional management practices. Within this pyramid the product is passed on to the consumer through the different functional departments. In every department supervisors at different levels take decisions concerning their own functional responsibility, often without being concerned about the effects that those decisions can have on the performance of other departments, clients and other end-users. For example, a production department may be more concerned with achieving good unit production costs than with the losses that may be generated in storage because of over-production.

Lefiero (1995) estimates that within such functional organizational frameworks, the total duration of the product generation process up to the product's delivery to the end-user (also called lead time) is 100% to 200% greater than the real duration of the activities needed to perform the process. In other words, the dead time of a product can be 100% to 200%. Such inefficiencies have been well described by Hammer and Champy in their book "Reengineering the Corporation" (1993), in which a "fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical contemporary measures of performance such as cost, quality, service and speed" is proposed. Process redesign concentrates on major processes with cross-functional boundaries and goes beyond merely improving existing processes, as it continuously asks the question: "should we be carrying out this particular task, and if so, with what labour organization and participation?" Reengineering has evolved because the new skill requirements of the work force and rising consumer expectations have made the division between "doing" and "thinking" unworkable (MacDonald, 1995). A second factor often associated with reengineering concerns modernization through the application of modern information, (tele)communication and organizational technologies. Clearly, solutions for increased competitiveness must include both organizational and technical innovations.⁷

In order to achieve continuous improvement, most companies concentrate on internal processes and methods. However, benchmarking techniques may be used to determine the relative position of the

company as compared to rival companies which are applying the latest (quality management) innovations. There are two types of benchmarking. The "product-oriented" type addresses cost reduction through the evaluation of products and services, while "process-oriented" benchmarking examines production and management processes. In general, benchmarking involving the search for opportunities within the company's environment has resulted in efficiency increases and cost reductions (Zairi, 1996). If process-oriented benchmarking is applied within a culture of TQM it can lead to increased organizational efficiency along the lines of consumer satisfaction and continuous improvement.

The term "downsizing" refers to the discontinuation of specific functions or areas that are not part of the core competences or real competitive advantages of the enterprise. Due to competitive pressures, enterprises are specializing in what they do best and subcontracting related activities (outsourcing). The term "delaying" means reducing the number of hierarchical levels and, like downsizing and outsourcing, may result in increased efficiency and flexibility.

It should be noted that reengineering, actualization, downsizing, outsourcing and delaying often aim to secure increased efficiency through fundamental, radical and/or drastic organizational changes. The results may be visible in the short term, and reductions in personnel are common. However, it is reported that more than 30% of companies have failed to implement reengineering principles or to attain efficiency benefits (Champy, 1995). In the specialized literature, there is some consensus that reengineering principles should be combined with those of total quality management.⁸ In this respect, it is recommended that any organizational change should be accompanied by human resources development. This is crucial for ensuring proper understanding of the new organizational principles and technologies.

2. Quality: a good product

Total quality management principles can provide guidance for the application of management practices relating to all the factors of competition mentioned above. This means that the TQM philosophy and

⁷ The present discussion will be limited to the first of these aspects. However, many organizational innovations will have consequences for technical innovations, and vice versa.

⁸ See, for example, MacDonald (1995) and Lefiero (1995).

quality management techniques are at the very heart of enterprise-level competitiveness. A study made among 700 companies in Western Europe (KID, 1996) reports that companies which have effectively applied TQM principles are characterized by higher consumer satisfaction, increased personnel participation, greater quality awareness, cost reduction and improved business results.

Quality management generally implies the systematic planning, control and improvement of quality by designing an appropriate organizational structure for the application of quality management techniques, which may be referred to as a "quality management system". A system of this type involves a company's organizational and responsibility structure and the procedures, processes and resources for implementing quality management. The ISO 9000 international standards provide a number of different quality assurance models for quality management systems. For example, the ISO 9001 standard consists of 20 guidelines for a quality system, covering the design, production and final inspection phases. An objective, accredited third party may be responsible for verifying whether a system effectively complies with ISO 9001. Such quality system certification is given after a third-party certification audit. In general, both internal and external quality management audits are common practices. An ISO 9000 certified company can use that certification to promote its products or services among its clients, and the implementation of an ISO 9000 quality system should be viewed as a valuable intermediate step towards achieving TQM (*Q Review*, 1993). Within production chains or enterprise networks, ISO 9000 standards are in line with the demand for process-oriented quality assurance schemes. Various surveys among ISO 9000 certified companies indicate that about 65% to 75% encourage their suppliers and subcontractors to seek certification as well. These are some of the reasons why ISO 9000 may be associated with competitiveness (Schuurman, 1997a).

In view of the tendencies towards outsourcing, it is increasingly important that an organization should be able to assure or guarantee its clients that it is capable of conforming to certain predetermined quality standards. In seeking decreased transaction costs, quality assurance schemes have moved away from product-oriented approaches (final inspection) to quality management standards, of which ISO 9000 is the most popular. This reflects the assumption that

good quality process management results in good quality products (ISO, 1993), although this is not always true, as the standard does not guarantee compliance with absolute quality performance indicators or specifications.

Quality cost calculation structures may be established in order to control and evaluate an organization's effectiveness in seeking zero quality defects. The Activity Based Costing (ABC) technique may be a useful methodology for facilitating the establishment of quality cost calculation systems at the activity (process) level. Quality costs may be classified as the costs of prevention and quality assurance activities and the costs associated with internal and external faults. Optimal expenditure on quality hence involves balancing preventive and assessment costs, on the "costs of quality" side, against the estimated benefits deriving from the reduction of quality failures, on the "costs of non-quality" side (Van de Broek, 1991).

It has been reported that expenditures on the establishment and maintenance of quality management systems (classified as preventive and assessment costs) help to reduce the costs due to unacceptable quality. For example, it is estimated that in medium-sized to large companies the cost of ISO 9000 quality system implementation and certification is roughly between 0.5% and 1.5% of their total turnover, whereas the reported tangible quality cost savings and reductions, as a percentage of turnover, are several times greater (Schuurman, 1997b). An advantage of establishing quality cost calculation structures is that they can show tangible results which can be used to justify and facilitate the implementation of (new) quality management techniques. Another type of quality cost benefits may involve the quantification of the results of quality management. Such benefits may take the form of significantly improved product performance, conformity with specifications, durability and serviceability: all improvements that may lead to increased consumer demand and market share. These improvements may be termed "revenue enhancers", although it is difficult to ascribe them solely to quality management implementation (Winchell, 1987; Spitzer, 1993).

Some of the conclusions concerning quality cost issues cited in the literature are:

- i) Quality costs may account for a significant percentage of total turnover. A study in the Netherlands concluded that quality costs differ from one

industrial sector to another but averaged 10% of turnover. A study among 54 companies in France reports that quality costs vary from 5% to 23% of turnover (Van de Broek, 1991). The ISO estimates that the costs of poor quality in developed countries range from 15%-25% of turnover, while they are likely to be higher in developing countries (ISO/UNCTAD/GATT, 1993).

ii) Between 60% and 70% of quality defects detected on the shop floor are directly or indirectly attributable to errors in other areas such as design, engineering, purchasing, production, packaging, dispatch and transportation, although almost all traditional quality assurance activities (inspection) are directed to the shop floor (Nakamura, 1992).

iii) After taking actions for quality improvements (along the lines of TQM, preventive and assessment measures), quality costs may decrease significantly. In the Netherlands, companies have achieved savings that average 3% of total turnover (from 10% to 7%, see Van de Broek, 1991). It is estimated (TUV Rheinland Chile, 1995) that an organization can decrease its quality costs from 23% to about 6% during a period of 4-5 years: i.e., the time needed to implement a system of total quality management.⁹

The majority of the costs in the TQM implementation phase are associated with preventive and assessment activities, which are well compensated by the costs of quality defects (scrap, reworking, guarantees).

3. Reasonable delivery times

As well as providing the client with the right price, quantity and quality, short and reliable delivery times for products and services can be the next crucial factor in achieving better competitive performance for an enterprise. Especially in the case of clients who apply operational quality management techniques in the production process (such as Just In Time procedures), the delivery time for material supplies is very important and is often related to optimization of the logistic processes of the company which may have consequences for the lead time in functional areas other than distribution, such as production and new product and process development (see section 4

below). Choosing a suitable organizational structure, or the way (process) functions are grouped, is important in optimizing delivery times. For example, the organizational structure may be classified by the type of activity (function), product or service and/or geographical location.

Technical and statistical quality management methods are often used to control and improve logistical processes. Another technique involves the relocation of the client order supply point (COSP), which is the last important material supply point from which the client's order may be fulfilled. By relocating the COSP further upstream in the production system (closer to the final product), shorter and more reliable delivery times may be achieved (Pandora, 1989). Thus, for example, by locating the COSP at the "stock of main components", the final product may be assembled from these main components when client orders are received. Assembly time will then form the main component of delivery time. A more integral management concept that allows the management of time factors within an organization is "time-based competition" (Wildschut, 1993).

