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(...)	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 interplay of macro- *and microeconomics*

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**Gert Rosenthal**

*Executive Secretary of ECLAC.*

## I

First of all, I would like to express my satisfaction at being here in Central America, and to thank our hosts warmly and sincerely for their support. The United Nations in general and the Economic Commission for Latin America and the Caribbean in particular owe a great deal to Costa Rica for its unwavering support over the years, especially since President José Figueres Olsen assumed office. Our gratitude is also due to this country for its important contributions to intraregional cooperation and especially to Central American integration. This occasion demonstrates again the unfailingly constructive contribution which President Figueres and his Administration have made to strengthening our relationship of interdependence.

For this reason, and because ECLAC is both part

of the United Nations and part of Latin America and the Caribbean, we feel very much at home here. If I may make a personal comment, for me, being in Costa Rica is like being in my own country, surrounded as I am by many friends, including President Figueres himself and Mr. Fernando Naranjo, Minister of Foreign and Religious Affairs.

For the welcome we have received, the personal interest of Government officials in this meeting and the splendid facilities placed at our disposal, many thanks. I am also grateful to my distinguished predecessor, Mr. Enrique Iglesias, now President of the Inter-American Development Bank, for joining us today, and to all the delegates gathered here, at such a critical time for our region and for ECLAC.

## II

As the Chinese curse would have it, it has fallen to the lot of those of us gathered here to "live in interesting times". Time appears to have contracted in recent years. We have witnessed so many changes, in the world at large and in our region, that our capacity to absorb them is sometimes overloaded. Nevertheless, in meeting the enormous challenges of Latin

American and Caribbean development, we have learned a great deal, both from our successes and from our mistakes. What is more, we have benefited from the huge variety of situations occurring simultaneously in the region, which have given us a wide range of lessons and helped us to learn not only from our own experiences, but also from those of others.

On this occasion, the Secretariat wishes to present assessment of those experiences, both in order to confirm the Commission's views on what stage the

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□ Statement delivered at the twenty-sixth session of the Commission (San José de Costa Rica, 19 April 1996).

countries of the region have reached in their development process, and to design approaches for eliminating the obstacles to accelerated growth within a framework of stability, social equity and democracy. The need for such an assessment became even clearer in the light of the dismay aroused in the region by the 1995 Mexican financial crisis and its impact on other countries.

#### **Our assessment of 15 years of reforms**

It is not easy to summarize in a short statement the many and often contradictory conclusions that can be drawn from the variety of situations seen in the region over a prolonged period. Be that as it may, I would like to emphasize four points.

First, the achievements and limitations of varying scope observed in the great majority of the region's countries have led us to conclude that economic performance has improved significantly in recent years in comparison with the previous decade. This recovery—moderate, but a recovery none the less—which has taken place in a context of financial stability, accompanied by major changes in productive structures, unquestionably places us in a better position to cope with future challenges. At the same time, we are concerned at the relative fragility and vulnerability of this growth and its varying effects on different segments of the productive system and on different social groups, since this may lead to problems that undermine the continuity of the development process. It can be said, therefore, that clear progress has been made, but that the region has not yet achieved sufficiently robust growth to ensure a higher level of well-being for all, especially the most disadvantaged groups.

Secondly, debate continues to rage in the region over the alleged virtues and shortcomings of a stereotyped "model" of development, as if the implementation of a given set of policies invariably produced certain results. In practice, however, it is difficult to establish a cause-and-effect relationship between a set of policies and their results. While nearly all the countries display certain common characteristics that are all but inevitable in the light of the demands of globalization, such as trade liberalization, financial deregulation and greater confidence in the operation of market mechanisms, there are also some important features in which they differ, namely, the pace, sequence, depth and scope of certain economic re-

forms, the speed with which they are implemented and their specific content. The various foreign exchange regimes applied in recent years that have similar general goals are among many examples of such diversity.

Thirdly, the redressment of macroeconomic imbalances and the maintenance of stability through the design and consistent and disciplined implementation of policies are not a product of conceptual or ideological preferences; they are basic requirements for an increasingly transnationalized economy. Frankly, there is no substitute for stable and coherent macroeconomic management, and we should not fall into the temptation of partially sacrificing stability in order to achieve higher growth. The region offers much evidence that an appropriate combination of policies makes it possible to advance simultaneously in the areas of growth and stability.

Fourthly, past experience demonstrates amply that structural and institutional problems prevent the achievement of rapid and sustained growth solely on the basis of market signals and sound macroeconomic management. Probably the most crucial aspect of the proposal which we are submitting at this session is recognition of the need to enhance and strengthen macroeconomic policy through the implementation of public policy measures at the microeconomic, mesoeconomic and institutional levels in order to support productive modernization, the development of financial and labour markets and the establishment and bolstering of institutions which can help to create an environment conducive to development.

#### **Continuity and change in the debate over the approach to development**

Nevertheless, this proposal has sparked controversy, since it raises very old dilemmas. Recognizing that not all problems can be solved by the market alone reopens the debate over selective public policy intervention, with everything that implies. How much intervention is called for? What types of measures are appropriate? What does the search for a creative interplay between State and market mean in practice?

Doctrinaire opposition to selective intervention in the 1980s reached the point where the application of what used to be called sectoral policies all but disappeared from the agenda. The pendulum apparently swung so far that gaps in public policy began to

appear which hindered a wider dissemination of technological progress to productive activities –especially to small- and medium-scale enterprises– a deepening of financial markets and a more equitable distribution of the benefits of the emerging recovery.

It is important, therefore, to pay renewed attention to the interplay of macro- and microeconomics in the Latin American and Caribbean development agenda. For the same reason, it is necessary to clarify what we mean when we speak of explicit microeconomic and mesoeconomic policies in the new context of globalization, policies which are designed to strengthen, not supplant, market forces. In the proposal which we have submitted at this session, we try to illustrate this interplay by linking it to two central themes –productive and technological development, and financial development.

### The crux of our proposal

This is neither the place nor the time to summarize the content of our proposal, which, moreover, has already been circulated to delegations during the technical stage of this meeting. I would, however, like to outline its main points.

First, we posit the need to nearly double the average growth rate of recent years and to expand gross domestic product by around 6% per annum. We feel that this is necessary in order to eliminate some of the obstacles to increasing productivity and providing more and better jobs. A large part of our proposal revolves around the question of how to achieve this goal.

Secondly, we stress the need continually to adapt the main economic policies –in the monetary, credit, fiscal, foreign exchange, trade and wage spheres– so as to ensure the long-term sustainability of macro-

economic equilibria and prevent distortions in the efficient allocation of resources needed in order to expand the production frontier, promote saving and investment and step up innovation.

Thirdly, achieving growth rates of around 6% per annum means that certain requirements must be met in terms of national saving, channelling total saving into productive investment and making better use of the existing capital stock. We contend that “correct prices” –including interest rates, naturally– do not in and of themselves guarantee the fulfilment of this goal. In addition to ensuring a stable macroeconomic environment, public sector intervention must include both financial development policies and policies to stimulate capital formation, including, of course, human capital formation.

Fourthly, the aforementioned growth target requires an accelerated and systematic incorporation of production and management techniques designed to raise productivity in a growing number of firms. To achieve this, it will be essential to increase linkages within productive systems and to enhance the tendency for demand and technical progress to radiate outward from the modern, leading sectors to the rest of the economy. This will, in particular, influence the capacity of exports to generate momentum. Thus, in addition to macroeconomic policies which contribute to stability and promote an efficient allocation of resources, we propose two sets of measures: actions at the microeconomic level to assist certain firms in making use of the best international practices and technologies most suited to the conditions in each country; and mesoeconomic or horizontal actions to promote the dissemination and large-scale assimilation of the best practices, especially actions which facilitate access by all firms to a capital market and a well-organized training system.

## III

It is no accident that the topics dealt with expressly or tacitly in our proposal coincide with the priorities established in our medium-term plan. Achieving higher growth in a context of economic stability, while securing greater social equity and democracy, are goals deriving from the interplay of macro- and microeconomics. They all have aspects which link national efforts to intraregional and international cooperation, and they all require consideration of how

best to facilitate the adaptation of the region’s countries to the changing context of an increasingly transnationalized global economy. In its medium-term plan ECLAC proposes to give due consideration to all these questions.

This leads me to make a few brief comments on the role of ECLAC within a reformed United Nations system. As you know, tremendous efforts are now being made to transform the Organization into an in-

stitution capable of meeting the needs of the twenty-first century. Within each Government, in numerous intergovernmental forums and within the Secretariat itself, the debate centres on how to enhance the Organization's efficiency, effectiveness, coherence and relevance. The discussion also involves ECLAC, the current session of the Commission, and its Secretariat. It is logical, therefore, that the Commission should also express its views on the measures which Governments should take in this regard.

Some of these decisions will be taken by the United Nations at the highest, system-wide level, such as those concerning the optimum degree of decentralization for the implementation of the medium-term plan, the relative importance of the economic and social spheres within the Organization's overall activities and the budgetary resources to be allocated to them. Other decisions can be adopted at the level of the Organization's various organs and forums, in our case, ECLAC. Nevertheless, while it is possible to distinguish between these two levels of decision-making, it should be recalled that the agreements to be reached are interrelated and that the Commission's member Governments participate in the discussion at both levels.

It is appropriate, therefore, to take this opportunity to advance further in the ongoing process of consultations concerning the future of ECLAC—its mission, the content and scope of its programme of work, its ways of interacting with the Governments

and civil societies of member countries, the quality of its management and the relevance of its outputs. If, after discussing these issues, our member Governments agree on a common position, the chances are greater that that position will be recognized and adopted in the debate at Headquarters, and also that the Commission will be able to meet its members' expectations effectively. This will not only have a positive impact on the region, but will also contribute to revitalizing the United Nations as a whole.

I think that ECLAC has a great deal to contribute to this discussion: the contributions which it has made to development in Latin America and the Caribbean throughout its institutional life; the importance of its analysis of the major development issues from a Latin American and Caribbean standpoint; its capacity for constant renewal of both its substantive activities and its management; and lastly, —what is perhaps our greatest merit— the way in which the secretariat and its member Governments interact, as two parts of a single intergovernmental organization.

This does not, of course, mean that there is no room for defining our institutional identity more precisely, enhancing our efficiency and effectiveness and heightening the impact and relevance of our activities, specifically in the framework of a revitalized United Nations. The Secretariat undertakes to collaborate closely with its member Governments in fleshing out these goals on the basis of guidelines which will no doubt emanate from the current session.

## IV

I conclude this statement with a final thought. This week marks the tenth anniversary of the death of Raúl Prebisch, whose life and name were so closely bound up with ECLAC. One of his chief virtues was that he was able to reconcile continuity with change in the Commission's ideas. We remember him with affection and admiration today, when both ECLAC and our region are experiencing deep transformations. In a similar spirit, we reaffirm that while change, with its resulting risks and op-

portunities, causes uncertainty, it also gives rise to creative and dynamic solutions. This, in my view, accounts for the great vitality which the Latin American and Caribbean societies are now displaying, as they strive to overcome adversities and consolidate their achievements. Such vitality is contagious and has spread to ECLAC. This is why we take a hopeful view of the future of Latin America and the Caribbean. It is also why we take a hopeful view of the future of ECLAC.



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# Economic policy, *institutions and productive* development in *Latin America*

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**Oswaldo Rosales V.**

*Economic Affairs Officer  
Office of the Executive  
Secretary, ECLAC.*

ECLAC has submitted an overall assessment of the economic reforms implemented during the past 15 years to the Governments of the region and, based on that assessment, a proposal for strengthening the development process. The central message that emerges from this analysis is that the region needs to work towards forming closer linkages among its macroeconomy, microeconomy and institutional structure by reinforcing the complementarities between macroeconomic and microeconomic sources of competitiveness and fortifying the institutional framework for the development of production activity. Without jeopardizing existing macroeconomic sources of competitiveness—low and declining inflation, incentives for saving and investment, and a competitive exchange rate—the region needs to design microeconomic policies that will open the way for new sources of competitiveness: training and productivity, technological dissemination and innovation, investment abroad and infrastructure. To this end, a unified approach should be adopted which, while preserving a growth-oriented form of macroeconomic stability on the basis of a more determined savings and investment effort, will also foster a greater dissemination of technical progress and less heterogeneous gains in productivity than at present. This type of approach also appears to call for a better balance in terms of both institutions and resource allocation between macroeconomic policies and policies for promoting productive development. In addition, an effort must be made to refine the assessment capabilities and relevance of policy tools for productive development, to enhance the performance and decentralization of policy management in this area, and to reinforce these policies' linkages with growth and efficiency.

# I

## Economic changes: the overall picture

The 1980s were a watershed decade in terms of the behaviour of the Latin American and Caribbean economies. Although there were differences in sequencing, intensity and outcomes, all the countries experienced sweeping changes in the content of their economic policies and strategies as well as in their production systems themselves and their relationship with the global economy.

These reforms were triggered by the external debt crisis and were implemented as part of the monumental effort made by all the countries – each according to its individual possibilities and traits – to adapt their economies to newly emerging circumstances at home (the gradual obsolescence of one style of development) and abroad (technological change and economic globalization).

Although they are far from being alike, all these reform programmes have pursued the goals of macroeconomic stabilization and international competitiveness by means of fiscal discipline, trade and financial liberalization, a stronger emphasis on market mechanisms, greater reliance on private investment, and new incentive and regulatory systems. Where these economic strategies have differed has been in the intensity of the reforms, in the sequencing of those reforms and of stabilization policies, in the types of exchange policy tools employed (fixed exchange rates, crawling pegs, with or without currency bands), in the liberalization of the capital account (the extent of the process and the sequencing of financial and trade-related measures), in anti-inflation policy (how steep of a reduction, with or without indexation), in the extent of corrective government action (transfers and the targeting of government ex-

penditure) and, last but not least, in the share of GDP represented by public-sector expenditure and in the share of public-sector expenditure represented by social expenditure.

The combination of these similarities and individualities has brought about a fundamental change in the region's development process. The similarities provide us with grounds for talking about a turning point in strategy, while the individualities prevent us from summing up this process as a transition to a homogenous and generally-applicable "model".

One of the main features that differentiates the individual countries' experiences is the extent to which economic reforms have been accompanied by institutional changes. Examples include the autonomy of monetary authorities, a code of conduct for fiscal policy and for the management of State enterprises, the prudential supervision and regulation of the financial system and the degree to which privatization processes have been coupled with a reinforcement of institutions and tools for promoting competition, including the regulation of natural monopolies.

Within this same institutional framework, significant differences are also to be found in the countries' policies on productive development (with or without mechanisms for building a consensus among the relevant actors) and the specific attributes of their sectoral policies in terms of degree and content.

As a result of these processes, the countries of the region have made headway in both the macroeconomic and microeconomic spheres. In the macroeconomy, advances have been made in stabilizing prices and, to a lesser extent, in promoting growth. Contributing factors in this respect have included fiscal and monetary discipline and, since 1991, an abundant inflow of external capital; the existence of large differentials in rates of return has certainly been one of the reasons for these inflows, but another has been the confidence inspired by the countries' macroeconomic management and structural reforms and the progress they have made towards the establishment of democratic systems. Nonetheless, the region's

□ The ECLAC view on the issues discussed in this article is set forth in a key document, *Strengthening Development. The Interplay of Macro- and Microeconomics* (ECLAC, 1996a) the empirical support for which is contained in a companion volume entitled *The Economic Experience of the Last Fifteen years. Latin America and the Caribbean, 1980-1995* (ECLAC, 1996b). The reader is referred to these two publications for quantitative evidence and a more detailed analysis of each issue.

average growth rate for the 1990s has been no more than moderate: respectable but below its traditional level of performance and unsatisfactory from the dual standpoint of technical progress and the elimination of social lags.

The restructuring of production patterns which is now underway has not yet generated a sufficient rate of job creation or an acceptable reduction in inequalities; in fact, many countries' indicators of social equity have still not even regained their pre-crisis levels. The number of high-quality jobs has been very slow to rise, and the relative wage rates for jobs requiring different skill levels have tended to diverge further.

Compensatory social policies have so far been of limited effectiveness; social expenditure has been curbed by efforts to maintain budgetary discipline, and social policy management has not evolved or progressed to a sufficient degree.

The region's economies continue to work from a position of vulnerability. In most cases, macroeconomic stability has been achieved at the cost of large deficits on the balance-of-payments current account, and in some instances these deficits have been financed with volatile capital that may be withdrawn the moment that anything shakes investors' confidence.

Indeed, one of the hallmarks of the 1980s was a steep downturn in saving –and, in particular, investment– rates, although this decrease was sharper in some countries than in others. These coefficients have gradually been moving back up during the 1990s, but have still not reached their pre-crisis levels in the vast majority of the countries.

The structural reform and adjustment processes have acted as a powerful screening device which has forced each economic agent to adapt to the new conditions existing in relation to price signals and the regulation of production activity.

The production activities that have been hit the hardest by this change in the ground rules and the regulatory system have been branches of industry that serve the domestic market, which make fairly intensive use of local engineering services; small and medium-sized firms; and State-run enterprises as a group. In contrast, export sectors, natural resource-based activities, large locally-owned conglomerates and many transnational corporations have been more successful in adapting to these new circumstances.

A shift in production towards natural resource-intensive tradables, especially mining products, has been observed. Among non-tradables, the growth rates

for the energy, construction and transport sectors have been outpacing the expansion of GDP. In the Caribbean, the tourism sector, *maquila* industries and data-transmission services are particularly important areas of activity. The manufacturing sector is being restructured as it moves away from a pattern of specialization based on mechanical engineering and towards a pattern based on natural resource-intensive activities (aluminium, petrochemicals, paper and pulp, food products and non-ferrous metals). The expansion of these areas is balanced out by reductions in textiles, leather and footwear, capital goods and fine chemicals.

There have been promising signs of the absorption of technology in industries involved in developing and managing natural resources for production purposes (agriculture, forestry, fisheries and mining) and of the effects of modernization processes on financial services, telecommunications, energy and transport.

On the other hand, the structural heterogeneity which is characteristic of the region's production apparatus has been heightened as the productivity gap widens between the large companies at the forefront of the modernization drive and the broad range of activities that have fallen behind in this process.<sup>1</sup> This not only sets the scene for greater social inequality by increasing domestic productivity differentials and the production structure's degree of economic concentration, but also impairs the economy's growth potential by limiting the expansion of linkages and the spread of technical progress while also slowing the momentum of exports.

The economies of the region are quite clearly turning their attention to external markets, and this reorientation is firmly backed up by a more intensive development of natural resources. Indeed, the export coefficient has climbed from 14% of GDP in 1980 to 21% in 1990 and to 25% in 1995.

The region's economic buoyancy has been bolstered by trade agreements and the intensification of integration schemes that have sparked a substantial expansion of intraregional trade and investment, rising levels of competitiveness in a growing number of

<sup>1</sup> Productivity gains tend to be concentrated in and among modern manufacturing activities, export-oriented agriculture, large-scale mining enterprises, the energy sector, telecommunications and financial services.

production sectors and enterprises, and a notable increase in the ability of firms in the region to win over outside markets. Progress is also being made in the diversification of export activity and the application of technical advances (natural resource development, agricultural distribution chains, and natural resource-intensive industries).

Although, generally speaking, commodity trade is declining as a percentage of total exports, the growing significance of manufactures and semi-manufactures attests to a strong bias in favour of

natural resource-processing industries, and the share of external sales accounted for by commodities—foodstuffs, non-food farm products, metals and minerals, and fuels—remains above the average for developing countries. Moreover, commodity trade yields a surplus which helps to cover the manufacturing and services sectors' net deficit.

Given this situation, part of the region's export effort has been thwarted by the fact that its export structure is still highly concentrated in slow-growth products with weakening and erratic prices.

## II

### Institutional structure and changing production patterns

Overconfidence in the "automatic" effectiveness of macroeconomic signals and reforms has engendered a tendency to underestimate institutional weaknesses and the flaws to be found in the region's markets (which may be imperfect, segmented or incomplete, or may have been distorted by externalities) and to what is perhaps an over-reliance on the ability of macroeconomic policy alone to set in motion the dynamic of growth and the absorption of technical progress. As stabilization and structural adjustment efforts have tended to coalesce, the underlying structural causes of the region's macroeconomic instability have come to be recognized.

This recognition should prompt the Latin American and Caribbean countries to address their concerns as to the current operation and growth potential of their economies from a vantage point which integrates macroeconomic conditions, regulatory systems and institutions, the operation of factor markets and microeconomic behaviour. Consideration of these interactions leads to a fuller understanding of the practical difficulties involved in simultaneously achieving macroeconomic stability, rapid growth, satisfactory levels of employment, and sufficiently high rates of saving, investment and technical progress to ensure sustained development.

Virtually all the economies of the region suffer, to a greater or lesser extent, from structural and institutional problems which make it difficult to achieve a sustained increase in growth based on market signals

alone. On the one hand, existing natural resource-based activities and public services offer greater advantages in the short run in terms of both risk and profits than many promising activities that require the development of technological capabilities; on the other hand, the shortcomings of the region's capital market impede profitable longer-term investments and the deployment of innovations in production activities.

The existence of segmented or incomplete markets diminishes the range of opportunities for multiplying linkages within production systems as well as the spread of demand and technical progress from leading sectors to the rest of the economy. Furthermore, segmented or incomplete financial markets provide no assurance that savings will be channelled into investment.<sup>2</sup>

The structural failings of the region's financial markets hinder both investment and innovation. The segmentation of the credit market continues to have the effect of denying small and medium-sized enterprises access to mainstream resource flows. Large interest-rate spreads transform low real interest rates on deposits into onerously high real lending rates for

<sup>2</sup> In the early 1990s, the injection of large quantities of external resources into these types of markets fueled major booms in financial activity and in the region's stock exchanges which were reflected, to a large extent, in consumption and investment in non-tradables via predominantly short-term transactions.

production activities, while, in general, the region's financial systems continue to operate according to a rationale that stresses security over profitability.

The aims of productive development policies are to boost total factor productivity, to upgrade the quality of goods and services, and to promote efforts to generate and disseminate technological capabilities with the help of a series of measures designed to further the development and reinforcement of national systems of innovation. These systems need to foster an effective form of interaction among the various institutional actors concerned and should be based, to an increasing degree as time goes by, on private-sector resources. Means of strengthening such systems include support for information networks, reinforcement of the entrepreneurial base, protection of intellectual property rights, promotion of sectoral technological outreach and research centres, adoption of international quality standards and regulations, and skills development and training.

The network of public institutions involved in the design and implementation of development policies needs to keep pace with the internationalization of the region's economies. In particular, development policies and instruments need to be brought into line with commitments made in connection with multilateral agreements and integration schemes. Along similar lines, as part of the effort to promote exports, a higher priority needs to be placed on investment abroad and participation in marketing chains as well as on brand differentiation and quality.

The main message here is that the macroeconomy, microeconomy and institutional structure need to be more closely linked to one another so as to reinforce the complementarity of macroeconomic and microeconomic sources of competitiveness and to strengthen institutional mechanisms for promoting productive development.

### III

## An assessment of economic policy

### 1. The external credit crunch and adjustment

Since the time of the debt crisis, the situation as regards the external sector imbalance can be divided into two clearly differentiated periods in terms of the net direction of resource transfers and how this has influenced the region's economic performance. The first period, from 1982 to 1990, was a time of adjustment during which there was a negative net transfer of resources amounting to 3.2% of GDP; during the second, from 1991 to 1994, external savings fueled a recovery and the countries received net inflows equivalent to 1.5% of GDP.

During the period from 1982 to 1990, economic performance fell far behind the production frontier, with actual GDP being well below the region's potential GDP; this led to a serious underutilization of production resources and—in combination with the existing instability of the economy—to a steep drop in investment, which, in turn, limited the future expansion of output. All of this translated into slow growth, a decline in per capita GDP and virtually flat domestic demand up to 1990.

As a consequence of the international credit squeeze experienced during these years, balancing the current account became a top priority. Since the countries of the region had to set aside large sums of money for interest payments and profit remittances—thereby generating a deficit on the financial services account—they had to find some way of building up a large trade surplus, and in order to do so, they had to keep real exchange rates above their long-term levels. During the 1990s, once the external credit crunch had eased, this ceased to be the leading objective, and attention shifted to the need to finance the balance of payments, which entailed attracting enough capital to cover the growing deficit on current account. Except in a few cases, the authorities stopped using the real exchange rate as one of their main economic policy tools, and this rate thus came to be determined by the volume of capital flows.

At the start of the present decade, the negative transfer of financial resources seen between 1982 and 1990 reversed direction. The countries of the region regained access to private external finance and began to secure large quantities of such funds from a variety

of different sources, although lenders did display a stronger preference for short-term operations than in other developing regions.<sup>3</sup>

Foreign direct investment (FDI) and portfolio investment rose in response to bond and stock offerings made either directly or via ADRs and GDRs, while official financing and private debt both shrank. Net capital flows climbed to 5% of GDP in 1992-1994, thereby surpassing their previous all-time high (4.5% in 1977-1981). Although inflows were concentrated in Mexico, Argentina, Brazil, Chile and Peru, incoming capital amounted to over 5% of GDP in 11 countries of the region.

Between 1992 and 1994, as external financial constraints abated, a heavy net inflow of resources permitted the region to cover its mounting trade and current-account deficits, for the region's trade deficit reappeared, in 1992, with imports climbing at twice the pace of exports, and a deficit on current account of more than 5% of GDP was posted by nine countries (Bolivia, Costa Rica, Guatemala, Haiti, Honduras, Mexico, Nicaragua, Paraguay and Peru) although in most cases the income registered on the capital account was more than enough to cover the shortfall.

Between 1991 and 1994, capital inflows did away with the external financial constraints affecting the region and helped to galvanize production and domestic demand, which had a beneficial effect on employment and wages. The increase in investment prompted by the change in the macroeconomic climate was bolstered by the capital inflows which helped the region to finance its widening deficit on current account up to 1994. Furthermore, inflation slowed considerably, and the public sector posted either surpluses or small, manageable deficits. These conditions helped the region's economies to regain some of their growth potential within a context of greater stability and diminishing external constraints.