4. Flexibility: product diversity or uniqueness

Flexibility refers to the ability to deal with the increasing differentiation and volatility of markets. In the present discussion flexibility is associated with the capacity for the timely production of the right variety and quantity of products according to market demand. The incorporation of flexibility will have consequences for the organization, structure and planning of the production process, with efficiency, quality and delivery time as important parameters. Obviously, new products are not excluded from this approach, and therefore flexibility and innovation may be overlapping terms. Flexibility in the production process in order to respond adequately to market demands usually means shorter periods of adjustment, variations in the amount of inputs and cost-oriented strategies, while innovative flexibility normally involves longer adjustment periods, improved human resources, productivity gains and strategies oriented towards new products and processes (Reinecke, 1996).

Management of flexibility is important, because consumers demand large numbers of product families and varieties and moreover consumer demand fluctuates in time. This requires batch production, and the

⁹ For more details on the phases in the implementation of a total quality management system, see section IV below.

amount of non-productive hours in which installations have to be adjusted to produce new batches can be substantial. Fluctuating demand can be tackled by establishing stocks of finished products, but this solution may lead to high costs and risks, considering the large variety of products and rapidly changing market demands. As producers need to deliver their products to their clients promptly, control of the lead time in the production process is crucial. This requires management of the various types of flexibility, such as:

- i) Product flexibility (the ability to change easily to produce different varieties of products);
- ii) Flexibility of the installed machinery (the ability to make different parts within a product family);
- iii) Process flexibility (the ability to produce a product family in different ways, for example by using different materials);
- iv) Volume flexibility (the ability to accommodate to changes in production volume efficiency);
- v) Functional flexibility (the ability of the employees to perform different tasks in order to make possible the above types of flexibility);
- vi) Numerical flexibility (flexibility of the number of employees on the payroll, overtime, flexible timetables, subcontracting); and
- vii) Flexibility of incentives (wage, promotional and bonus schemes to reward employees for their group or personal achievements).

There are various management techniques that can be applied to make the production process more flexible. These include, among others, just-in-time management (JIT), *kanban*, and cellular factory layout. JIT involves a form of organization of production that aims to produce the right quantity at the right time at the right quality. JIT is often thought of in terms of relations with suppliers, but internal JIT is probably a necessary precondition for external JIT. Internal JIT requires a reduction in lot sizes, and production is most efficient when flows of materials are simple and straightforward; it also requires a multi-skill and multi-tasking labour force. External JIT involves the establishment of subcontracting tiers that deliver in small lots, as well as coordination of government institutions responsible for implementing long-term economic and industrial policies (Japan).

Kanban is a form of inventory and production control using simple manual and clerical procedures.

Kanban utilizes the demand in the next production step as a pull system and operates best in an environment of steady demand and limited number of products. Cellular factory layout establishes "mini-factories" which, together, unify various processes and installations capable of producing a complete family of products (JIT and *kanban* procedures are often applied too). Clearly, these operational techniques involve increased responsibilities of the operators, and ensuring that workers are sufficiently skilled and trained is crucial to the successful implementation of these techniques (Vispo, 1994).

5. Innovation: new products

In recent decades, companies that operate in global markets have competed successively in terms of price, quality, delivery time and flexibility. In view of the tendencies towards larger and more open markets and increased consumer purchasing power, consumer demand in global markets is likely to shift to products that are of higher quality, more unique and incorporate the latest innovations. Moreover, companies will specialize in sub-markets through advanced technology and automation, resulting in more rapid ageing and depreciation of products and machinery. In the near future, it may therefore be expected that the determining additional competition factor in global markets will be innovation.

As already noted, markets are subject to rapid changes, shortening the life-cycle of products. Producers need to be able to rush changes onto the market by optimizing the amount of time needed to design, develop and launch new products or processes. For example, one indicator of innovation may be the proportion of products in the overall product spectrum which have been introduced to the market within the last two to four years (Kaplinski, 1995). The current meaning of design is coming increasingly close to that of product development: not only is it necessary to comply with technical and functional product characteristics, but the successful marketing of the product also needs to be assured. Such criteria are closely related to the wishes of the consumer and include aspects such as image, recognition and form. After taking the decision on a new product concept, almost 80% of the decisions subsequently taken concern production costs and use. Moreover, the R&D and design phases determine about 70% of the total quality costs involved later (Maas, 1992).

The rapid development of new processes and products depends to a large extent on the firm's capacity to benefit from its knowledge, both internally and within its direct surroundings. This means that ideas for improvement can come from almost anyone, including consumers, workers, suppliers, staff and managers. Innovation thus depends on the pro-active involvement of different functional areas and calls for the right balance between creativeness and control. On the one hand, rigid bureaucratic processes inhibit creativeness, but on the other hand, lack of discipline can lead to chaos and unprofessional attitudes. Innovation (R&D, product development) is often a long-term process that may involve considerable investments and bring fundamental structural organizational changes. This highlights the importance of the strategic planning of quality management innovations.

IV

Implementation of total quality management

In order to implement TQM, enterprises must formulate and implement strategies related to quality and must be able to adapt these strategies at any time in response to changing market, client and supplier conditions. The strategic planning of quality aims to guide performance along the entire value chain—from research and development (R&D) through production and marketing to after-sales services, both at the company and the inter-company level (Kaplinski, 1995): As discussed in the previous section, the concepts of consumer satisfaction and continuous improvement are the basis for competitive performance, which in turn may be broken down into the following elements:

- i) The definition of core competences and the maximization of capital and labour productivity (efficiency);
- ii) The pursuit of zero quality defects in organizational activities, services and products (quality);
- iii) The optimization of total lead time (delivery time);
- iv) The organization and control of production inputs and outputs to cope with diverse and fluctuating market demand (flexibility); and

In general, project formulation and quality management are the right instruments for controlling these processes of change and innovation. Quality function deployment (QFD) is a systematic planning method for integrating customer satisfaction into product and process development. Another similar technique that places emphasis on quality control in the design phase has been developed by Taguchi. Both are planning techniques that aim to identify essential design aspects and reduce manufacturing costs and lead time, securing better product quality at less cost. Both are often the responsibility of cross-functional product teams. Quality control circles (cross-functional and cross-hierarchical working groups) also seek to identify opportunities for innovation in a general sense and are not necessarily limited only to the design process.

v) The organization and control of product design and development in order to ensure timely responses and anticipate changing market conditions (innovation).

A possible company strategy for implementing different quality management techniques is presented in box 1. Basically, implementing TQM implies the pro-active application of the concepts of consumer satisfaction and continuous improvement in the most effective and efficient way. It may be seen from box 1 that the combination of reactive-reactive strategies implies low efficiency and little effectiveness (taking unnecessary measures in the wrong way). A highly efficient but ineffective organization takes unnecessary measures in the right way, while an effective organization with limited efficiency takes necessary measures in the wrong way. In contrast, a pro-active – pro-active combination would mean that the company meets specific quality and competition criteria both internally and externally (taking the necessary measures in the right way).

During the gradual implementation of TQM, organizations will be switching between the conditions shown in the second, third and fourth quadrants of

Box 1		
ENTERPRISE-LEVEL STRATEGIC PLANNING FOR THE IMPLEMENTATION OF QUALITY MANAGEMENT		
More effective		
	Reactive	Pro-active
Reactive	NO STRATEGY No quality system Quality costs unknown Traditional perception of quality * quality costs more * quality decreases productivity * quality means inspection	CUSTOMER SATISFACTION Inventory of clients' wishes Delivery time, JIT Quality assurance External audits Benchmarking Anticipation of new quality standards and prevention of technical barriers to trade External communication and dissemination of information in the production chain Diffusion of quality policy to the society at large
Pro-active	CONTINUOUS IMPROVEMENT Reengineering of core processes Delaying, downsizing, outsourcing Establishment of a quality system Training Delegation of responsibilities Statistical process methods Quality cost calculation structure Internal audits Optimization of lead time Just-in-time system, <i>kanban</i> Evaluation of suppliers	TOTAL QUALITY MANAGEMENT Systematic evaluation of quality performance Continuous readjustment of processes, products and services Reliable supplier base Teamwork Quality function deployment Quality control circles Leadership and dynamic quality culture Strong emphasis on human resources management Employee satisfaction Participation in quality prize schemes
More efficient		

box 1, depending on their internal resources and the relevant competition factors in the markets in which they operate. Internalization of consumer satisfaction often involves the reorganization of various departments concerned with key processes in the production system, which in turn requires increased cross-functional cooperation. Once this is established, the functional departments seek improved business performance and cost efficiency through the application of management tools that enable the continuous improvement of their activities. The driving force for sustaining the total quality process is the development of an appropriate culture within the organization. This emphasizes the importance of leadership by the management in promoting the total quality culture and the implementation of such leadership through a quality strategy (Technovation, 1994).

According to a survey among 700 Dutch companies (Dutch Institute for Quality, 1996), companies

may be classified in different phases, according to the extent or orientation of their quality management efforts:

Phase 0: Non-existent or limited quality management.

Phase 1: Product-level management (inspection of product quality).

Phase 2: Process-level management (management of quality aspects in processes pertaining to the different functional areas).

Phase 3: Systemic quality management (management of integrated quality systems, such as ISO 9000).

Phase 4: Production chain quality management (quality management regarding clients and suppliers).

Phase 5: Total Quality Management (integration and simultaneous application of all the above quality management phases).

V

The importance of quality management, and the obstacles to its implementation

The European Commission (1995) has classified quality awareness in Japan and the USA as "excellent" and "good", respectively. This is confirmed by the main findings of a study (American Quality Foundation, 1991) on the quality management practices applied by more than 500 firms in North America, Japan and Germany. This study reported that:

- i) More than 50% of the firms studied evaluate the business consequences of their quality performance at least monthly;
- ii) 40% of the companies attach prime importance to customer satisfaction in strategic planning;
- iii) 30% of United States and Japanese companies attach prime importance to analysis of their competitors' performance (benchmarking);
- iv) 90% of Japanese and 25% of United States companies continuously reengineer their production or service processes; and
- v) All companies view cross-functional quality teams as the best way of increasing employee involvement.

In most European countries, quality awareness is classified as insufficient. A survey made by the Dutch Institute for Quality (1996) reports that 45% of the 700 companies studied focus their quality strategy on the primary process and related subprocesses. Very few companies are concerned with social objectives and do not seek process improvements through communication with clients and suppliers. According to the survey 70% of the companies are positioned somewhere in phase 2 or 3 of the quality management classification given in section IV above. Only 2% of the participating companies consider that they have achieved total quality management, while 13% are in phase 4. The remaining 15% are in phase 0.

In practice, it is difficult to embody quality issues firmly in company strategy, principally because of the difficulty of defining tangible objectives relating to the implementation of quality management issues. Also, the implementation of organizational innovations such as TQM is less systematic than in the case of technological innovations, because the imple-

mentation of quality management techniques involves changes in personnel attitudes and relations, affects almost everybody in the organization, changes the structure of responsibilities, requires a high level of management commitment, and leaves room for different interpretations. The application of quality management techniques therefore involves complex and far-reaching organizational innovations and is often carried out in a sequential manner. It consists of a learning process of a gradual and cumulative nature. Therefore, it may be observed that most companies which have introduced quality management have done so through trial and error and have progressed through a steady build-up of capabilities, beginning in specialized areas and later extending to company strategy and external relations (Fleury, 1995).

In the light of the TQM ranking presented by the *World Competitiveness Report* and the small number of companies with certified ISO 9000 quality systems¹⁰ (1% of the total; see also table 1), it may be concluded that the application of integral quality management techniques and the average level of quality awareness in Latin America is limited or occasional. In order to understand some of the factors underlying this, the obstacles to the implementation of quality management in Latin America will be discussed below.¹¹ The main question in the current discussion is whether the widespread use of quality management practices is only a matter of time, since there is a sequential process of learning involved, or whether there may be a variety of specific factors which inhibit the systematic implementation of quality management techniques.

¹⁰ The amount of ISO 9000 certificates in a country is assumed to indicate a tendency towards the adoption of quality management techniques (Schuurman, 1997a).

¹¹ The information presented here is taken from Fleury (1993 and 1995), Humphrey (1993 and 1995) and Kaplinski (1993 and 1995), unless otherwise stated.

TABLE 1

**Selected regions and countries: Companies
with certified ISO 9000 quality systems**
(Number of companies and percentages)

Region/country	January 1993	June 1994	March 1995	December 1995	Percentage
United Kingdom	18 577	36 832	44 107	52 591	41
<i>Continental Europe:</i>	4 515	18 577	27 810	40 019	31
Germany	790	3 470	5 875	10 236	
France	1 049	3 359	4 279	5 535	
The Netherlands	716	2 718	4 198	5 284	
Italy	188	2 008	3 146	4 814	
Spain	43	586	942	1 492	
<i>North America:</i>	1 185	4 830	7 244	10 159	8
United States	893	3 960	5 954	8 762	
<i>Pacific:</i>	1 862	4 628	6 479	10 526	8
Australia	1 668	3 710	5 299	8 834	
<i>Asia:</i>	692	3 421	6 568	10 278	8
Japan	165	1 060	1 827	3 762	
Newly industrialized countries ^a	382	1 561	3 004	3 892	
India	8	328	585	1 023	
China	10	150	285	507	
South East Asia ^b	4	59	229	370	
<i>Africa/Middle East:</i> ^c	954	1 705	2 286	2 340	2
South Africa	824	1 161	1 369	1 454	
Israel	110	279	497	526	
Saudi Arabia and the United Arab Emirates	7	65	108	202	
<i>Latin America</i>	39	533	873	1 440	1
Brazil	19	348	548	932	
Mexico ^d	16	85	145	215	
Total	27 824	70 526	95 367	127 389	

Source: ISO 9000 News, 1996.

^a The percentages of certificates issued up to December 1995 were: Taiwan, 35%; Singapore, 30%; Hong Kong, 19%, and South Korea, 16%.

^b The percentages of certificates issued up to December 1995 were: Thailand, 39%; Indonesia, 34%, and Philippines, 27%.

^c The majority of the certificates have been issued in South Africa (62%), Israel (23%), Saudi Arabia (4%) and United Arab Emirates (4%).

^d It is estimated that by 1998-1999 approximately 225 000 ISO 9000 certificates will have been issued.

1. Trade and market considerations

With the abandonment of import substitution practices by most Latin American governments in the late 1980s, international trade increased together with the amount of foreign direct investment. The resulting competitive pressures from international markets have brought a need for organizational and technological innovations. A sizable proportion of trade is within the region itself. In spite of the existence of various regional free trade agreements, the demand for formal quality management systems has been limited to certain countries and industrial sectors. This indicates that quality management and assurance in intra-regional trade is still of the product inspection type and has not (yet) been formalized along the lines of more process-oriented types of quality assurance such as ISO 9000.

Most of the consumers on domestic markets have low purchasing power and base their purchasing decisions on considerations of price rather than product quality. In those domestic markets where demand for consumer goods exceeds supply, almost anything sells. Because of the low levels of education, consumers' knowledge of quality and its implications is limited. Furthermore, the absence of international competition as a result of protectionist measures in the past has hindered the growth of national quality cultures, although the quality of imported goods is often greatly admired both in consumer and industrial markets. The current more open market regimes mean that domestic producers face competition from such imports, resulting in greater attention to quality issues (ISO/UNCTAD/GATT, 1993).

2. Companies' access to resources

Generally speaking, the lack of adequate resources and the lack of quality awareness at the enterprise level are the principal obstacles to the widespread implementation of quality management techniques in Latin America. While multinationals, national economic groups and large State-owned enterprises have access to the necessary resources, this is undoubtedly more complicated in the case of small and medium-sized enterprises (SMEs), especially in times of macroeconomic instability. Stable macroeconomic conditions facilitate the definition of long-term company competitiveness strategies, foreign investment flows and investment in the modernization of equipment. Macroeconomic instability and high inflation, in contrast, limit the private sector's ability to engage in medium and long-term planning and often result in high interest rates. Related cuts in training activities and work force numbers undermine the motivation of employees to participate in the implementation of quality management, if indeed it is implemented at all.

Domestic market pressures on small and medium-sized supplier firms to apply quality management techniques generally come from their clients, through the production chain. Thus, for example, SIDERAR (a basic metals subsidiary of a large national economic group in Argentina) evaluates its suppliers according to their financial stability and their level of technological modernization (50%) and use of quality management techniques (50%). With regard to the latter, SIDERAR may require ISO 9001 or ISO 9002 certification, depending on the type of supplier and its importance to the company's activities (Schuurman, 1997b). However, many SMEs tend to be product-driven rather than marketing-led, and therefore the focus on the customer and service quality may be secondary. In SMEs, quality system documentation is rarely seen as a priority and is often poorly organized. This leads us to conclude that their knowledge of the production function is very makeshift. Therefore, the SME sector could greatly benefit from the implementation of an ISO 9000 quality system, since these standards allow for a better definition of operational routines (Schuurman, 1997b and Ramos, 1995).

A study among SMEs in Brazil indicates that many firms and industries in traditional sectors lack the internal capacity needed to conform to the pressures for quality assurance exerted by their clients. Another survey in Brazil, carried out by the Brazilian

Micro-enterprise Support Service (SEBRAE) in 1994 among 35 small, 38 medium-sized and 37 large firms certified or in the process of certification under ISO 9000 reported that 85% of the small, 75% of the medium-sized and 55% of the large companies reported difficulties in obtaining the resources needed to implement the ISO 9000 quality system. Moreover, 80% of the small, 45% of the medium-sized and 25% of the large companies needed to rely on external consulting services (ABNT (Brazilian Technical Standards Association), 1996). Another survey made in Brazil (INMETROMICT, 1996) among 592 ISO 9000 certified companies reported that an average of 55% used external consulting services, while in small companies (less than 100 employees) this percentage was 70%.

3. Traditional management practices

The limited level of quality awareness in Latin America may be associated with the predominant application of traditional management practices resulting in employee resistance to change, lack of management commitment, and limited human resources development.

The introduction of quality management techniques will often require the reorganization of former responsibilities and power structures. Traditional labour practices (authoritarian attitudes, detailed division of labour) represent an obstacle to the more horizontal-oriented type of organization in which employers grant employees greater confidence and responsibilities. Even though organizational innovations can lead to improvements in production, the resistance of middle and senior management in different departments can be a major obstacle to the timely implementation of quality management. This may result in inconsistent implementation arising from the partial visions of specialized departments. This is why it is so crucial that top-level management should strongly support the implementation of a quality-oriented approach. In this respect, in most companies that have not been able to implement quality management, the problems can be traced to an inadequate commitment from the top management to provide the necessary leadership, or to the failure to give this objective sufficient attention and the necessary resources: in other words, quality management has been given a low priority and considered as a part-time activity.