## 2. Unconsolidated stabilization

A comparison of the macroeconomic environments of the mid-1990s and the second half of the 1980s

reveals some major changes: a moderate increase in the level of activity, less of a tendency to run up public-sector deficits, a slower expansion of the money supply, an upsurge in investment levels and a reduction in unemployment.

Thanks to a more favourable international financial environment for suitable mixes of financing and adjustment, the reforms and improved quality of the countries' economic policies were reflected in a slowdown of inflation in most cases, particularly in Bolivia since the mid-1980s and, more recently, in Argentina, Brazil, Nicaragua and Peru. During the 1990s the number of countries with inflation rates near or below 10% has been increasing, in sharp contrast to the situation in earlier years (see table 1).

By permitting the value of the currency to rise in real terms, the increased volume of external finance has contributed to the stabilization effort in various countries. The use of "nominal anchors" is important in any stabilization process, but it is especially so if such a process is initiated following bouts of hyperinflation and capital flight; their contribution is all the greater, of course, if they form part of a policy package designed to bring about a lasting improvement in the fiscal situation and to buttress the financial system's solvency.

One of the important lessons learned from the debt crisis was that a sudden jump in the supply of external resources will usually trigger an unsustainable rise in consumption. To prevent this from happening, the bulk of available financial resources must be channelled into real investment in order to boost the economy's future payment capacity; otherwise, any stabilization will be short-lived.<sup>4</sup>

In order to achieve and maintain a low inflation rate over the long term in an economy undergoing trade and financial liberalization, its export sectors and industries producing tradable goods need to have attained a sufficient level of development, diversification and flexibility. The stability of incentives for these sectors plays an important role in consolidating an economy's stabilization and, as past experience has demonstrated, large real revaluations are there-

<sup>3</sup> Between 1990 and 1994, portfolio investment flows for developing countries as a whole represented 41% of total inflows of external resources, while 37% corresponded to foreign direct investment (FDI). For the region, however, portfolio flows amounted to 66% and FDI 30%. In contrast, in Asia a marked preference for long-term funds (45% in FDI) was evident, while only 24% of total resources corresponded to portfolio investment (IMF, 1995).

<sup>4</sup> One crucial factor for the success of a country's stabilization policies is the achievement of high, stable levels of investment. Inflation discourages investment and diminishes its efficiency, thereby limiting a country's growth potential. Thus, a successful stabilization effort ought to be reflected in higher growth and investment rates.

TABLE 1

**Latin America and the Caribbean: trends in selected  
macroeconomic variables, 1986-1990 and 1991-1994**

Trend	Public-sector deficit	Public-sector surplus	Growth of money supply (M1)	Gross fixed investment/GDP	Real exchange rate for exports	Real average remunerations	Urban unemployment
<i>Upward</i>							
1986-1990	-	1	8	5	7	3	7
1991-1994	4	2	4	8	4	11	3
<i>Downward</i>							
1986-1990	6	-	6	7	4	7	5
1991-1994	4	1	10	1	5	1	3
<i>Stable</i>							
1986-1990	-	-	-	1	-	3	1
1991-1994	3	1	1	8	6	3	9
<i>Variable</i>							
1986-1990	11	-	3	5	6	2	4
1991-1994	3	-	1	1	2	-	3

Source: ECLAC, on the basis of official figures.

fore inadvisable; ideally, such adjustments should be kept in line with productivity growth in the tradable goods sector.

### 3. A shaky fiscal adjustment

The financial crisis that overtook the public sectors of the vast majority of countries in the region was one of the most significant aspects of the economic disturbances experienced by Latin America and the Caribbean during the 1980s (ECLAC, 1993). In the 1990s, the situation—at least up to 1994—has been just the opposite, since almost all the economies have enjoyed a period of relative stability thanks to the progress made since 1991, particularly in terms of the fiscal adjustment processes begun in earlier years and the resumption of external financing. Although the situation varies from country to country, during the 1990s there has been a widespread trend towards a reduction of fiscal deficits.

The sweeping fiscal adjustment drives that were launched in the first half of the 1980s, when the debt crisis was at its height, enabled most of the countries to cut their fiscal deficits by between five and six points of GDP. Except in a few cases, however, these processes failed to yield satisfactory results because external conditions remained adverse.

The restoration of external credit, the resumption of growth and the price stability characteristic of the

Latin American economy in 1990-1994 helped to strengthen its fiscal performance. The possibility of obtaining voluntary financing in international markets opened up the field for domestic borrowing and reduced its cost. As a result of the appreciation of the countries' currencies, which was also associated with their capital inflows and the build-up of reserves, interest payments on the external debt came to represent a smaller portion of public budgets in real terms. Tax receipts' response to the acceleration of economic activity was quite elastic, and the slowing of inflation boosted real tax revenues (see table 2).

All these factors, together with the countries' structural reforms, helped to reshape the fiscal environment. In terms of their effects on public finances, an especially important role was played by changes in the tax system (a greater emphasis on excise taxes, the expansion of the tax base, the lowering of tax rates, reductions in customs duties and stricter enforcement of tax laws). In some cases, the sale of State-run enterprises and the expansion of programmes for the privatization of public utilities have had a decisive effect. The decentralization process was also carried forward, the civil service was downsized and efforts to privatize social security (medical and pension) systems were stepped up.

The after-effects of the debt crisis still weigh heavily on fiscal policy, especially since, in a number of cases, localized financial crises have escalated to

TABLE 2

**Latin America and the Caribbean (18 countries): public-sector balance at current prices <sup>a</sup>**  
(As percentages of GDP)

Country	Level <sup>b</sup>	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Argentina	NNFPS WP	-5.5 <sup>b</sup>	-9.6	-10.6	-10.5	-8.3	-4.3	-3.3	-5.3	-8.2	-3.7	-3.8	-1.6	-0.1 -0.9	-0.1 -0.3	-0.4 -0.7
Bolivia	NFPS	-7.8	-7.6	-14.2	-17.9	-26.6	-10.9	-3.1	-7.3	-5.8	-4.8	-3.9	-3.7	-4.8	-5.8	-4.2
Brazil	CPS	-1.6	-3.2	-4.1	-4.1	-3.4	-4.2	-3.6	-5.7	-4.8	-6.9	1.2	-0.2	-2.8	-1.3	1.2
Chile	CG	6.5	2.8	-3.4	-2.6	-2.9	-3.8	-0.8	1.9	1.7	2.8	3.5	2.4	2.8	2.0	2.0
Colombia	NFPS	-2.6	-5.3	-6.0	-7.6	-6.3	-4.0	-0.3	-1.9	-2.2	-1.9	-0.6	-	-0.2	0.3	2.6
Costa Rica	CG NFPS	-8.1	-3.5	-2.6	-4.3	-3.1	-2.0	-3.4	-2.0	-2.5	-4.1	-4.4	-3.1	-1.9	-1.9	-7.0
							-1.7	-1.8	-	0.1	-	-2.5	-0.1	0.7	0.6	-6.9
Ecuador	NFPS	-7.4	-8.5	-7.2	-5.2	-1.2	0.2	-3.7	-9.6	-5.3	-1.6	0.6	-1.0	-1.7	-0.4	-0.2
El Salvador	CG	-5.3	-6.6	-7.0	-8.8	-5.8	-3.8	-2.8	-3.8	-3.2	-4.9	-3.6	-5.2	-5.2	-3.3	-2.1
Guatemala	CG	-4.7	-7.4	-4.7	-3.3	-3.8	-1.8	-1.9	-2.4	-2.4	-3.8	-2.3	-0.1	-0.5	-1.5	-1.5
Honduras	CG	-8.7	-8.1	-13.0	-10.9	-12.3	-9.8	-8.7	-8.1	-6.9	-7.4	-6.4	-3.3	-4.9	-9.3	-5.2
Mexico	CG WP	-3.2	-7.0	-12.9	-8.6	-7.7	-8.2	-13.2	-14.3	-9.7	-5.1	-2.8	-3.5	4.8	0.8	-0.4
													-0.2	1.6	0.4	-0.8
Nicaragua	CG	-9.3	-11.7	-13.2	-28.7	-23.6	-22.4	-17.3	-16.6	-26.6	-6.7	-17.1	-7.5	-7.6	-7.3	-9.7
Panama	CG	-9.3	-7.8	-12.9	-5.7	-6.7	-2.1	-1.9	-4.5	-5.3	-7.0	-0.7	-2.7	-1.4	-0.4	-0.8
Paraguay	CG	0.3	-2.2	-0.1	-2.0	-2.5	-1.2	1.0	-0.2	0.7	1.5	3.0	4.4	-0.1	-0.7	0.8
Peru	CG	-2.4	-4.0	-3.2	-7.5	-4.4	-2.2	-3.7	-5.7	-2.5	-4.2	-2.5	-1.4	-1.4	-1.6	2.1
Dominican Republic	CG	-2.9	-2.3	-3.1	-2.8	-0.9	-1.5	-0.5	-2.2	-1.6	-0.1	0.3	2.8	2.9	-0.4	-1.1
Uruguay	CG CPS	-	-1.5	-9.1	-3.9	-5.2	-2.9	-1.2	0.1	-2.0	-3.4	-0.1	0.4	0.3	-1.1	-2.3
		1.1	-1.8	-11.1	-4.0	-4.5	-2.3	-0.7	-0.9	-4.5	-6.1	-2.5	-	0.5	-1.5	-3.0
Venezuela	CG NFPS	-0.2	2.8	-1.1	-2.0	2.5	2.3	-0.5	-5.0	-6.2	-1.0	-2.1	2.8	-3.6	-3.4	6.5
					-2.4	6.8	3.2	-5.3	-4.4	-8.6	-1.1	0.2	0.2	-5.8	-3.5	-13.8

Source: ECLAC, on the basis of official figures.

<sup>a</sup> A minus sign (-) indicates a deficit.

<sup>b</sup> The meanings of the abbreviations given in this table are as follows: NNFPS = national non-financial public sector; NFPS = non-financial public sector; WP = hypothetical situation of no income from privatizations was registered; CPS = consolidated public sector; CG = central government.



the point where the relevant countries have had to undertake extremely costly bail-outs. Furthermore, the chosen mode of fiscal adjustment, which has at times relied too heavily on spending cuts, has severely curtailed social and infrastructure investment and has driven down public-sector wages as well as seriously impairing the quality of that sector's performance.

The countries' fiscal positions have at times been distorted by the practice of recording non-recurring profits from privatizations above the line, rather than as a form of deficit financing.<sup>5</sup> This artificially lowers the government deficit and distorts the change in the public sector's net assets.

Thus, a failure to draw a proper distinction between temporary and permanent factors may undermine fiscal stability. This is because fiscal positions may appear to be well balanced only because temporarily high external income levels may spur economic activity and boost tax receipts. If the incoming resources are not saved and are –worse yet– used to finance current expenditure, pressure for excessive expenditure may build up which will later –once external credit levels have returned to their trend values– have to be siphoned off.

**4. A shortfall of domestic savings**

Although to differing degrees in each country, saving rates and, in particular, investment levels tumbled in the 1980s. These coefficients have been making a gradual recovery during the 1990s, but have yet to reach their pre-crisis levels in most of the countries.

Studies on the subject<sup>6</sup> underscore the fact that, although interest rates do contribute to a more efficient use of available resources and help to regulate capital movements, they do not have any decisive effect on savings levels; in order to influence saving rates, policies are needed that will reinforce the complementarity between external and national saving and between public and private saving.

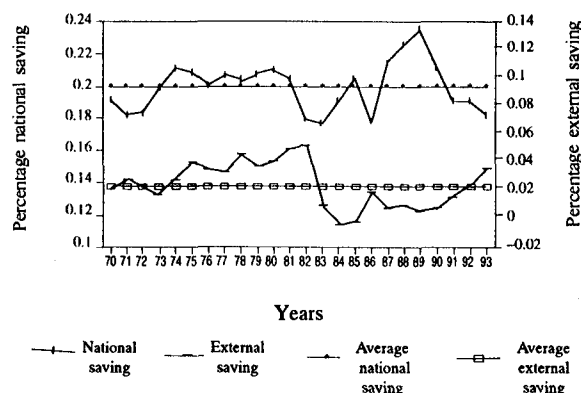
<sup>5</sup> In macroeconomic terms, financing a deficit with the proceeds from privatizations is equivalent to borrowing via public bond issues. This is because the sale of government assets alters the Treasury's asset position, on the one hand, and, on the other, absorbs private-sector savings, thereby having much the same effect on the financial market as an issue of public debt would have (Marcel, 1989).

<sup>6</sup> References on this topic include two overviews prepared by ECLAC: Massad and Eyzaguirre (1990) and Held and Uthoff (1995).

Saving activity in the region exhibits three main characteristics: i) it tends to level out at a rate of about 20% of GDP; ii) any increase in external saving tends to crowd out national saving; and iii) public saving tends to partially crowd out private saving.