It is important that workers should understand their new responsibilities and be skilled to work with the new quality management techniques and technologies. Companies will have to meet these demands through the initiation of training and human resources development programmes. Employment practices in Mexico reveal that skill formation is often taken care of by hiring young, motivated employees who are then trained extensively on the job (Shaiken, 1994). Studies made in Brazil, however, indicate that although efforts to improve quality and productivity have achieved higher efficiency and better management practices, they have often failed to promote labour involvement and participation because of, among other things, limited training for direct production workers. On the other hand, employers are faced with high training costs due to low educational levels and high turnover rates in SME labour markets.

4. Macro-level analysis

There are various factors at the macro level which may have inhibited the diffusion of quality management techniques in Latin America. Among such factors which will be briefly discussed below are insufficient institutional support and capacity, inadequate supplier/subcontractor networks, labour issues and cultural factors.

Evidence from, for example, Japan, Great Britain and Sweden indicates that the diffusion of quality management practices requires a certain institutional network. In these countries, industrial and employer associations, research institutes, and government agencies at the national and meso-levels have provided the financial resources, technological support and information needed to support the diffusion of quality management techniques. The existence of such institutional support varies greatly between the different Latin American countries (and also between different regions of countries). In many cases, the establishment of an institutional framework requires the support of governments.

The application of quality management techniques requires suppliers to change traditional delivery practices and deliver reliably in small batches of guaranteed quality, as any quality defects in buffer stocks will lead to delay. External subcontractors and suppliers of utilities may not be able to conform to the demands of the new production methods of the

client company. In Brazil, for example, there are supplier firms which seem to have adapted to a sophisticated level of quality management in the auto parts manufacturing sector. They are often subsidiaries of international companies that strongly support such changes. The client firms frequently assist in the implementation of quality programmes, often with a strong emphasis on technical and operational aspects. These companies mention that full implementation of operational quality management practices (such as JIT) has not been possible because large suppliers of materials and utilities (such as steel and electricity) could not guarantee quantity, quality and reliability of delivery. In addition, a sufficient level of physical infrastructure is required to operate and promote a dynamic and flexible supplier network.

Conditions in labour factor markets play an important role in the adoption of quality management: because this requires multi-functional workers, flexible production and innovation at the plant level, the responsibilities and tasks of direct production are enlarged. In Latin America, employers have been reluctant to invest in training programmes for direct production workers and have also been hesitant to improve wages and promotion opportunities, even though these have been identified as crucial factors for facilitating the commitment of those workers. In view of the importance of labour issues within quality management there seems to be scope for increasing the active involvement of labour organizations.

5. Cultural aspects

Brache (1988) describes the human performance system as one in which the individual receives input, produces output, and then adapts his performance in line with the consequences or feedback received. The quality of an individual's performance is affected by four factors. First, the input an individual receives affects the quality of his work. This input includes the clarity of performance expectations, the logic of work procedures, the sufficiency of skills and knowledge, and the clarity of signals (incentives) that trigger performance. Second, the positive and negative consequences of performing desired or non-desired tasks affect an individual's work. Third, an important role is played by the quality of the feedback an individual receives: the information given; when and how often it is provided; the manner in which it is given, etc. Finally, an individual's

physical, mental and emotional capacity to perform his functions affects the quality of his work.

The establishment of a "quality culture" in an organization, then, involves clarity of company strategies and working procedures, quality awareness, and communication. In Latin America, standardization of quality issues and in-company training have been given low priority and quality awareness in general has been low; traditional management techniques have resulted in command-control communication based on hierarchy, and reward and incentive mechanisms have been limited and often not available at all to much of the work force. However, it would be hard to prove that these aspects are inherent to Latin American cultures or cannot be changed. In general, the cultural factors prevailing in societies or regions are not considered to inhibit the applica-

tion of quality management techniques, because: i) almost all of the particular TQM practices have been successfully transferred between different countries and cultures, and ii) a variety of incentives have been used to support the implementation of quality management techniques (lifetime employment, payment and promotion schemes, etc.).

This indicates that quality awareness within an organization is facilitated by reward or incentive schemes, whose specific features may depend on the cultural environment. Culture should rather be viewed as a dynamic concept that is interdependent with economic, technological, social, political and existing cultural conditions that may have a significance at both the macro and micro levels. Therefore, an adequate "quality culture" may be developed by establishing the right mix of these conditions.

VI

Market failures and government programmes

From the above discussion, it may be concluded that even though quality management techniques have proved that they can enhance the productive and competitive performance of companies and even countries, the market mechanism alone cannot always ensure the timely and widespread diffusion of new forms of production management and organization. For example, the diffusion of ISO 9000 standards through the market mechanism has been limited, and only certain sectors and companies have adopted them (Schuurman, 1997a). Some argue that this may also indicate the efficiency of the market. However, the limited levels of quality awareness observed in SMEs may ultimately affect competitiveness and limit the options for sustained economic growth and employment. Furthermore, as mentioned in the previous section, certain implementation obstacles at the macro level emphasize the importance of government involvement in promoting the use of quality management techniques among a broader range of economic agents.

Basically, market failures can occur within organizations, between organizations and in factor markets (Lall, 1995). Box 2 shows the impact and nature

of various market failures and gives examples of possible government intervention to correct them. It may be assumed that government policies and strategies that aim to eliminate these market failures will tend to enhance the rate of diffusion of quality management instruments. Thus, for example, the governments of Japan, the United States, Brazil, Great Britain and the Netherlands have implemented competitiveness and productivity strategies which provide for the diffusion of quality management, and at the regional level a European Quality Promotion Policy has been drafted (European Commission, 1995). In the Netherlands, the Ministry of Economic Affairs estimates that an average of 15% of the total turnover of the economy is lost due to redundancies and that US\$ 1.2 billion is lost through internal quality failures annually (Dutch Institute for Quality, 1996). Investments in government programmes to reduce these figures may thus be well worth while.

Such programmes often include specific activities concerning the diffusion of the ISO 9000 standards. From a policy point of view, the ISO 9000 guidelines provide a clear, systematic and enforceable way to implement quality management and con-

Box 2
MARKET FAILURES AND EXAMPLES OF GOVERNMENT INTERVENTION
AIMED AT DISSEMINATING QUALITY MANAGEMENT TECHNIQUES

<i>Type</i>	<i>Market failures</i>		<i>Government programmes</i>	
	<i>Impact</i>	<i>Nature of problem</i>	<i>Example of interventions</i>	
A. Within organizations	Little diffusion of quality management, especially within SMEs (insufficient widespread adoption of technological and organizational innovations).	Application of traditional management techniques; limited quality awareness. Limited access to resources. Insufficient capacity to implement quality management. Limited demand for quality assurance schemes in the production chain.	Dissemination of information. Facilitation of access to technology, skill and capital factor markets (see type C). Improvement of institutional capacity and support structure. Promotion of inter-firm and institutional linkages (see type B).	
B. Between organizations	Insufficient use of quality management techniques throughout the production chain or in enterprise groups.	Undeveloped inter-firm relations. Inadequate capacities of supplier and subcontractor infrastructure. Insufficient institutional support for the diffusion of organizational innovations.	Promotion of quality management and quality assurance in enterprise networks. Use of the purchasing power of large (State-owned) organizations for supplier preference schemes. Promotion of linkages between relevant institutions (academic, economic, labour, export, technological, etc.).	
C. In factor markets				
1. Technology	Insufficient technical capacity and support.	Limited investment in metrology and R&D.	Upgrading of capacity of standardization and metrology institutes. Promotion of relevant R&D.	
2. Skills	Insufficient human resource capacity and support.	Insufficient investment in human resources.	Stimulation of relevant human resources development (academic, auditors, consultants, in-firm).	
3. Capital	Limited access to financial resources needed to implement quality management techniques.	Commercial loans not viable (high risk and interest rates).	Establishment of economic incentives.	
4. Product	Limited recognition of quality assurance schemes in domestic and international markets.	Limited institutional harmonization and standardization of quality issues.	Establishment of quality assurance schemes that are recognized among trade partners (e.g., auditor and consultant registration schemes).	

Source: For a detailed description of government programmes, see Schuurman, 1997b.

tribute to harmonization of quality in trade issues. In the United Kingdom, for example, a funding programme assisted smaller firms with the cost of engaging external ISO 9000 consultants, and between 1988 and 1994 companies with 50 employees or less could obtain reimbursement of up to 50% of consultancy fees. Clearly, this has been a very important

contributory factor in the large number of ISO 9000 certificates in that country (see table 1).

1. Government programmes in Latin America

The key challenge for Latin American governments is to promote industrial growth on the basis of rapid

TABLE 2

Brazil: Progression of Total Quality Management Indicators^a

Indicator	Brazil 1990	Brazil 1993	USA and Europe	Japan
Rejections (defective parts per million)	23 000-28 000	11 000-15 000	200	10
Reworking (% of products returned for reprocessing)	30	12-20	2	0.001
Technical assistance expenses (% of sales)	2.7	2.0	0.1	< 0.05
Average delivery time (days)	35	20	2-4	2
Average lot size	1000	100-250	20-50	1-10
Inventory rotation (times per year)	8	8-14	60-70	150-200
Setup time (in minutes)	80	30-40	10	5
Machine downtime (as % of time idle)	40	21	15-20	5-8
R&D expenditures (as % of sales)	< 1	1-2	3-5	8-12
Training (% of working hours/employee/year)	< 1	< 1	5-7	10
Hierarchical levels	10-12	4-8	7	3

Source: IMAM Consultaria Ltd., cited in Frischtak, 1995.

^a Evaluation of the Brazilian National Quality and Productivity Programme from 1991 to 1994.

productivity increases in order to reduce the competitiveness gap with developed countries. In this respect, it is estimated that average total factor productivity in Latin America is 2 to 3 times lower than in the latter countries (Ramos, 1996). The governments of Brazil, Chile, Costa Rica and Mexico have also formulated and implemented programmes to promote the diffusion of quality management techniques, although these programmes have not yet been as extensive as in some of the countries of the European Union, except in the case of Brazil, where the National Quality and Productivity Programme was initiated in 1990 in order to establish a set of activities to induce industrial modernization. The Programme is coordinated by a national commission set up for the purpose and is being implemented by a large number of different ministries, institutes, business associations, State and private sector enterprises, etc. The Programme includes various activities related to raising quality awareness, disseminating quality management techniques, human resources development, improvement of quality-related technical services, and institutional articulation, as well as some selective sectoral activities (Government of Brazil, 1991).

In synthesis, the methodology of the National Quality and Productivity Programme involves:

- i) An analysis of the economic environment, with an assessment of systemic and internal constraints on the competitive behaviour of industry and the diffusion of quality management techniques;
- ii) The establishment of baseline quality and productivity indicators and the definition of sectoral and global benchmarks for the country;

- iii) The design of a campaign to sensitize society and opinion-makers to the importance of quality management techniques for the country, and the costs associated with waste and low productivity;

- iv) Upgrading of the institutional organizations involved in the diffusion of quality management techniques;

- v) Targeted dissemination of general information, followed by a massive training effort; and

- vi) Definition of financing mechanisms to promote the widespread adoption of quality management techniques (Frischtak, 1995).

In order to evaluate the Programme, two comparative surveys were made of 950 firms in 1990 (year one of import liberalization and the initiation of the Programme) and in 1993. With the exception of the indicator referring to training, all the indicators (presented in table 2) show some degree of improvement over this three-year period. The data indicate, however, that there is still a gap in average key productivity and quality indicators between Brazilian firms and international practice.

In view of the limited diffusion of the ISO 9000 standards and the market failures indicated in box 2, it is proposed that an ISO 9000 programme should include the following elements:

- i) Dissemination of information in order to create quality awareness among a broad range of economic agents and change traditional management perceptions of the importance of quality;
- ii) Support for enterprises, by facilitating their access to technical, capital and human resources factor markets;

Box 3
LATIN AMERICA: OVERVIEW OF NATIONAL ISO 9000 PROGRAMMES IN SELECTED COUNTRIES ^a

Country	Formal quality and competitiveness policy document or programme	Dissemination of information on ISO 9000	Support for implementation of ISO 9000 quality systems and related institutional infrastructure	
			In small and medium-sized enterprises	In enterprise groups
Argentina	(-)	yes	yes	(-)
Brazil	yes	yes	yes	yes
Bolivia	(-)	(-)	(-)	(-)
Chile	yes	yes	yes	yes
Colombia	(-)	yes	yes	(-)
Costa Rica	yes	(-)	(-)	(-)
Cuba	(-)	yes	(-)	(-)
Mexico	yes	yes	yes	(-)
Peru	(-)	yes	(-)	(-)

Source: Information gathered by the author during missions.

^a (-) means information not available or not found; programmes of this type may possibly exist.

iii) Support for ISO 9000 implementation and certification in enterprise networks in order to promote the diffusion of quality assurance concepts in production chains and institutional frameworks; and

iv) Consolidation of the national institutional structure to support the implementation, certification and international recognition of the ISO 9000 standards (Schuurman, 1997b).

Box 3 presents an evaluation of ISO 9000 programme activities (according to the programme elements described above) in selected Latin American countries,¹² from which it may be concluded that:

i) Government agencies in almost all the countries surveyed have supported activities concerning the dissemination of information on the ISO 9000 standards, but this has not yet resulted in the widespread diffusion of certified ISO 9000 quality systems.

ii) Several governments have acknowledged the existence of market failures in capital and human resources factor markets and have established economic incentives, credit lines, training and technical support activities to stimulate ISO 9000 implementation and certification.

iii) The governments of Brazil and Chile have initiated and supported projects aimed at promoting the use of quality management techniques in specific groups of enterprises in the production chain. For example, in Chile, government projects aim to develop quality assurance activities in the supplier/subcontractor network of a large company, thereby creating a situation from which both will benefit. In Brazil, large companies and organizations in the public and private sectors have used their purchasing power by initiating preference schemes for ISO 9000 certified suppliers and contractors.

iv) Most governments are developing –or have already established– national ISO 9000 accreditation and certification schemes.

In short, there seems to be an increasing tendency among governments of the region to establish programmes promoting and supporting the diffusion of the ISO 9000 standards and quality management techniques. This tendency shows that these governments acknowledge the existence of market failures relating to the diffusion of quality management innovations in organizations and economic sectors and are aware that such diffusion is desirable from a national point of view. In this respect, quality will play an increasingly important role in the social and economic development objectives of the countries of Latin America.

¹² The reader is referred to Schuurman (1997a,b) for more information and references on matters dealt with in this section.

VII

Concluding remarks

The advantages deriving from the incorporation of quality management innovations in government competitiveness strategies in Latin America may be summarized as follows:

Quality-related measures such as total quality management and quality assurance schemes can further the competitiveness of economic sectors and even entire countries competing in today's globalized markets.

A variety of quality management techniques can be associated with the parameters determining the competitiveness of companies (competition factors related to consumer satisfaction) and continuous process improvement.

A number of studies indicate that the costs of implementing quality management techniques are less than the costs that result from not applying such techniques. For example, the costs of quality defects can be as high as 25% of a company's turnover, whereas the cost of preventing such errors is estimated to be no more than 7% of that amount.

Quality awareness in Latin America is low and the application of quality management techniques is

limited. Enhanced diffusion of quality management will help to reduce the gap in levels of competitiveness and productivity between Latin America and the rest of the world.

There are certain obstacles to the implementation of quality management techniques in Latin America, associated with the failure of the market mechanisms to promote adequate diffusion of such techniques, especially among small and medium-sized enterprises. Governments could seek to correct these market failures by including quality issues in their programmes for enhanced competitiveness and productivity. The Government of Brazil, for example, through its National Quality and Productivity Programme, has helped to improve the business performance of various domestic economic sectors (see box 3).

The fact that other governments in the region are taking similar measures, as for example by promoting the use of ISO 9000 quality management systems, suggests that quality issues will play an increasingly important role in the social and development objectives of Latin America.

(Original: English)

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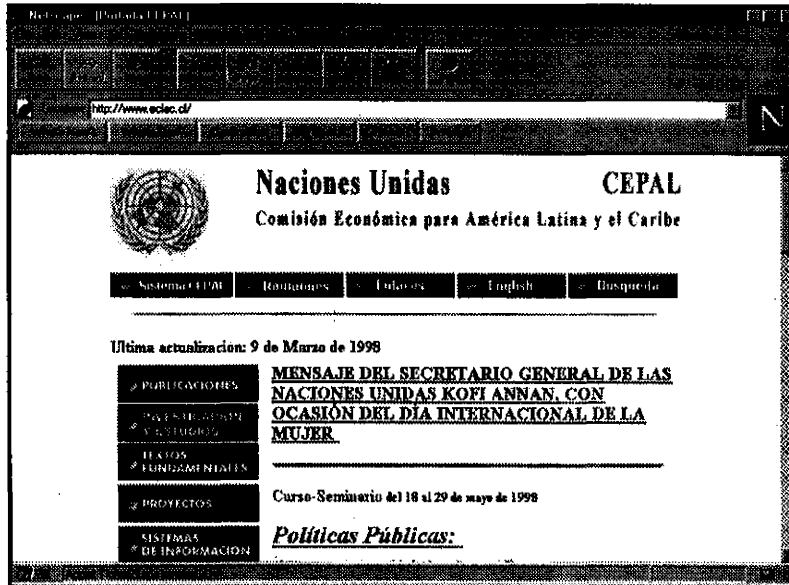
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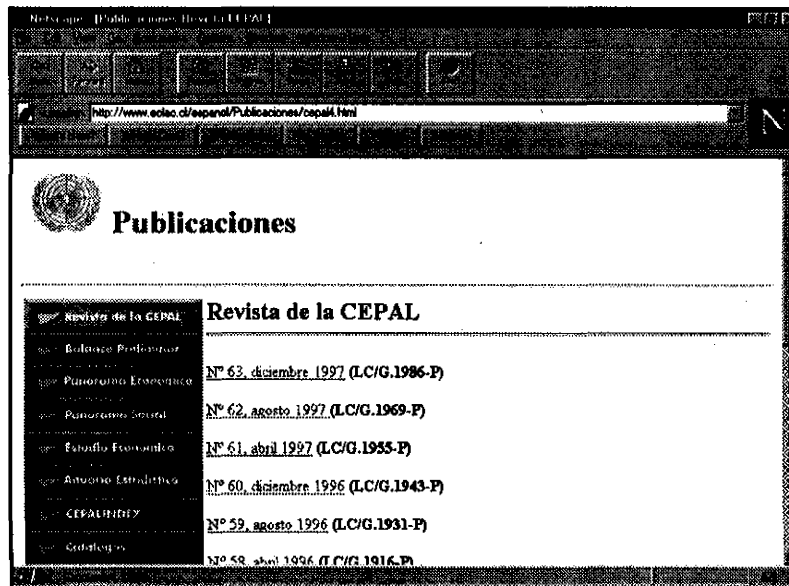
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La inversión extranjera en América Latina y el Caribe. Informe 1997 (Foreign investment in Latin America and the Caribbean. 1997 report), LC/G.1985-P, United Nations publication, Sales No. S.97.II.G.14, ECLAC, Santiago, Chile, March 1998, 196 pages.