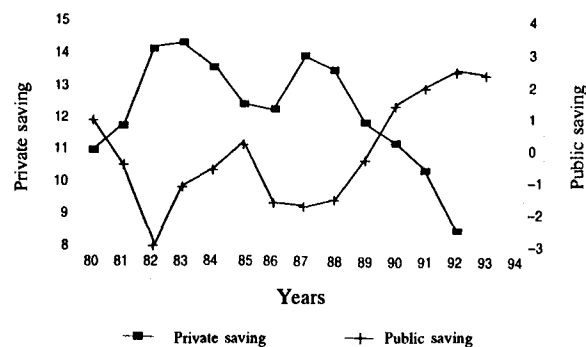
In other words, conflicts have arisen in the region among the various sources of savings. An upturn in public saving has largely offset the decline in private saving. At the same time, a disproportionate amount of the increase in real disposable income generated by the region's larger inflows of external savings has been channelled into consumption and has thus gained ground at the expense of all the various forms of national saving (see figures 1 and 2).

FIGURE 1  
Latin America and the Caribbean: indicators of national saving and external saving at current prices (As percentages of GDP)



Source: ECLAC, on the basis of official figures for 15 countries.

FIGURE 2  
Latin America and the Caribbean: indicators of private saving and public saving at current prices (As percentages of GDP)



Source: ECLAC, on the basis of official figures for 11 countries.

Gross national saving, measured as a percentage of GDP (at current prices), was fairly stable during the period 1974-1981, when high levels of international liquidity gave the countries access to external financing (and more specifically, bank loans). Then, when the debt crisis engulfed the region and an adjustment had to be made in economic activity in order to cope with the interruption of external financing, gross national saving declined. Later on, it picked up again as the per capita level of disposable income rebounded, but its upward climb came to a halt when the region regained access to external capital markets in the early 1990s.

Cyclical variations in income tend to have a marginally positive impact on saving and, hence, a strong effect on consumption.<sup>7</sup> In other words, it has been the region's experience that external or internal shocks that lead to a "temporary" increase in income have the effect of significantly raising consumption levels, causing national saving to fall.

External saving's negative effect on national saving is greater when external saving rises above its trend value.<sup>8</sup> National saving's negative response to cyclical swings in external saving suggests that the types of linkages maintained with international financial markets have a significant influence on national saving levels.

The substitution of external saving for national saving has been greater in countries whose re-entry into international capital markets in the early 1990s prompted them to adopt macroeconomic policies which have led to serious over-spending (in relation to national income) and which have relied on increasingly sharp currency appreciations to promote stabilization.

The influx of financial capital has not been balanced out by a matching creation of production assets, thereby generating a wealth effect owing to the

steep rise in prices of existing assets. Consequently, capital inflows have engendered a stronger inclination to consume.

## 5. A weak investment effort

At the start of the 1980s, the region's average investment rate was verging on 23.5% of GDP. Following the economy's adjustment to the effects of the external debt crisis, it fell to 16.6% of GDP in 1985 and continued to slide until reaching a low of 15.9% in 1990. Since then it has been making a gradual recovery, rising to 22% of GDP in 1994-1995, but this is still below its pre-crisis level.<sup>9</sup>

As a consequence of the countries' adjustment policies and, later, the steps they took to redirect the focus of economic policy, the crucial consideration in private investment decisions came to be policy stability and economic agents' degree of certainty. Under these circumstances, the effectiveness of the countries' efforts to close the external financing gap was a decisive factor in stabilizing macroeconomic variables and new investment incentives. The fact that investors have been slow to respond to these new incentives may, in part, be attributable to misguided policy sequencing or inconsistencies in economic policy or reforms that may have affected the stability or predictability of relative prices. The greater the degree of uncertainty, the greater the benefits of biding one's time and, hence, the slower the response of investment to an improvement in macroeconomic conditions (see table 3).

A comparison of 1978-1981 with 1990-1994 indicates that all the countries for which information is available have witnessed a steep downturn in public investment (measured as a percentage of GDP)<sup>10</sup> with the sole exceptions of Colombia, where it has held steady, and Costa Rica, where the decline has been very slight.

<sup>7</sup> If very little is saved out of temporary income inflows, the implication is that the marginal propensity to consume diverges from zero, which runs counter to the permanent income hypothesis. Although the deviation of income from its trend level has a positive influence on saving, its coefficient is in the vicinity of 0.20, which means that in order to increase saving by one point of GDP, measured income would have to exceed its trend levels by five points.

<sup>8</sup> A one-point rise in external saving above its trend level drives national saving down by around one half point of GDP (ECLAC, 1996a, p. 45 and table IV.1).

<sup>9</sup> Chile, Colombia, Costa Rica and El Salvador are the only countries in which the rate of gross fixed capital formation for 1990-1994 was equal to or higher than it was before the external debt crisis.

<sup>10</sup> The steepest decreases were in Mexico (from 11% to 5% of GDP, for a drop of 6 points), Argentina (4.6% of GDP), Brazil and Venezuela (3 points each).

TABLE 3

**Latin America (17 countries): evolution of  
gross fixed capital formation and GDP, 1978-1994**

Country	Gross fixed capital formation <sup>a</sup> (Index, average 1978-1980=100)				GDP <sup>a</sup> (Annual average variation over the period)				Gross fixed capital formation as a proportion of GDP <sup>b</sup> (Percentages)			
	1978- 1981	1982- 1984	1985- 1989	1990- 1994	1978- 1981	1982- 1984	1985- 1989	1990- 1994	1978- 1981	1982- 1984	1985- 1989	1990- 1994
	Argentina	97	73	67	82	0.3	0.9	-0.9	6.1	24.0	18.1	16.2
Bolivia	95	52	68	81	0.4	-3.1	1.3	4.0	16.6	9.9	13.3	14.3
Brazil	99	80	94	84	4.4	1.1	4.5	1.0	22.5	17.5	17.0	15.5
Chile	111	82	130	229	7.2	-3.1	6.1	5.7	17.4	14.0	17.8	22.3
Colombia	104	121	128	157	5.0	2.2	4.8	4.0	16.3	17.6	15.6	16.0
Costa Rica	93	61	90	135	2.3	1.1	3.8	4.7	24.5	16.5	21.3	24.5
Ecuador	99	79	76	80 <sup>c</sup>	5.3	0.7	2.2	3.3	23.2	17.2	15.2	14.1
El Salvador	92	57	72	91 <sup>c</sup>	-3.2	-0.9	1.5	4.2	15.2	11.2	13.3	16.6
Guatemala	100	70	66	85 <sup>c</sup>	3.7	-2.0	2.2	3.8	13.5	9.5	8.6	9.7
Honduras	95	74	78	113 <sup>c</sup>	5.2	0.5	3.9	2.6	24.5	18.2	16.9	21.9
Mexico	109	92	86	119	9.2	-0.4	1.1	3.0	23.9	18.6	17.2	20.8
Panama	108	111	84	120 <sup>c</sup>	8.3	1.6	-1.1	6.5	21.4	18.7	13.6	17.8
Paraguay	110	102	106	135 <sup>c</sup>	10.5	-0.2	4.2	2.9	25.8	21.4	19.9	21.4
Peru	109	104	89	89	3.9	-2.3	-0.2	2.8	22.9	22.0	17.6	19.7
Dominican Republic	100	87	114	129 <sup>c</sup>	4.0	2.2	4.4	1.8	22.5	22.0	21.6	21.1
Uruguay	102	66	49	71	4.9	-5.5	3.9	3.7	17.2	12.7	9.7	12.5
Venezuela	96	64	55	60	-1.1	-2.7	1.7	3.8	29.2	20.1	15.9	16.1

Source: ECLAC, on the basis of official data.

<sup>a</sup> In 1980 dollars.

<sup>b</sup> Coefficient in constant currency of each country.

<sup>c</sup> Average 1990-1993.

This slump in public investment has not, for the most part, been counterbalanced by a matching upswing in private investment; in Brazil and Venezuela, the decrease amounted to 4 and 10 points, respectively.<sup>11</sup>

The orderly way in which the external imbalance was financed had a strong influence on economic agents' expectations and helped to allay their uncertainty. A few countries were successful in procuring support from multilateral agencies (Chile) or obtaining unrequited transfers (Bolivia and Costa Rica), which allowed them not only to renegotiate their debts with the private international banking system

but also to secure external credit for an expansion of imports. Thus, the availability of external finance proved to be a decisive factor in the performance of private investment.

In 1991, the strong reactivation of international capital flows into the region began to reverse the downward trend in external variables. The resulting recovery, which took place within a framework of greater stability and receding external constraints, helped to boost investment rates. The (initially hesitant) increase in FDI and in the public sector's savings effort also contributed to the growth of investment.

The furtherance of the economic reform process, progress towards fiscal and price stability, and the liberalization of foreign capital regimes helped to create a favourable climate for the resumption of FDI streams.

Until the 1980s, Latin America and the Caribbean received the lion's share of total developing-

<sup>11</sup> Measured as a percentage of GDP, Chile's level of private investment in 1990-1994 was twice what it had been in 1978-1981 (16.8% versus 8.2%). Comparisons based on much the same time periods reveal that figures for recent years have surpassed the pre-crisis rates in Costa Rica, El Salvador and Mexico (up to 1994, in this last case).

country FDI inflows. During the 1970s, the region received twice as much FDI as the developing Asian countries did, but this situation was later reversed by the region's debt crisis and the upsurge in the Asian countries' incoming FDI flows after 1986. This put the latter in a better position to take advantage of the worldwide boom in FDI that began in 1987 and continues to the present day.<sup>12</sup>

The Latin American and Caribbean region's reinstatement as a participant in FDI flows has been a gradual process. Incentives (discounts based on debt-equity swaps, privatizations) played an extremely important part in the resumption of such flows into Mexico in 1986-1988 and Chile in 1985-1990. Thereafter, these flows returned to "normal" –until the crisis of December 1994 in the case of Mexico; they have remained so in Chile– and have since expanded considerably, although they do tend to be heavily concentrated in certain countries and sectors.<sup>13</sup>

## 6. Lags in employment and social equity

The backlog of social needs that built up during the preceding development stage has been compounded by the after-effects of the crisis (e.g., lower wages, higher unemployment and the various forms of underemployment). Throughout the 1980s almost all the countries experienced a severely regressive redistribution of income and a slump in per capita income levels which resulted in a considerable expansion of urban poverty.

The steps taken to restructure the countries' production sectors in the wake of the adjustment process, changes in relative prices, and trade liberalization have not yet generated a sufficient level of job creation or a satisfactory reduction in inequalities. Indeed, in many

countries, indicators of social equity have still not regained their pre-crisis levels (see table 4).

The process of modernizing production is taking place at a time when the region's structural heterogeneity is on the rise, as it witnesses a further widening of the already striking productivity gap between large companies and the varied group of activities that are lagging behind. The bulk of new job creation continues to take place in low-productivity, low-wage sectors, while the share of employment accounted for by formal activities is shrinking. In a parallel process, the range of wage rates has increased as a function of workers' differing levels of education and skills, while the incomes of own-account workers –and specifically those of the non-professional/non-technical members of this group– are falling in relative terms (ECLAC, 1995d).

The fiscal adjustment of the 1980s brought reductions in the level of social expenditure and in the quality of social services (ECLAC, 1994), and this has affected the coverage and effectiveness of social policies. By the same token, these policies have lagged behind in qualitative terms because they have not been adapted to meet the challenges posed by the new style of economic policy.

The new operational mode of the region's economies has exhibited regressive trends in income distribution. These tendencies may be a temporary phenomenon that could disappear once the economies' new production and occupational base has been consolidated.<sup>14</sup> It is also possible, however, that they are inherent traits of the new development style. Accordingly, these trends should be carefully monitored and may call for preventive or corrective policies in the future.

<sup>12</sup> Between 1970-1974 and 1990-1993 the developing Asian countries' share of worldwide FDI flows jumped from 4.6% to 14.8%, whereas Latin America's tumbled from a peak of 13% in 1975-1979 to a low of 6% in 1985-1989 before rebounding to 8.6% in 1990-1993. Thus, the region has still not regained the relative position it occupied prior to the debt crisis.

<sup>13</sup> Up to 1993, of the seven countries for which the fullest information is available, Mexico and Argentina took in over two thirds of the region's total incoming FDI (37% and 34%, respectively).

<sup>14</sup> Of those economies that are already functioning within these new macroeconomic and regulatory scenarios at points fairly close to the production frontier, only Colombia (temporarily) and Uruguay have recorded inequality indicators that are lower than they were before the crisis. Chile, which has maintained high, stable growth rates since 1985, boasts significant reductions in poverty, but its indicators of inequality are similar to or above their pre-crisis levels.

TABLE 4

**Latin America and the Caribbean: indicators of well-being  
in the 1980s and early 1990s**

Country	Year	Real per capita income (indexes)	Poverty (% of households)		Income concentration in urban areas (Gini coefficient) <sup>a</sup>	Utilization of labour force <sup>b</sup> (indexes)	Real wages (indexes)	Per capita social expenditure (indexes)
			National	Urban				
<i>Countries with per capita incomes above their pre-crisis levels</i>								
Colombia	1980	100	39	36	0.518	100	100	100
	1986	105	38	36	0.455	92	120	109
	1990	112	...	35	0.450	99	118	117
	1992	113	...	38	0.454	96	116	128
	1994	121	...	...	...	94	122	...
Costa Rica	1981	100	22	16	0.328	100	100	100
	1990	103	24	22	0.345	103	98	112
	1992	110	25	25	0.362	106	97	96 <sup>c</sup>
	1994	116	...	...	...	97	112	...
Chile	1981	100	...	...	...	100	100	100
	1987	90	39	38	0.485	100	87	85
	1990	103	33	33	0.471	108	96	82
	1992	111	28	28	0.474	110	106	97
	1994	118	24	24	0.479	106	114	...
Uruguay	1981	100	11	9	0.379	...	100	100
	1990	90	...	12	0.353	...	85	101
	1992	101	...	8	0.301	...	91	118 <sup>c</sup>
	1994	108	...	...	...	...	96	...
<i>Countries with per capita incomes below their pre-crisis levels</i>								
Argentina	1980	100	9	5 <sup>d</sup>	0.365 <sup>d</sup>	100	100	100
	1990	72	...	16 <sup>d</sup>	0.423 <sup>d</sup>	88	77	75
	1992	85	...	10 <sup>d</sup>	0.408 <sup>d</sup>	85	79	89
	1994	95	...	...	...	72	78	...
Brazil	1979	100	39	30	0.493	100	100	100 <sup>c</sup>
	1990	98	43	39	0.535	94	116	125
	1994	100	...	...	...	85	108	...
Mexico	1981	100	...	...	...	100	100	100
	1984	88	34	28	0.321	96	72	66
	1989	83	39	34	0.424	86	73	59
	1992	88	36	30	0.414	86	86	74 <sup>c</sup>
	1994	88	...	...	...	82	97	...
Panama	1979	100	36	31	0.399	...	100	...
	1989	93	38	34	0.460	...	114	...
	1991	85	36	34	0.448	...	111	...
	1994	90	...	...	...	...	112	...
Peru	1979	100	46	35	...	...	100	100 <sup>c</sup>
	1990	72	...	...	...	...	44	40
	1994	81	...	...	...	...	46	...
Venezuela	1981	100	22	18	0.306	100	100	100
	1990	75	34	33	0.378	93	48	65
	1992	76	33	32	0.380	94	47	...
	1994	70	...	...	...	85	36	...

Source: ECLAC, on the basis of official figures.

<sup>a</sup> Calculated on the basis of the household distribution of per capita income, by deciles.

<sup>b</sup> Percentage of the non-agricultural labour force employed in formal activities.

<sup>c</sup> 1991.

<sup>d</sup> Metropolitan area (Greater Buenos Aires).

<sup>e</sup> 1980.

## IV

### The restructuring of production and competitiveness

Thanks to the countries' economic reforms and the resumption of external resource flows, in the 1990s the region's level of economic activity has risen at a moderate yet steady pace<sup>15</sup> and the countries' growth rates have been converging. During these years, investment has also been making a gradual comeback (although sharp differences exist from country to country), economic units have undertaken a sweeping rationalization of production, and total factor productivity has increased.

In a number of cases, labour productivity has made significant gains, although in some instances these advances have been due to a cyclical recovery or a steep drop in inflation. This is a transitory component of productivity whose future level cannot be projected with any confidence.

The region lags far behind industrialized countries and the newly industrializing economies (NIES) of Asia in terms of productivity. This gap, which is evident in a majority of the region's companies and sectors as well as in both the hard and soft technologies they employ, has, generally speaking, been widening in recent years.

If something is not done about these lags, sharp distributive differences in the production base may arise which will be virtually impossible to redress by means of social policy. It is in this area that productive development policies may play an important role in achieving improvements in productivity which are not divorced from considerations of social equity.

#### 1. Slow advances in productivity

During the period from 1950 to 1980, Latin America grew more rapidly than the industrialized countries, with the exception of Japan. Labour productivity and

<sup>15</sup> The average annual growth rate for the countries of the region was 3.6% in 1990-1994. The rate's steep drop to a meagre 0.6% in 1995 was almost entirely attributable to the recessions experienced by Argentina and Mexico, since economic activity in the rest of the countries climbed by more than 4% (ECLAC, 1995a).

total factor productivity rose less than in those countries, however, thus attesting to the presence of a very substantial lag in technology. Consequently, technical progress generated only one seventh of Latin America's growth during that period.<sup>16</sup>

This situation stands in contrast to the trends observed in such other regions as those of the Asian NIES and the members of the Organization for Economic Cooperation and Development (OECD), where total factor productivity not only rose more rapidly but also continued to do so even in the 1980s. During the years of fastest growth (1950-1973) in Latin America, the rate of increase in total factor productivity was only half of what it was in the Asian NIES and the member countries of the OECD. Between 1950 and 1994, the contribution to regional growth made by technological advances was a scant 0.6% per annum, versus 2.8 points for the Asian NIES and OECD<sup>17</sup> (see table 5).

Labour productivity rose at an annual average rate of 3% during the 1960s and 1970s thanks to the general tendency to incorporate more capital into the region's economies. The rate slipped in the 1980s, but then began to rebound in the 1990s in some countries, particularly Argentina and Chile.

The severe slump in growth during the 1980s drove down productivity as a consequence of the underutilization of factors of production. In addition to the effects which economic stagnation and the downswing in investment had on productivity, the region also fell further behind the international frontier of productive efficiency.

<sup>16</sup> Total factor productivity in the region climbed at an annual rate of 1.2% between 1950 and 1980; it showed zero growth between 1973 and 1980, and declined during the 1980s. In 1989-1994, it exhibited a slight upturn (1.1%).

<sup>17</sup> Of the 4.3% average annual growth rate for the region's GDP recorded for the period 1950-1994, approximately 35% was attributable to the expansion of the volume of physical capital, 10% to improvements in labour quality (mainly as a result of higher levels of education), 31% to increased employment and only 14% to technological progress.

TABLE 5

**Latin America (6 countries): International comparison of  
growth and total factor productivity, 1950-1994**  
(Mean variation between annual averages)

Country	Gross domestic product <sup>a</sup>		Factor productivity: labour <sup>b</sup>		Factor productivity: capital		Total factor productivity	
	1950-1980	1989-1994	1950-1980	1989-1994	1950-1980	1989-1994	1950-1980	1989-1994
Latin America	5.3	4.0	3.6	3.7	6.2	2.3	1.2	1.1
Argentina	3.8	6.1	2.1	2.3	4.9	0.8	1.0	4.5
Brazil	7.0	0.9	4.4	2.8	9.8	2.3	1.2	-1.6
Chile	3.4	6.4	1.8	4.1	4.0	4.7	1.1	2.5
Colombia	5.1	4.3	3.6	4.0	4.1	3.5	1.7	0.8
Mexico	6.5	3.0	4.4	3.7	7.7	2.4	1.5	0.1
Venezuela	5.9	3.6	5.2	5.5	6.6	0.2	0.7	0.3
Asian countries	7.7	7.6	5.0	1.5	6.7	7.4	2.6	4.4
Japan	8.0	3.8	1.8	1.7	8.7	10.5	4.3	-0.4
Rest of OECD countries	4.1	1.7	0.1	0.5	5.5	3.0	2.4	0.5
United States	3.3	1.7	1.7	0.9	3.3	2.2	1.3	0.5

Source: ECLAC, on the basis of estimates prepared by Hofman, "Economic growth and fluctuation in Latin America. The long run", paper presented at the Conference on Development Strategy after Neoliberal Economic Restructuring in Latin America, Miami, North-South Center, University of Miami, 1995; and "Capital stock in Latin America: a 1994 update", *Cambridge Journal of Economics* (at press).

<sup>a</sup> In 1980 dollars.

<sup>b</sup> The labour factor includes increases in the average number of years of schooling.

In agriculture, the productivity of land and labour has improved substantially in the region,<sup>18</sup> but is still well below the levels seen in Europe, United States, Canada and Japan. The productivity of farm labour is only one third as high as it is in Europe and a scant 7% of the level achieved in United States/Canada. What is more, far from narrowing, this gap actually widened in 1970-1990; this was especially true of labour productivity and somewhat less so in the case of per-hectare land productivity.<sup>19</sup>

At the international level, the mining industry has exhibited a tendency towards an increased concentration of ownership as large transnational corporations increase their presence in the sector and continue to redeploy a portion of their activities to developing areas. This, in combination with the natural advantages enjoyed by the region's mining sector and the efforts it has made to promote foreign investment, has helped the region's large-scale mining enterprises to increase their level of technological development in keeping with the

international frontier in these areas, including a greater concern with the use of environmentally sustainable production processes.<sup>20</sup>

On this basis, the region's mining industry has acquitted itself well from three basic standpoints: the development of physical production, the region's share of world output, and the industry's technological development.<sup>21</sup> This trend is being reflected in an increasing degree of local processing of mining products and in greater internal production linkages which are having very substantial multiplier effects in terms of the generation of value added.

The productivity of the manufacturing sector is on the rise. In the second half of the 1980s its growth was even higher than the rates achieved in the 1970s, and in the 1990s its gains in productivity have outshone anything accomplished in the two preceding decades, although it is true that the performance of medium-and large-scale enterprises in the larger economies have strongly influenced these results.

<sup>18</sup> The strongest performances in the agricultural sector have been turned in by oilseeds (soya and sunflower), but a number of other commodities (meat, maize, vegetables and fruit) have also done very well.

<sup>19</sup> The reasons for this relative lag include the insufficient use of fertilizers and improved seeds, the low level of mechanization and, particularly, the marked heterogeneity which exists in relation to access to land, irrigation and credit.

<sup>20</sup> Reasons for this redeployment include the depletion of high-quality reserves in industrialized areas, the continuing decline in the prices of major mining products on the international market, and stricter environmental standards in the countries belonging to the Organization for Economic Cooperation and Development (OECD).

<sup>21</sup> Especially in the cases of copper, tin, iron ore, silver and zinc.

This improvement has, in part, been based on a fuller utilization of installed capacity and, above all, on changes in the way production activities are organized. In other words, this upswing has been achieved with relatively few new investments thanks to considerable technical changes of a "disembodied" nature (not directly linked to the incorporation of new capital goods, although they do entail complementary investments) which have led to a reduction in employment.

## 2. Internal productivity gaps widen

During the 1980s the region's mounting structural heterogeneity was manifested with particular clarity in plummeting levels of labour productivity in the services sector. A large part of the labour force that was affected by the increasing instability of employment during this period sought refuge in low-productivity activities in the tertiary sector.

At present, signs of increasing economic concentration and structural heterogeneity are to be observed which are being reflected in large and persistent cross-sectoral productivity gaps.

The productivity of the farming and livestock activities that are conducted primarily by small- and medium-scale producers in temperate-zone ecosystems is nearly on a par with their developed-country counterparts. In addition, the region's commercial agricultural sector is developing modern agribusinesses which represent a new form of internationalization. In contrast, the productivity gap between international standards and the crops typically grown by subsistence farmers in a wide variety of agro-ecological systems is enormous.

The mining sector's buoyancy is not shared by small- and medium-scale enterprises, whose technological level is lagging further and further behind that of the large-scale mining concerns which are positioned on the international technological frontier. In the manufacturing sector, the rapid productivity growth seen in the 1990s has been concentrated in medium- and large-scale industries, and the gap between them and the small firms and micro-enterprises that account for the bulk of industrial employment is widening. In the tertiary sector, telecommunications and financial services are being radically restructured in many countries of the region, and these changes are prompting sharp gains in productivity in these activities. In some countries, such as

Argentina, Colombia and Chile, this has helped to bring about a considerable improvement in the tertiary sector's average labour productivity. In most cases, however, the expansion of low-productivity activities (non-professional, non-technical own-account workers and micro-enterprises) continues to be the mainstay for increases in employment in the sector as a whole. The coexistence, in many countries, of a rapid modernization process in some tertiary activities and an expansion of informal activities points to a widening of productivity differentials within this sector.

A comparison of gains in productivity for the secondary sector as a whole (mining, manufacturing and construction) between 1990 and 1993 with productivity growth rates for large- and medium-scale manufacturing enterprises shows that the former are far below the latter. If, in addition, the increases in this variable observed in large-scale mining activities are taken into consideration, the conclusion to be drawn is that labour productivity in small- and medium-scale manufacturing, construction and, probably, small-scale mining dropped sharply during this period.

A greater concentration of production activity is also to be observed in companies belonging to large national or transnational conglomerates. This is partly because of the greater capital-intensiveness associated with the more rapid growth of commodity-producing industries, but it is also due to the concentration of vast amounts of financial resources, the realization of capital gains and the attraction of new sorts of quasi-rents by the small number of huge multisectoral conglomerates which formed in most of the countries during their structural reform and adjustment processes and which, in many cases, have profited from privatization drives that did not do enough to ensure competition.

## 3. Sectoral changes

The recovery seen in the 1990s has, generally speaking, embraced all the sectors of the economy.<sup>22</sup> Among the producers of tradable goods, the mining industry has made an outstanding showing, while producers of non-tradables (e.g., power, construction, transport)

<sup>22</sup> The most glaring exception is community and social services, whose level of activity has lagged quite far behind as a consequence of the curtailment of current fiscal expenditure and the rationalization of employment in the public sector.



have outperformed the rest of the economy by a wide margin. The manufacturing sector has lost ground, in terms of its share of GDP, to natural resource-based activities and to non-tradable goods and services.