The new layout of this annual report consists of five basic components: i) a section on trends in foreign direct investment (FDI); ii) a case study of a recipient country in the region; iii) a case study of an investor country in the region; iv) technical notes on relevant matters, and v) updated statistical annexes. The 1997 report was prepared in accordance with this new layout, except for section iii.

In the 1990s, world FDI flows have grown significantly, rising from an annual average of US\$ 142 billion between 1985 and 1990 to over US\$ 350 billion in 1996. A key aspect of this process is the progressive orientation of international FDI flows towards the developing countries, whose share in the world total increased from 14.9% in 1990 to 37.8% in 1996.

At the same time, the reforms carried out and the macroeconomic stability achieved significantly improved foreign investors' perception of Latin America and the Caribbean. This was reflected in a bigger share of long-term capital, especially FDI, in the total inflows into the region, as well as an improved capacity to react to external changes. These achievements were clearly visible in the rapid recovery of the regional situation after the financial crisis which affected Mexico late in 1994.

The effects of the Asian crisis have not yet been reflected in FDI flows to Latin America and the Caribbean. Macroeconomic stabilization, greater trade and financial openness, extensive privatization programmes, the liberalization of the regulatory frameworks for private investments, and regional integration processes have considerably changed the business environment in the region, because they have encouraged investment by domestic and international firms which were already operating in it, as well as others which were just beginning to do so. Consequently, in spite of the seriousness of the Mexican financial crisis and the disturbances originating in Asia, the inflow of FDI has continued to grow steadily, attaining a record figure in 1997 estimated at US\$ 50 billion.

The report seeks to identify the particular features of this fresh expansion in FDI flows to the region, which is marked by such aspects as the purchase of private firms, new privatization policies, the weight of sunk costs, and business strategies.

Social panorama of Latin America, 1997, LC/G.1982-P, United Nations publication, Sales No. E.98.II.G.3, ECLAC, Santiago, Chile, February 1998, 231 pages.

This edition of the *Social Panorama of Latin America, 1997* comprises seven chapters and a statistical annex with 36 tables on eco-

nomical and social indicators which permit a quantitative analysis of the social situation.

Chapter I deals with important aspects of the processes of changing production patterns and economic growth and recent labour market trends in various Latin American countries, together with their consequences with regard to poverty and income distribution. In the three-year period 1995-1997, most of the countries of the region registered annual average economic growth rates of between 3% and 4%. Open unemployment increased in many countries, as did employment in activities with a low per capita product. This gives grounds for assuming that the poverty and income distribution situations remained unchanged or even got worse. This chapter makes a more detailed analysis of the cases of Argentina, Brazil and Mexico, which were affected, inter alia, by problems in the area of employment. Only Chile managed to keep up high and sustained economic growth rates, which enabled it to reduce poverty significantly, even though it is still marked by the pronounced income concentration deriving from the reform processes. The other Latin American countries registered low levels of economic growth and insufficient growth of employment. This suggests that, except in Brazil and Chile, poverty levels have not gone down markedly in recent years and have even tended to increase in some countries. Furthermore, the situation with regard to income concentration has not appreciably improved in any of the countries for which information is available.

Chapter II studies the evolution of income distribution in 12 Latin American countries in the medium and long term. In this area, concentration of household income is observed, side-by-side with concentration of education both of the head of household and of the members of the household who are employed. In most cases, the average number of years of schooling of the members of both these categories corresponds to that of the seventh decile in the per capita income distribution scale. The concentration of wealth-based income is even more marked than that of total income, and in some countries the respective average income stands at the level of the ninth decile. It is therefore clear that in order to achieve better income distribution it is necessary simultaneously to adopt policies in the areas of population, employment, wealth and education. In order to identify the strata which best illustrate the differences in income, certain characteristics of households with four or more members, without significant wealth-based income and with employed members who have less education than the average, are contrasted with those of households made up of a maximum of four persons with appreciable wealth-based income and whose employed members have at least two more years of schooling than the average. This reveals that in most of the countries the first group, which represents between 30% and 45% of the total number of households, have incomes below the average in almost all cases, while the income of the households in the second group places them in most cases in the top two deciles. Furthermore, significant differences are observed between the two types of households in terms of the number of years of schooling of young people between 20 and 24 years of age. Because of the overall effects of the set of factors examined, it is likely that, unless a significant effort is made in the area of public policies, the households that these young people form in the future will reproduce the differences in income currently existing in their parents' households.

Chapter III looks at the changes of a structural nature observed in the labour market in the 1980s and 1990s. The first item that stands out is the rapid growth in the labour force, together with an increase in open unemployment. This shows that the employment structure adjusted to the high rates of growth of the product, which averaged

slightly over 2% per year, but which also involved an increase in underemployment and in the number of low-productivity jobs, rather than in open unemployment. In the case of women, employment grew by over 4.5% per year in six of the 11 countries studied, and only in Argentina and Uruguay was it as low as around 2.5%. Most of the women entering the labour market are between 25 and 49 years of age and have 10 to 12 years of schooling. Social expenditure and the expansion of the services sector have been reflected in the creation of jobs for which women are particularly suitable. In the late 1980s and the first half of the 1990s, the number of women entering economic activity even exceeded that of men in absolute terms in Argentina, Brazil and Uruguay.

Chapter IV analyses the close relation existing between the educational and employment opportunities of young people and the socio-economic and educational situation of their households of origin. It is observed that there is still inequality of opportunities between the different social strata in spite of the noteworthy expansion of education in the region. The influence of the social contacts of the household of origin are also quantified: above certain levels of education, these are reflected in around 30% more income for young people. This chapter also presents empirical information on the important influence of the inter-generational transmission of educational capital and employment possibilities on the rigidity of income distribution. This is presented as a hypothesis (in addition to those already put forward) to explain the imbalance observed in various countries of the region between the macroeconomic achievements of the economy and the feelings of dissatisfaction with regard to the possibilities of improving the standard of living revealed by public opinion surveys.

Chapter V deals with three items related to childhood and adolescence: the main effects of the Convention on the Rights of the Child in the 1990s, including its legislative consequences; and early role differentiation and its economic and social consequences for girls and boys; in addition, quantitative data are presented on adolescent motherhood and its implications for well-being and equity.

Chapter VI describes the heterogeneity which exists in the region with regard to types of families and stages in the family life-cycle, and the effects of these factors on opportunities for well-being. In addition, the incidence on poverty of the level of education of the parents and the stage in the family life-cycle of households is analysed and the economic contributions made to the home by its adult members and children and young people are compared, as well as the contribution made by female spouses, which varies according to their age and whether or not they have children. It is concluded that, in view of the importance of the factors relating to the formation and configuration of households, these should be taken into account in the design of policies aimed at poor families.

Finally, in chapter VII, "The social agenda", the emerging tendencies in the structuring of the social institutions are analysed in the light of the conditions created by the international economic, social and political context of the 1990s. It is asserted that these conditions make it necessary to modernize the functions of the State apparatus, to create new mechanisms for dialogue between the State and society, and to seek more efficient performance of the traditional functions of social integration and provision of social services. This chapter therefore addresses four items related to the new institutions: the need for the existence of a social authority which acts as a guide for social policies; the importance of inter-sectoral coordination; the need for efforts to decentralize financial, territorial and decision-making matters, and finally, new forms of participation.

Statistical Yearbook for Latin America and the Caribbean, 1997, LC/G.1987-P, United Nations publication, Sales No. E/S.98.II.G.1, ECLAC, Santiago, Chile, February 1998, 753 pages.

The 1997 edition of the *Statistical Yearbook for Latin America and the Caribbean* contains a selection of the main available statistical series on the economic and social evolution of the countries of the region, updated to the beginning of December. It represents a systematic effort by the Statistics and Projections Division of ECLAC to homogenize the figures and make them internationally comparable.

No changes have been made in the structure compared with the 1996 edition, but the content of the chapters on social development and welfare and social conditions displays considerable differences, since some of the tables have been redesigned, relocated and replaced. The balance of payments tables continue to be presented in accordance with the guidelines for their analytical version taken from the Fifth Edition of the Balance of Payments Manual, published by the International Monetary Fund in 1993.

Part One contains derived economic and social indicators (growth rates, proportions or coefficients) which give a summary view of each area of interest and provide the necessary material for use in specialized analyses. This set of indicators includes those used in the periodic regional assessments of the development process of Latin America and the Caribbean made by the ECLAC secretariat.