A greater propensity to absorb technical progress has been most closely associated with natural resource-based activities; this is particularly true of the mining industry, but also applies to the rest of the primary sector. The introduction of new technology has been intense throughout the agricultural distribution chain (which includes packing houses, cold storage and processing facilities, and shipping, among other stages), in the fishery and forestry industries and in tourism activities in the Caribbean.

The restructuring of the manufacturing sector has brought about a shift away from a metalworking-based pattern of specialization<sup>23</sup> and towards a pattern that is gradually being geared to natural resource-intensive industries. Although these are not entirely new branches of industry, during the second half of the 1970s and in the 1980s they spawned a new generation of highly modernized, more capital-intensive industrial plants employing state-of-the-art technology (aluminium, petrochemicals, paper and pulp, iron and steel, non-ferrous metals, foodstuffs). These new machine-paced, continuous-flow factories are comparatively less labour intensive than metalworking industries and make relatively less use of systems engineering techniques for organizing production and determining production methods.

In addition to the metalworking industry's lower profile, this transition has also been associated with a decline in the production of textiles, leather and footwear. Production activities involving a high degree of value added and an intensive use of in-house engineering services, such as capital goods and fine chemicals, have also been scaled down.

An increase in the supply and quality of natural resources has prompted a rapid expansion of the industries that process these materials. As a rule, these new industrial plants have confined their activities to the initial processing stages rather than moving on to

<sup>23</sup> The metalworking complex encompasses a cluster of industries primarily concerned with technical sub-processes for producing and assembling metal parts and sub-components. All these activities are labour intensive, require skilled workers, and make use of industrial engineering services for organizing production and designing the production methods to be employed. They include manufacturers of consumer durables, motor vehicles, fairly simple capital goods such as engines and boilers, farming equipment, equipment used by the food-processing industry, etc.

higher levels of local value added or the manufacture of special products (such as high-grade paper, hydrogenized or low-cholesterol oils, specialized steel products, aluminium angles or sections, instant coffee, copper alloys, etc.), which have tended to remain in the hands of foreign buyers.

#### 4. Corporate restructuring

In each country there is one group of firms –which, although few in number, play an important role in terms of their contribution to GDP– that are reacting “proactively” to changes as they take place; in other words, these companies are adapting to the new conditions in their environment and have significantly altered their operational procedures and expanded their investments and production capacity through the use of new types of facilities and organizational production models. A second group is reacting “defensively”, adapting to new conditions by making minor changes in the areas of organization, subcontracting or outsourcing and vertical delinking but not undertaking any major investments or expansion of installed capacity. A third group –the largest in number but with the smallest share of GDP– does not have the capacity, information or resources its members would need to adapt to changing circumstances; as a result, some of the firms in this group have disappeared while others are sinking fast.

Among the subsidiaries of transnational manufacturing enterprises operating in the region, the vast majority have opted for strategies based on a defensive reorganization involving the use of information and management technologies, cost-cutting measures, manpower reductions, and the suspension of any further major investments (Mortimore, 1995).

The macroeconomic imbalances of the 1980s sent out signals which led economic agents to focus their attention on financial and speculative operations more than on technology. Uncertainty as to the permanence of economic reforms led them to emphasize short-term decisions and to veer away from investments having longer lead times or involving more risk or uncertainty; this led to a decline in investments in modern technologies and equipment associated with new product designs and research and development (R&D) activities.

By virtue of their competitive advantages –which stand out more clearly now that the countries have shifted the focus of their development strategies– and their absorption of new technology, industries that

process natural resources and producers of basic, widely-used manufactures both occupy extremely strong positions within the new structure of macro-economic incentives.

##### 5. Institutional reforms and the modernization of services

Trade liberalization, market deregulation, privatization and the elimination of obstacles to foreign investment, together with the dynamic created by technological progress and the development of new forms of corporate organization, are bringing about institutional changes that make it necessary for us to re-draw the conventional dividing lines between tradable and non-tradable goods and services and, indeed, between goods and services as such.

The exportation of financial, engineering and consulting services has converted many such former non-tradables into tradables. So too, the mobilization of financial resources (in some cases, pension funds, and in others, bond and equity issues on local or international markets) has deepened capital markets and has in some instances promoted investment in neighbouring economies. Recent privatizations of power and telecommunications utilities have helped set in motion major productive investment processes that have galvanized these sectors as well as the construction and transport industries.

The current trend towards subcontracting or outsourcing services is boosting the volume of transactions between the services sector and other sectors of the production system and is building up the markets in which these transactions are conducted. This process is leading to the emergence of industrial-scale service activities.

The production of commodities and basic manufactures for export places enormous demands on a country's road and rail, port and communications infrastructure, and this is one of the reasons why the transport, storage and communications sector has, on average, grown twice as fast as GDP since 1980. The same is true of the electricity, gas and water sector, which has become one of the most rapidly growing industries in the economy since 1980 due to the energy needs of new natural resource-based production activities and to the discovery of new non-renewable sources of energy.

Privatizations and the deregulation of domestic markets are shaping a new economic arena in which private agents interact with public policies and in

which institutions find themselves faced with emerging challenges in relation to regulation and the promotion of competition.

The privatization process has involved a wide variety of sectors. It began with a cluster of dissimilar firms positioned within competitive markets, but then spread to manufacturing concerns, financial services, transport companies and natural resource-related enterprises. More recently, the wave of privatizations has spread to public utilities and infrastructure activities.

Privatization processes in Latin America have differed in terms of sequencing, speed, intensiveness, sectoral coverage and transfer mechanisms. This process has been widespread in the case of firms operating in competitive markets and of considerable magnitude in the transport and agro-industrial sectors. An analysis of the privatizations slated for the next few years clearly shows a shift towards public utilities and infrastructure activities. For example, privatizations or the formation of partnerships with private agents—in the form of operating concessions or the like—are planned in the power sector (Bolivia, Brazil, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Panama, Paraguay and Venezuela); telecommunications (Bolivia, Brazil, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras and Panama); port or road infrastructure (Brazil, Chile, Colombia, Ecuador, El Salvador, Guatemala, Mexico, Panama, Peru and Venezuela); and drinking water supply (Brazil, Ecuador, El Salvador, Honduras, Mexico, Panama, Paraguay and Venezuela). A somewhat less notable emphasis on financial services, transport and natural resources is also to be noted.<sup>24</sup>

##### 6. Competitiveness and exports

The region's agricultural exports continued to be concentrated in products that exhibit a very slow rate of growth in the international market place. Although a number of notable exceptions bear witness to a strong ability to

<sup>24</sup> Recent events in this area include the partial implementation of a capitalization process in Bolivia which is expected to bring in investments equivalent to nearly 30% of the country's GDP over the next seven years; partial privatizations in the telecommunications industry, natural gas distribution, hydrocarbons sector and shipping services in Brazil; privatizations in the areas of transport, telecommunications, natural gas and infrastructure in Mexico; and the use of operating concessions in the areas of infrastructure, natural gas distribution and sanitation (including waste water treatment) in Chile.

TABLE 6

**Latin America and the Caribbean: international competitiveness, 1980 and 1993**  
(Percentages)

	Latin American Integration Association (ALADI) <sup>a</sup>		Central America and the Caribbean <sup>b</sup>		East Asia <sup>c</sup>	
	1980	1993	1980	1993	1980	1993
I. Contribution (structure of exports to OECD)	100.0	100.0	100.0	100.0	100.0	100.0
Natural resources (1) + (2) + (3) <sup>d</sup>	75.6	49.2	85.1	54.0	13.1	6.4
Agriculture (1)	30.3	25.2	48.7	41.5	5.8	4.7
Energy (2)	36.1	18.6	22.5	4.9	4.9	1.3
Other natural resources (textile fibres, minerals and others) (3)	9.3	5.4	13.9	7.7	0.7	0.4
Manufactures (4) + (5)	23.1	48.1	12.2	43.0	84.7	92.1
Based on natural resources (4)	8.5	7.2	3.2	3.6	4.1	1.7
Not based on natural resources (5)	14.6	40.5	9.0	39.4	80.6	90.4
Other (6)	1.3	2.7	2.7	3.0	2.3	1.5
II. Share in OECD import market	4.4	4.1	0.9	0.6	3.5	5.9
Natural resources (1) + (2) + (3)	7.6	8.5	1.7	1.3	1.0	1.6
Agriculture (1)	9.3	8.5	3.0	1.9	1.9	2.3
Energy (2)	6.2	8.0	0.8	0.3	0.7	0.8
Other natural resources (textile fibres, minerals and others) (3)	11.3	11.5	3.4	2.2	0.7	1.3
Manufactures (4) + (5)	1.9	2.7	0.2	0.3	5.4	7.3
Based on natural resources (4)	6.7	6.6	0.5	0.4	2.5	2.2
Not based on natural resources (5)	1.3	2.4	0.2	0.3	5.7	7.6
Other (6)	3.0	4.2	1.3	0.6	4.2	3.4

Source: ECLAC, on the basis of results generated by CAN software, Country competitiveness analysis, version 2.0.

<sup>a</sup> Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Paraguay, Uruguay and Venezuela.

<sup>b</sup> Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, Barbados, Cuba, Dominican Republic, Haiti, Jamaica, and Trinidad and Tobago.

<sup>c</sup> Republic of Korea, Hong Kong, Singapore and Taiwan.

<sup>d</sup> The numbers given in parentheses in this table refer to the following categories of the Standard International Trade Classification (Rev. 2):

(1) Sections 0, 1 and 4; divisions 21-25 and 29;

(2) Section 3;

(3) Divisions 26-28;

(4) Divisions 61, 63 and 68; groups 661-663, 667 and 671;

(5) Sections 5, 6 (except for those divisions and groups included under category 4), 7 and 8.

(6) Section 9.

move into new market niches, the region's share of world trade in agricultural products has shrunk, slipping from nearly 15% in 1980-1985 to 11.2% by 1993.

Some of the agricultural sector's most rapidly growing exports include forestry products, new export items such as fresh fruit and vegetables, and exports of a single good in a wider variety of types (fresh, chilled, frozen) or in a more highly processed form to fit the varying needs of consumer markets. All of these product lines are very strong performers in the flow of exports from the region to the OECD countries.

Mining activities in Latin America have moved into a very dynamic phase at present thanks to reforms in mining laws that have heightened the complementarity between the high yields of the region's

mines (above the world average) and the fact that its large-scale mining activities are falling into step with the pace of technical progress at the international level, thereby permitting them to take fuller advantage of these resources' rent-producing potential. A new wave of mining investment is expected that will expand the region's exportable supply.<sup>25</sup>

Since the late 1970s, the volume of exports of manufactures has climbed considerably (around 7% per year) even though the production of such goods has been flat. This fact demonstrates that the external sector

<sup>25</sup> Investment commitments in the region for the remainder of the 1990s total approximately US\$14 billion, which is almost one third of total projected mining investment worldwide for those years.

has become the most buoyant component of demand and, at the same time, that many companies have managed to redirect their output towards external markets.

Exports of manufactures played a very important role in the 1980s and have continued to expand in the 1990s in terms of both volume and value despite weakening prices for many of the basic inputs that are exported by the region (e.g., copper, pulp and fishmeal). Meanwhile, imports of manufactures, which had decreased markedly during the first half of the 1980s, have been climbing quite sharply since then. As a result, the small trade surplus posted by the manufacturing sector in 1985 gave way to a deficit in 1990 which proceeded to widen quite rapidly in the ensuing years, overshadowing the deficit recorded in 1980.

Now, in the mid-1990s, the manufacturing sector is exhibiting an increasingly widespread renewal of its growth capacity, productivity gains, a greater export capacity than in previous decades, a strong expansion of imports of manufactures and a sizeable deficit on trade in manufactures.

The Latin American countries that belong to the Latin American Integration Association (ALADI) have shifted the product mix of their exports to the OECD

in the right direction (the percentage of manufactures doubled –from 23% to 48%– and the percentage of manufactures not based on natural resources virtually trebled between 1980 and 1993). Nevertheless, their share in total imports from OECD countries declined slightly (from 4.4% to 4.1%) and the competitive position of the fastest-growing sectors showed no more than halting advances between 1980 and 1993 (from 1.9% to 2.7% for manufactures and from 1.3% to 2.4% for manufactures not based on natural resources) (Mortimore, 1995).

The Latin American and Caribbean countries have clearly lagged behind the developing countries of Asia in terms of their competitive position. Although there has been a significant shift in their export mix towards the types of manufactures that are in the greatest demand, their share of the imports of the OECD countries, especially in respect of the most dynamic product lines, has made fairly little headway. The most notable exceptions are Mexico's automotive industry and Mexico's and the Dominican Republic's EPZ (*maquila*) industries. In both cases, transnational corporations have played a prominent role (see table 6).

## V

### Policies for strengthening development

The region's public policy objectives reflect its interest in moving towards a progressive institutionalization of open, stable and competitive market economies while it strives to redress its social problems and consolidate a democratic system of government.

This complex process is also reflected in a transition towards new production structures based on the interaction of business firms, production agents, markets, sectoral policies and regulatory bodies and mechanisms. The process is notable for the speed with which its ground rules may change and the slowness with which the relevant organizations adjust to such changes. Modes of behaviour geared to the workings of a closed economy are still to be seen, as is a lack of sufficient institutional flexibility to cope with competitive challenges; in particular, many companies have been very slow to adopt quality standards, technological innovations and staff training schemes, and their industrial relations continue to

be marked by a lack of cooperativeness. Meanwhile, the public sector has been reluctant to modernize and has clung to overly bureaucratic procedures, as well as, in general, pursuing policies without providing for their assessment and allocating funds without reference to performance standards.

The gradual resumption of growth and increase in competitiveness have been accompanied by widening internal productivity gaps that represent a drain on the sector's forward momentum and limit its capacity in terms of employment and greater social equity.

Hence the importance of an approach that seeks improvements in stability, competitiveness and social equity within a framework that melds macroeconomic, microeconomic and institutional issues. This does not imply any effort to lower the profile of the macroeconomy but simply to understand its role as one of various essential preconditions for changes in

the region's production patterns. It must be coupled with the development of the corresponding markets so that the macroeconomic incentives which are to be created will serve as concrete means of stimulating productivity, innovation and the dissemination of technology, thereby reducing the heterogeneity of the sector's growth and improving the distribution of its achievements.

### 1. Boosting the growth rate

While it is true that the region attained a growth rate of 3.6% between 1990 and 1995, this is clearly not fast enough if it is to accomplish the twofold task of rectifying its problems of social inequity while at the same time stepping up its absorption of technical progress. The above-cited growth rate is not only well below the rate for 1950-1980, but also, in effect, keeps the region's poverty rate at its existing level.

ECLAC estimates that in order to reach acceptable levels of employment and productivity, GDP will need to climb at something near 6% per year, which would mean that per capita GDP would be expanding at an annual rate of around 4%.

Reaching the objective of a high and stable rate of growth will require redoubled saving and investment efforts since, in order to grow at 6% per annum, the region's average investment rate will have to be raised from 22% to 28% of GDP; furthermore, there will need to be an appropriate mix of national and external saving so that this can be done in a way that preserves the region's macroeconomic stability.

Moving gradually towards growth rates of 6% and national saving rates of around 25% or 26% of GDP (implying an increase in external saving of about 2%-3% of GDP) will be difficult, but not impossible. In any event, it is not a question of specific numbers but rather ranges or approximate levels, since the swift pace of economic change makes it hard to extrapolate from past results.<sup>26</sup>

### 2. Consolidating economic reforms

The preservation of fundamental macroeconomic balances is essential to any attempt to strengthen the development process; to this end, decision-makers

need to have an overall picture of the economy as a basis for simultaneous efforts to achieve a low and declining inflation rate; carry forward the economy's stabilization with the help of fiscal austerity measures and increases in domestic saving, investment and productivity; hold the deficit on current account within a sustainable range; and keep the real exchange rate at a competitive level.

The management of macroeconomic variables should focus on the promotion of national saving and should ensure that external and domestic saving will complement each other by achieving stable levels of external saving and channelling both sources towards funding a higher level of investment and productivity. Lowering inflation, spurring forward public and private saving, attracting long-term external capital and taking steps to ensure that the signals sent out by relative prices are such that they emphasize permanent factors and encourage investment in tradables—these are all ongoing challenges that put to the test the consistency of macroeconomic policies designed to pave the way for changes in the region's production patterns.

In addition to recognizing the significance of the inflow of external capital to the region, it is important to appreciate the dilemmas faced by the economic authorities as they strive to achieve macroeconomic stability, maintain external capital inflows, ensure their complementarity with national saving, and channel these flows into productive investment—all at one and the same time.

In order to coordinate fiscal, exchange and monetary policies within an environment marked by an increasing liberalization of various markets, the authorities have to avert any revaluation of the currency that is not tied in with long-term external equilibria. The way of accomplishing this, however, will vary depending on the particular features of the relevant macroeconomic cycle and economic policy matrix. By the same token, a consensus exists as to the need to boost national saving, but differences of opinion arise with regard to the specific policy approach to be taken to the liberalization of the capital account and government intervention in foreign exchange and money markets. Consequently, a more careful examination of the specific macroeconomic and institutional features of the situation in each country is required, since, along with the necessary increase in saving rates, the possibilities of supplementing national saving with external saving by regulating the

<sup>26</sup> In particular, it is to be hoped that economic reforms will boost the efficiency of investment and therefore permit a higher growth rate to be achieved at a given level of investment. This does not automatically follow, however, since an increase in the efficiency of financial intermediation also plays a crucial role.

flow of foreign capital are strongly influenced by those features.

Hence the relevance of an analysis that traces the links among macroeconomic, microeconomic and institutional factors for an examination of public policies and of ways of reorienting them to cope with external and internal challenges. Such an instrument is useful in dealing with the various stages of development and the differing national conditions found in the countries of the region and, as such, enriches comparative studies and helps us to avoid overgeneralizations. Nonetheless, national specificities should not blind us to the fact that the macroeconomic situation ought to manifest itself in relative price stability, credible exchange rates, positive yet moderate real interest rates and more export-led growth.

As more experience is gained in this regard, it is beginning to become clear that a strong degree of complementarity exists among policies dealing with macroeconomic variables, productive development and the promotion of competition. On the one hand, a steady decline in the real exchange rate can thwart efforts to promote technology, productivity and training, thereby leading to a reduction in competitiveness. On the other, privatization drives may enhance competitiveness by channelling support to competitive markets and strengthening the regulation of markets that tend to be dominated by natural monopolies. These are important aspects of the economic reforms which are now under way, and they deserve more attention than they are currently receiving.

### 3. Saving, investment and finance

In order to make gradual progress towards a sustained growth rate of around 6% per annum, an investment rate of nearly 28% of GDP will be required (given the region's existing productivity levels and capital mix), which is between 5.5 and 6 points more than the present average investment coefficient.

Within this growth environment, national saving is sure to increase; if it holds to the trend line observed over the past two decades, however, the upturn will not be large enough, since this would only raise the rate from 18% to 23% of GDP, and the difference of slightly more than 5% of GDP would have to be covered with external savings. One of the lessons to be learned from the Mexican crisis is precisely that countries must refrain from relying too heavily on external saving, particularly when it is

composed of short-term funds. While it is reasonable to conclude that the current status of economic reforms in the region will ensure a more stable and orderly type of access to external finance than in the 1980s, it is also clear that a current account deficit of 5% of GDP would exceed the bounds of macroeconomic prudence and, ultimately, would severely reduce the region's chances of attaining stable growth.

Hence the need to rely primarily on national saving, which should be raised to somewhere around 25% of GDP (a jump of 5 or 6 points of GDP over a period of four or five years).

Such levels cannot be reached through growth alone, since their achievement would require a shift in the saving function of such a magnitude that, at each income level, it would add another three points of GDP to the saving rate. This assumes a substantial change in behaviour patterns with regard to consumption and private saving, as well as public saving. Nor does it appear possible to attain such savings levels by relying entirely on changes in relative prices. While clearly very important, the use of relative prices should be coupled with institutional modifications all along the capital formation sequence in order to encourage all forms of saving and ensure their efficient conversion into productive investment.

To this end, the countries need institutional mechanisms that will increase the efficiency with which their financial systems attract funds, perform intermediation services and allocate resources as well as enhancing the supervision and regulation of those systems.

Not only is the region's saving rate very low in comparison to the rate achieved by Asian economies, but its forms of intermediation are also inefficient in channelling savings into productive investment.

An integrated approach to the capital formation process needs to take into account not only macroeconomic stability and the existence of a growth climate, but also the relevance and continuity of incentives, the effectiveness of the regulatory system and the quality of financial intermediation, since the aim is both to generate savings and to make it easier for these funds to be channelled into productive investment in an efficient manner.

The foregoing suggests that financial policy ought to touch upon all the links in the capital formation chain. Such a policy should actively create and promote new sources of saving and should foster a

vigorously-paced development of financial institutions and instruments while taking into account externalities, problems in terms of information, and the flaws and even actual gaps existing in the region's credit and capital markets at their current stages of development; in addition, it needs to address the demands associated with the financing of specific forms of investment (fixed investment by business enterprises, investment in infrastructure, in housing, etc.) along with the required complementary investment in human capital.

The nature of the relationship between the financial market and the capital formation process calls for institutional changes to permit the inclusion, on the one hand, of a segment of long-term operations (which would open up the field for investment in technology, for example) and, on the other, a segment that would serve the needs of small and medium-scale enterprises. Both of these segments could benefit from financial innovations that would give them access to leasing operations, collateral funds, group collateral funds for project loans, and technical assistance-tied loans.

Pension-system reform plays a special role in the promotion of private saving.<sup>27</sup> There have also been a number of promising experiments with institutional saving schemes that entitle workers to receive housing subsidies. A similar system might be used to provide preferential loans to individuals or groups working in the field of education and training; under such a scheme, social security collection systems might be used for the automatic discounting and repayment of such credits. Such a mechanism could be supplemented by secondary markets in these instruments that would pave the way for their diversification and securitization, thereby making them more attractive to the financial system.

In respect of public-sector saving, there are various possible combinations of increases in tax revenues, reductions in current public expenditure, and financial reorganizations of State enterprises and pension systems. Two countries that have managed to carry out stable external adjustment processes—Chile and Colombia—are also notable for their achievement of a lasting fiscal balance. In both cases, public ac-

counts were in better shape prior to the crisis than they were in other countries, and throughout the fiscal adjustment process, both countries continued to make basic public investments. Now, they boast the two highest levels of tax revenues and current income as percentages of GDP. These growth-based fiscal adjustments have included both a reduction and rationalization of expenditure and an increase in receipts of tax revenues and current income.

In the area of investment, interesting results have been obtained with the use of tax incentives to promote the retention and reinvestment of profits as a means of shifting the tax load from businesses to individuals. One little-used mechanism is to finance training for individuals through an equivalent tax reduction as a way of fostering investment in human capital.

Another relevant aspect in the promotion of competitiveness is investment in infrastructure, especially since the region has fallen behind in this area as a consequence of the fiscal constraints of the 1980s. Privatizations in the telecommunications and energy industries have had a significant effect and have opened the way for investments which have improved such services' coverage and level of efficiency more than could have been done with public funds. Something similar is occurring with private investment in seaports, airports and railways, although in these cases there is also a need to bolster these trends with regulatory schemes that will spur competition and reduce the possibility of vertical integration or cross-subsidization. The recent formation of public-private linkages in road-building projects and in the sanitation sector in Chile and recent privatizations in Bolivia and Peru point in this direction.

#### 4. Complementarity between external and domestic saving

The current account deficit has proved to be a meaningful indicator of the sustainability of macroeconomic equilibria in open economies. It is not regarded as a cause for concern if it is moderate in size (2%-3% of GDP)<sup>28</sup> or if it is sustainable by virtue of

<sup>27</sup> Careful thought should be given to the economic and financial implications of such reforms, particularly for public and private saving, the fiscal budget, financial deepening, risk management in securities and insurance markets, and real investment.

<sup>28</sup> Chile's economic authorities have set the trend level of external saving at between 3% and 4% of GDP (Zahler, 1995), whereas Summers considers any deficit on the current account of the balance of payments in excess of 5% of GDP to be dangerous (Summers, 1996).

the fact that it is covered primarily with long-term capital inflows. Nor is it regarded as worrisome if it supplements national saving rather than taking its place, is reflected chiefly in an increase in investment rather than consumption and is invested in tradable activities that enhance a country's external payment capacity.

Measures aimed at stabilizing external capital inflows have shown themselves to be useful in averting serious distortions in key prices such as the exchange and interest rates. A number of Governments have intervened in the foreign exchange market in order to forestall just such an occurrence; in these cases, they have not simply bought up hard currency but have also neutralized the monetary effect of those purchases by issuing domestic debt paper. Chile and Colombia have encouraged inflows of long-term funds and have tried to limit inflows of short-term resources by adopting provisions specifically designed to discourage them. In 1995, Brazil and Peru also began to implement policies of this sort, although less aggressively. These policies are not without their costs,<sup>29</sup> but they have proved to be effective during transitions towards a greater degree of financial integration.

In the most prominent cases—both within and outside the region—involving the management of large volumes of external finance, the chosen approach has consisted of a series of integrated economic policy measures designed to increase fiscal restraint and boost domestic saving. These measures have included the elimination of exchange insurance, sterilization, the phasing out of capital controls and obstacles to resource outflows, a moderate appreciation of the local currency and steps to discourage an excessive inflow of short-term capital (ECLAC, 1995b).

Events in the region during recent years indicate that a combination of little or no exchange uncer-

<sup>29</sup> These include both microeconomic phenomena (e.g., less effective financial intermediation) and macroeconomic costs occasioned by the quasi-fiscal losses incurred by the monetary authority (it pays more for domestic debt than it gains on the international reserves that are amassed as a consequence of this policy). It would not be efficient to attempt to use the exchange rate to neutralize all the ramifications of such measures, even if they were considered to be temporary in nature, because this might stimulate arbitrage and reduce the manoeuvring room available to monetary policy-makers.

tainty,<sup>30</sup> sterilization measures that check the convergence of interest rates, and the liberalization of capital inflows encourage the entry of short-term capital and augment its destabilizing effects (IMF, 1995).