Part Two gives historical series in absolute figures, which can be used for a wide variety of purposes. Most of the statistical tables give figures on a particular topic, organized in such a way as to facilitate comparison between countries and between national figures and regional totals or averages. Only the balance of payments and national accounts tables are an exception to this, since they have been prepared on a country basis.

Although there are now 33 Latin American and Caribbean countries which are members of the Commission, the regional totals given in the tables generally correspond to the data for 25 countries. It should be noted in this respect that the statistics for Caribbean countries are less complete, which is why the regional coverage varies according to the subject area in question. Continuing efforts are being made to overcome this situation, and it is hoped to have full information in the medium term, at least on the main macroeconomic statistical areas such as the national accounts, the balance of payments and foreign trade.

In most of the tables, the countries are listed in alphabetical order, excluding those for which there are no data or the figures are zero or extremely small.

The indicators in Part One of the Yearbook generally correspond to the years 1980 and 1985 and the period from 1990 through 1996. When sufficiently up-to-date figures are not available, the last year available for each country is given. Some of the indicators based on census information are only available for the years in which the respective censuses were carried out. The statistical series in Part Two—both those of national origin and regional estimates—give figures for the years 1980 and 1985 and for the period from 1988 through 1996.

In view of the excellent reception given to them by users and the good level of approximation achieved in previous editions, preliminary estimates will continue to be published for the year in which the Yearbook is published (in this case 1997). This reflects a special effort made in the last two months of each year to assemble information to give the international community an idea of the macroe-

economic evolution of the countries of the region in the period in question.

Panorama de la inserción internacional de América Latina y el Caribe (Overview of the international linkages of Latin America and the Caribbean), LC/G.1978, ECLAC, Santiago, Chile, November 1997, 225 pages.

The 1997 edition of this periodical publication provides information on tendencies in the international economy which affect the access of the goods and services produced by the region to world markets; on the legal framework of the international trade system which largely conditions the countries' capacity to formulate and apply trade policies; on the trade and trade policies of the Latin American and Caribbean countries; and on the regional integration process in Latin America and the Caribbean.

This edition is divided into four parts. Part One, which deals with the international economy (chapters I and II), describes the main current tendencies and makes some observations on the structural changes under way, as well as analysing the recent evolution of the main regional economic spaces. Part Two, on Latin American and Caribbean trade and trade policy in 1996-1997 (chapters III and IV), analyses the application of the World Trade Organization's dispute settlement machinery as it affects the trade policies of the countries, and the changes made in such policies in the region, especially in the Central American countries. Part Three (chapters V and VI) summarizes the main events in the regional integration process in 1996 and 1997 and analyses some aspects of harmonization efforts in the fiscal field. Finally, Part Four (chapters VII, VIII and IX) looks at questions relating to access to goods and services markets within the context of the Uruguay Round agreements.

Other publications

The fiscal covenant: Strengths, weaknesses, challenges, LC/G.1997 (SES.27/3), document presented at the twenty-seventh session of the Commission (Orangestad, Aruba, 11-16 May 1998), ECLAC, Santiago, Chile, 1998, 283 pages.

Since the beginning of the 1990s, ECLAC has produced a series of documents on the proposal for changing production patterns with social equity which offer guidelines for addressing the present and future development of the region. As part of this process, the Commission decided to analyse at its twenty-seventh session the question of Latin America and Caribbean public sector finances.

A prerequisite for the viability of the proposals which ECLAC has been making is to put the public finances on a sound basis so that the State can act effectively, for both coherent macroeconomic management which makes it possible to speed up growth by raising the levels of saving and investment and due attention to demands for an improvement in the distribution of the fruits of such growth, together with preservation of the environment, are matters which are clearly linked with public sector action and with the institutional machinery for interaction between the public sector, private agents and society at large. The secretariat has thus considered it desirable to center its reflections on the public finances and fiscal management, articulated around the concept of the "fiscal covenant", understood as the basic social and political agreement which legitimizes the role of the State

and the ambit and scope of government responsibilities in the economic and social sphere. According to the proposals put forward here, the new fiscal covenant has five fundamental aspects: consolidating the fiscal adjustment which is already under way, raising the productivity of public action, imparting greater transparency to such action, promoting equity, and favouring the development of democratic institutions.

The document consists of three parts. Part One gives a summary of the progress made, the weaknesses and the challenges of the new fiscal covenant, and the fiscal and quasi-fiscal aspects of public action are analysed. An appeal is made for greater efforts to increase transparency, and various lines of action aimed at limiting the quasi-fiscal component of public policies are proposed. Part Two reviews the progress and changes made in the fields of public sector income, expenditure, deficits and indebtedness. Part Three analyses the achievements and pending tasks in the areas of public action which are of decisive importance and have major fiscal implications: social expenditure, reform of social security, fiscal decentralization, privatization processes and modernization of the State. Proposals are put forward with respect to each of these issues aimed at consolidating the progress already made and tackling the challenges which still lie ahead, seeking to learn from the best practices observed both within the region and outside it.

It is well known that the debt crisis of the early 1980s gave rise to profound changes in the development strategies of the Latin American and Caribbean countries. As it became clear that the crisis was not a transitory event but rather reflected a permanent change in the macroeconomic environment, the initial measures were quickly transformed into structural adjustment programmes designed to promote economic reforms compatible with the new situation.

Thus, from the 1980s onwards the economies of the region embarked, to different degrees, on a broad programme of structural reforms which included in particular trade liberalization and economic integration; opening-up to foreign investment; liberalization of prices; deregulation of financial markets; measures to make the labour market more flexible; the privatization, delinking and capitalization of public enterprises; changes in the social security financing model, and fiscal decentralization, especially in the provision of education and health services.

To a large extent, the crisis of the 1980s reflected a crisis in the conception of the State as an actor in the development process. The reorientation of regional development has therefore revolved around a review of the role assigned to the State, involving a permanent change in the fiscal system. Thus, for example, in many countries the privatization and modernization processes have meant windfall income and permanent reductions in public expenditure and employment, while at the same time there have been increased demands for a suitable system of regulation of privatized services. Decentralization has meant altering the distribution of resources and areas of responsibility among the various levels of government and, with it, changes in the systems of intergovernmental transfers. Likewise, trade liberalization has demanded the modification of tax structures, with an increase in the relative importance of domestic tax bases—especially consumption taxes in the form of value added tax. At the same time, the deregulation of the financial system—designed to promote the development of the domestic capital market—has facilitated (in different cases and to different degrees) a change in the social security financing model from unfunded systems to systems based on individual capitalization, which has made possible an in-

crease in domestic financing of the government and the private sector, including the possibility of private infrastructure projects.

The new external context of globalization and the marked increase in subregional trade agreements have added new challenges without eliminating the previous ones. Thus, the process of globalization heightens the integration and interdependence of markets, exerting a significant disciplinary effect at the macroeconomic level and in the public finances because of the great mobility of short-term financial capital. Likewise, the strong growth of integration or trade complementation agreements at the subregional level imposes restrictions in the field of tariffs, making necessary a gradual process of adjustment to the lower levels of customs revenue and raising challenges in respect of tariff administration and rationalization of the resulting effective protection.

Together, these two movements—whose interrelation has given rise to what is now known as “open regionalism”—help to reduce the leeway for the national authorities to adopt and implement domestic economic policy decisions, especially in the area of fiscal policy. Moreover, insofar as the recent events of the Asian financial crisis have highlighted the disciplinary effect of the markets, national economic authorities have had to pay growing attention to the signals of stability and consistency transmitted by their mixes of fiscal, exchange-rate, monetary and public indebtedness policies.

Now, after a little more than fifteen years, it can be asserted without reservations that the public finances of the region have made significant progress. For most of the countries, they are no longer a cause of imbalance but instead help to strengthen macroeconomic stability. Indeed, the magnitude of the fiscal adjustment carried out in the region in a short space of time is an outstanding feature and has been a major factor in the present situation of macroeconomic stability—not observed for a number of decades past—and the excellent relative performance of the region in the face of the external upsets which began in late 1997. There have also been advances in the institutional arrangements regarding fiscal management, which have facilitated adjustment to the demands of globalization, with forms of public deficit and public debt management more compatible with international patterns of budgetary discipline.

Even so, it cannot be said that the fiscal problems of the region are over and that all that is needed is to continue with the present attitude for a reasonable length of time. On the contrary, there are many short-term problems and crises—often of limited intensity and quickly brought under control, but crises all the same—which give a general impression of fragility: i.e., that the fiscal balance and the contribution it makes to the general macroeconomic balance are still constantly in danger and that the achievements of the immediate past need to be firmly consolidated before there can be any grounds whatever for complacency. There are also the bank crises, which, in the absence of suitable prudential regulation, are tending to become more frequent because of the greater volatility of capital and whose costs may greatly exceed those of traditional fiscal crises.

Furthermore, because of the urgent demands raised by the crises, attention has been concentrated on achieving and maintaining financial balance, leaving other possible objectives of fiscal policy in the background, even when there is strong consensus about their importance. Thus, for example, considerations of equity tended to be left aside during the 1980s in the design of tax and public expenditure structures, although there have been considerable advances in the latter respect in the 1990s. In contrast, efforts to improve the transparency of the public accounts, to design a new result-oriented form

of government management, and to promote more democratic discussion of the budget are still insufficient, to say the least.

These considerations have served as the basis for the fundamental thesis put forward in this document: that the strength or weakness of the public finances reflects the strength or weakness of the “fiscal covenant” which legitimizes the role of the State and the scope of government responsibilities in the economic and social sphere. Thus, the absence of a generally accepted consensus on what the State’s objectives should be undermines any degree of consensus about the size of the resources that the State should handle, the sources from which they should come, and the rules that should be applied for their allocation and use. In contrast, an explicit or implicit political agreement among the various social sectors about what the State should do helps to legitimize the level, composition and tendencies of public expenditure and the tax burden needed to finance it.

However, the success of the far-reaching changes which are taking place in the economy and which were summarized in the preceding paragraphs becomes more difficult if the State is not in a position to make the necessary contribution. Thus, the privatization of public services must be accompanied by efficient regulation; the accumulation of human capital and the provision of high-quality infrastructure are fundamental determinants of economic growth, and equity in the distribution of the fruits of development is necessary in order to achieve the political and social stability required by a stable growth process. The State cannot systematically and efficiently carry out its tasks if the fiscal covenant is not operative. It is therefore essential to reformulate and renew that covenant. This is beyond any doubt an enormous political and technical task, but, as this document seeks to show, it is not only necessary but also possible, since the elements for undertaking it are at hand.

The study and analysis of many of the components of a new fiscal covenant are already well advanced. It is necessary to press on with this task and, above all, articulate these components in a coherent manner at the technical level and promote the necessary social consensus at the political level. The next section in the document puts forward some ideas about the most important elements in this, and the rest of the chapter describes the progress made in each of these areas and the policies which could help to consolidate it.

Agroindustria y pequeña agricultura: vínculos, potencialidades y oportunidades comerciales (Agroindustry and small-scale agriculture: linkages, potential and trade opportunities), LC/G.2007-P, United Nations publication, Sales No. S.98.II.G.4, ECLAC/FAO/GTS, Santiago, Chile, January 1998, 166 pages.

This book summarizes the results of national case studies and working seminars carried out on this subject in Colombia, Ecuador, El Salvador, Guyana, Jamaica, Mexico, Peru and Trinidad and Tobago. However, these activities do in fact represent the culmination of other research carried out earlier by ECLAC and FAO for the same purposes in Argentina, Brazil, Costa Rica, Guatemala, Honduras, Nicaragua, Paraguay and the Dominican Republic.

At the seminars in question, various experiences (successful or unsuccessful) in contract agriculture were analysed and an assessment was also made of the competitiveness and specialization of the agricultural exports of the individual countries. A document was also prepared on the general lines of a public policy in this respect, and in conclusion some observations were made on the linkages between agroindustry and family agriculture in Germany. The conclusions of

these seminars were subsequently submitted to the main public and private sector authorities of each country at forum/panels organized in the countries in question. These meetings (in which Mexico also took part) were chaired by the respective ministers or deputy ministers of agriculture and were attended by agroindustrial executives and agricultural producers.

The book summarized here consists of two studies on different but complementary subjects. The first of these tries to trace the general lines of a policy for turning agroindustry into a modernizing agent for small-scale agriculture. The second makes a general analysis of the competitiveness and trade opportunities of the agricultural and agroindustrial exports of the region in the markets of the Organization for Economic Cooperation and Development (OECD) countries, and in particular the possibility that certain types of products suitable for cultivation by small-scale farmers could take advantage of those opportunities. As already noted, the two studies complement each other with regard to small-scale agriculture, although the first one approaches the subject primarily from the production angle and the second one from the external trade angle.

The first study maintains that the changes which have taken place both in the international context and in the rules governing the economies of the region have made a sustained increase in competitiveness and the constant incorporation of technical progress factors which are indispensable not only for the growth but even for the viability of the smaller production units, which are in danger of disappearing unless policies are adopted to facilitate their progress towards technological innovation.

As may be seen from the case studies, among the various ways in which the agroindustrial sector can link up with small-scale producers as its suppliers, what is known as contract agriculture represents a particularly suitable mechanism for technology transfer from the former to the latter and for changing the latter's production patterns. However—and this is perhaps one of the most important conclusions of the first part—it was also observed that not all products are suitable for contract agriculture, firstly because other forms of supply may be more beneficial for farmers and, above all, for agroindustries, and secondly, because the agricultural inputs themselves, their actual cultivation, and even the market to which they are sent must incorporate certain quite specific conditions if contract agriculture is to work properly.

A review is therefore made of the characteristics that the agricultural products and the respective chains must have in order to induce both parties to enter into a contractual relationship, and the advantages and risks that such an association involves for farmers and agroindustries is also analysed. With regard to the possible problems that the latter may be faced with, special mention is made here of the transaction costs that they may incur when dealing, for example, with a large number of small-scale farmers.

It is also concluded that a possible policy to promote contract agriculture must give due attention to all these factors and provide for specific measures to solve the problems arising in respect of each of them and in the linkages between them.

The second study analyses the competitiveness and trade opportunities of the agricultural products of the region on OECD markets. To this end, it defines various concepts (such as competitive position, specialization, revealed comparative advantages) which are subsequently used in the analysis of each country and type of product.

Other concepts are then set forth which make it possible to classify the countries in five categories, depending on the features and general tendencies of their external trade. Thus, the countries are

classified according to the degree of diversification of their exports, concentration in particular markets, the primary or modern nature of the respective industries, the weight of agricultural food products, and so forth.

With regard to competitiveness, an analysis is made of the growth rate of exports over a period extending broadly from 1979 to 1993. According to this criterion, four basic situations may be defined, depending on whether the products of the country in question have gained or lost positions in dynamic or non-dynamic markets.

All this makes it possible to identify the strengths and weaknesses of the region's exports: that is to say, the types of products where the countries have long-term comparative advantages or disadvantages, knowledge of which is essential in order to define the domestic production strategies and international linkages which will be most beneficial for each country.

The circle opened in the first study is thus closed by confirming the complementarity between the two, since the aim is precisely to establish in what conditions small-scale agriculture can renovate itself from the point of view of production and participate advantageously in world trade.

Survey of agriculture in Latin America and the Caribbean over recent decades: performance indicators in charts and tables, LC/L.1102, bilingual English/Spanish publication, ECLAC/IICA, Santiago, Chile, December 1997, 136 pages.

This document, which summarizes the experience and extensive material available in the various bodies connected with regional agriculture, is designed to make it easier for public and private bodies and actors to study the main features of this activity, thus contributing to the analysis of its problems and the identification of solutions for them.

It summarizes the main trends observed in Latin American and Caribbean agriculture in recent decades, through a set of figures and tables each accompanied by brief comments, thus giving a general overview of agricultural activity in the region and the countries which make it up.

The growth rate of agriculture has been relatively variable over the last twenty years. In the 1970s, the average growth rate was around 3.5%, in the 1980s it was only around 2%, and in the 1990s it recovered slightly to around 3%. Although the agricultural product currently accounts for no more than 10% of the total product, its share has not gone down compared with the other activities in which the region specializes. Surprisingly enough, agriculture still maintains an active and stable presence, in spite of the importance of other traditional activities and the appearance of new ones.

With regard to trade, the value of the agricultural exports of the region continues to exceed that of imports of the same type, although the relative weight of the latter is constantly increasing: in the mid-1980s, the value of agricultural imports was around one-third that of the exports of the sector, but by the mid-1990s it had increased to 50% of the latter, despite the generalized increase in agricultural exports. The value of this trade is now considerably greater than in the 1980s in almost all the countries of the region.

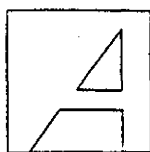
The population of the region is increasingly concentrated in and around urban centres, while the rural population is rapidly going down in importance. In 1970, almost half the region's population was rural, but in 1995 the proportion was no more than a quarter. Thus, the rural population has stagnated in absolute terms, and in most of

the countries of the region the proportion of the agricultural population in the economically active population as a whole has gone down markedly.

In order to present these results and other related figures in detail, the material was divided into five subject groups. The first group covers various aspects of the overall performance of the sector and its relative position with regard to the other economic activities in the region. The second group specifically deals with the situation as regards international trade in products of agricultural, forestry and fishery origin, which account for much of the export effort undertaken by the region in recent years. The third group includes indicators which give an idea of the competitiveness of the sector and its

degree of openness to the exterior. The fourth group deals with the situation of the main human and material resources involved in agricultural production. The fifth group covers various social aspects, especially those relating to rural areas. Finally, the Annex makes some technical points that clarify some of the special features of the tables and figures.

The information used here is taken mainly from the ECLAC databases. In the coordination, preparation and editing of this study, direct collaboration and assistance were provided by the Southern Regional Centre of the Inter-American Agricultural Cooperation Institute (IICA) and its technical division.



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Año 35

Agosto 1998

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Chile	\$	11.000	
América Latina	US\$	42	(incluye envío aéreo)
Europa y USA	US\$	52	(incluye envío aéreo)

NUMEROS SUELTOS O ATRASADOS

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Revista de Ciencias Sociales

Comité Editorial: Juan Carlos Torre (Director), Luis Beccaria, Roberto Bouzas, Daniel Chudnovsky, José Nun, Edith Obschatko, Juan Carlos Portantiero, Hilda Sabato, Getulio E. Steinbach (Secretario de Redacción)

ISSN 0046-001X

Vol. 38

Julio - setiembre 1998

Nº 150

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