The speed at which the capital account is opened up should be geared to the economy's absorption capacity and its ability to allocate external resources efficiently in order to safeguard the country's macroeconomic stability and avert fluctuations in the real exchange rate. A real devaluation of the currency is essential in order to ensure that the liberalization of the trade account will have the desired results and to prevent the transition in the production sector and labour market from having too high a cost.<sup>31</sup> Since financial markets adapt more swiftly than real markets do, a premature liberalization of the capital account may lead to a sharp appreciation of the currency and may send out contradictory signals regarding trade liberalization.

If financial liberalization is very sudden and sparks a massive influx of capital, then the deficit on current account may grow so large that it will have a severe impact on the country's macroeconomic equilibrium, as well as being unsustainable over the medium term. This situation is compounded by upward pressure on the price of domestic assets—real estate and stock—whose "wealth effect" spurs consumption and swells the deficit. This raises the level of country risk and heightens expectations of a devaluation. Under these circumstances, capital flows tend to reverse their direction, thereby triggering a recession or making traumatic devaluations necessary in order to rectify the external imbalance.

This having been said, it is nonetheless important to consider the specific features of each country. Past events in the realm of economic policy or the

<sup>30</sup> In April 1994, Mexico's financial authorities replaced local-currency government securities (CETES and the like) with Tesobonos; the value of these instruments was indexed on the basis of the exchange rate, which, in practice, provided total exchange rate certainty. As a result of the delicate economic environment and the political and economic turbulence existing in Mexico, the total value of Tesobonos in circulation jumped from slightly less than US\$ 2 billion in April to nearly US\$ 29 billion in December 1994.

<sup>31</sup> Between 1987 and 1991, six countries in the region either began to liberalize their trade regimes or took steps to intensify an existing liberalization programme at a point in time when their currencies were appreciating sharply. The resulting combination of more abundant capital inflows and lower import prices triggered an inordinately large increase in imports. See ECLAC, 1992a.



nature of a country's institutional capabilities may make it inadvisable to use certain types of instruments, such as capital controls. In other cases, it may be necessary to implement an entire array of economic reforms simultaneously because of economic policy considerations, as has occurred in Bolivia and Peru; in still others, a history of hyperinflation may make it wise to use exchange anchors and adopt a system of free convertibility in order to attract external savings that will contribute to a country's stabilization and growth, as has been done in Argentina.

Be all this as it may, the reasons for not allowing the current account deficit to exceed a reasonable level still stand. In cases where external savings can serve as a source of ample support, it is all the more important to maintain a stance of fiscal austerity and to promote productivity in order to counteract overspending and the local currency's tendency to appreciate in value.

## 5. Competitiveness and productive development

Inasmuch as world trade's most buoyant components are made up of products having a relatively greater technological content (particularly non-natural-resource-based manufactures), if the countries of the region are to meet the competitive challenge, they will have to redouble their efforts to diversify their exports, incorporate more technology and productivity into those exports, and upgrade the quality and depth of the linkages existing between exports and the rest of the production sectors in the economy.<sup>32</sup>

Viewing the situation from this vantage point, ECLAC has identified a number of the questions that have been raised in the regional debate on these issues:

Is the present process of specialization simply one facet of the transition towards more technology- and human capital-intensive activities or is it an end result whose repercussions are confined to the primary sectors of the economy? What kind of effect will this specialization have on growth, employment and income distribution? Does it allow the region to

<sup>32</sup> In order to grow at an annual rate of 6%, export volumes will need to expand by no less than 10%-12%. The achievement of this level appears to be unlikely if the present export basket remains unchanged, since in 1985-1994 (a period that saw an upturn in international trade), world commodity trade was unable to top an annual growth rate of 4% (somewhat less than half the growth rate for total trade and about one third of the increase in trade in manufactures).

carve out a fitting position for itself in dynamic international trade flows? And, if not, what are the alternatives? What other policy options are available?

### a) Policy-making

The positions taken on this subject in the region vary a great deal, ranging all the way from advocacy of the elimination of industrial policies altogether –with the exception of those that bolster systemic competitiveness– to support for the idea of drawing up sectoral policies to supplement existing horizontal policies, i.e., those designed to further the development of capital markets.

A definite asymmetry is also to be observed in terms of the available tools for furthering productive development owing to the fact that, even though the use of the traditional sorts of instruments is on the wane, the region has not been developing other tools to take their place which would be more in keeping with today's open economies and the growing importance of multilateral agreements.

Today, the region is focusing its attention primarily on horizontal policies aimed at refining its factor markets while remaining neutral as to the types of activities or business enterprises that may be involved. This policy stance is clearly weak in certain areas, however, such as in the way sectoral situations and the issue of retooling are being handled, in supporting the activities of innovative sectors and in the degree of coordination and cooperation between the public and private sectors (Rosales, 1994).

Thus, the region's policy-makers need to strike a balance between macroeconomic discipline and productive development policies based on a clear understanding of the dangers of government intervention and the excesses of protectionism. There is a less widespread awareness, however, of market flaws or shortcomings in relation to the promotion of competitiveness and technical progress, together with a tendency to underestimate the feasibility of productive-development learning processes in the public sector.

The technical requirements of the instruments in question tend to focus on market institutions and the provision of clearly delineated incentives that decline over time and are self-eliminating once they produce their intended results, along with assessable types of performance and limited objectives that are geared to the public sector's technical and institutional capabilities (Rosales, 1994).

Accordingly, productive development policies do not attempt to "pick winners" but instead to pave

the way for their emergence. They are aimed at boosting total factor productivity, promoting the development and spread of technology, encouraging investment in human resources, and fostering the formation of production linkages and chains in natural resource-based activities, including tourism.

The importance of incorporating improvements in infrastructure and the promotion of competition as factors of competitiveness is one of the lessons learned from the economic reforms of the 1990s. Fiscal reorganizations and adjustments have reduced the public sector's ability to invest in infrastructure and thus open up an opportunity to explore the possibility of the private sector's involvement in financing such investments.

Promoting competition has come to be an essential part of productive development, given the fact that market efficiency is determined by a market's competitiveness, transparency and accessibility. The region therefore needs to deregulate its competitive markets, regulate those markets in which there are natural monopolies and "fill out" those of its markets that are stunted or weak, such as its markets for technology, training, long-term capital, and credit for small and medium-scale enterprises (SMEs) or for investment in human resources.

The best way to spur efficiency is through competition. When this is not an option, the second-best choice is regulation. Hence the importance of encouraging regulatory agencies to make greater use of modern technologies, giving them greater autonomy and building up their institutional capabilities as a means of fostering competitiveness.

Privatizations have led to a number of advances in terms of increased efficiency and investment, and progress in these areas has been the greatest in cases where competition has been promoted by means of schemes for regulating natural monopolies that take into account rates and charges, investment, coverage, rules governing competition, and consumer protection.

*b) Systems of innovation and technological dissemination*<sup>33</sup>

The region is not allocating enough resources—in the form of funding, incentives and institutional

capacity—to the promotion and dissemination of technology. Its efforts in this area thus fail to reflect the strategic importance of technical progress for open, competitive economies, and the fact that the issue has not been placed near the top of national agendas may cause the region to fall further and further behind in terms of its competitive position.

Productivity growth is closely linked to advances in innovation and the promotion of technology and quality. Public policy therefore needs to support the development of a market for technology by building up the infrastructure for science and technology and strengthening the links between that infrastructure and the production apparatus. This idea is inherent in the concept of an "innovation system", which includes sectoral centres for technological research and dissemination, the promotion of quality, brand differentiation and design, management methods, and human resource development.

Most of what is spent on technology in the region is channelled through public-sector technological institutes and, in most cases, these expenditures are not subject to regular evaluations to determine their effectiveness or relevance. What is therefore being proposed is that a gradual transition be made towards a results-oriented system of resource allocation based on performance indicators that would introduce greater competition into the sector through the practice of putting projects out for tender.

This will probably lead to increased private participation in the management and funding of such institutes, which may give them greater autonomy and flexibility in the management of their resources as well as putting them into closer contact with the production base. Such a transition must be gradual, however, and care must be taken to safeguard basic research and areas of activity in which significant externalities exist in the public domain.

*c) Training*

A significant increase in corporate expenditure on training needs to be promoted through a reorientation of tax and financial incentives.<sup>34</sup> The content of existing training programmes is inadequate and ob-

<sup>33</sup> Previous ECLAC studies have explored such subjects as the dissemination of technology (ECLAC, 1995c, chapter VIII), the strengthening of technological infrastructure (ECLAC, 1992b, chapter V) and the funding of research and development (R&D) (ECLAC, 1990, chapter V).

<sup>34</sup> An average worker in the region only receives between two and four weeks of training during the entire 45 years of his or her working life, as compared to the 20-25 weeks of training that workers would receive if 1% of the payroll were allocated for this purpose, in accordance with internationally accepted norms.

solete, and bears little relation to what business firms actually need; furthermore, the training system's links to vocational and secondary educational systems are weak.<sup>35</sup>

It would therefore be helpful to modify certain operational aspects of the region's public training institutions in order to encourage business enterprises and employers' associations to participate more fully in defining the approaches to be taken, introducing more market-based criteria in their management, and linking up training programmes with technological programmes and priorities.

In order to further the development of the market for training, supply and demand need to be more closely coordinated; standards need to be established with regard to content, quality and relevance; and improved incentives need to be offered which will take into account the externalities associated with such investments. This undertaking can probably be accomplished more cheaply and more successfully if it is pursued on a tripartite basis in conjunction with management and labour organizations.

*d) The institutional structure and productive development*

Making the necessary adjustments in order to take up the challenge of internationalization will place certain demands on public and private institutions; the public sector will need to strengthen its commitment to the promotion of production and make a more determined export effort, and a greater degree of public-private cooperation will be required as well.

Such cooperation will help to improve the assessment and implementation of incentives, to bolster access to external markets and investments, and to deal with sectoral problems and the difficulties involved in retooling. Greater public-private collaboration is also called for in regard to brand differentiation and quality, the increased presence of private national enterprises in marketing networks

and in joint ventures with local firms in destination markets, and the need to open up the field for private investment in infrastructure.

As part of this same institutional scheme, consideration should be given to the possibility of setting up productivity centres to monitor the competitive position and technological and commercial trends of individual sectors. These would be tripartite centres formed by the Government, universities and technological centres, as one component, by employers' associations and by labour organizations, with the latter two groups representing the private sector.

Cooperation between private associations and businesses is fundamental to more effective promotion and marketing efforts, quality control and the design of private internationalization strategies. It also plays a basic role in fostering balanced labour relations that will promote training and productivity, a consensus-based form of flexibility and worker motivation, which is the foundation for the foremost competitive factor in today's economy, i.e., quality human resources.

The region's employers' associations and trade unions are relatively weak, as are its public sectors. Nonetheless, it is also true that a number of seminal and highly valuable initiatives have been undertaken that have strengthened collaboration and coordination between the public and private sectors in the area of productive development, thereby paving the way for a suitable distribution of responsibilities in those areas in which each has certain comparative advantages.<sup>36</sup>

Consensus-based schemes for the advancement of production activities have both strengths and weaknesses. On balance, however, they have helped to reduce the costs of coordination among production agents and between those agents and government policy-makers, to make information more accessible and to update incentives in this area.

<sup>35</sup> It has been suggested that flexible, modular systems should be established and that provision should be made for the mutual accreditation of courses of study pursued at secondary and vocational post-secondary educational institutions based on a grading certification system in which private and public enterprises would be directly involved. This would make it possible to evaluate the occupational relevance of what is taught and to make adjustments where necessary (Rosales, 1994).

<sup>36</sup> Examples include the Executive Chamber for Structural Matters (Brazil), the National Council on Competitiveness (Colombia), the Productive Development Forum (which has already been established in Chile and is soon to be organized in Bolivia and Paraguay), and the Andean experiments with "value-added chains".

Promoting innovations in the institutional structure and in the behaviour of social actors which are in keeping with the workings of an open economy and will contribute to the achievement of an authentic form of competitiveness is another key facet of economic reform. This represents a major opportunity for public policy to help strengthen the position of responsible, well-informed collective actors and to lend viability to the effort to forge a strategic consensus among those actors.

Productive development policies have the potential to promote both growth and social equity. In order to realize that potential, however, a greater effort will have to be made to refine the design and management of productive development policies and to evaluate such policies on an ongoing basis in order to foster a learning process within the public sector and thus increase the effectiveness of the policy tools used to promote such development.

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# Systemic competitiveness: *a new challenge for* firms and for government

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This article analyses the concept of systemic competitiveness by examining its determining factors and the way in which they inter-relate. The author puts forward the view that industrial competitiveness is the product of the complex and dynamic interaction between four social and economic levels in a national system, namely: the micro level, consisting of enterprises, many of them interlinked in mutual assistance networks, which aim to achieve simultaneously efficiency, quality, flexibility and speed of response; the meso level, corresponding to the State and social actors, which develop specific support policies, promote the establishment of structures and coordinate learning processes at the level of society; the macro level, where pressure is exerted on the enterprises through performance requirements; and finally, the level referred to in this article as the "meta" level, which is made up of solid basic patterns of legal, political and economic organization, an adequate social capacity for organization and integration, and the capacity of the actors to achieve strategic integration. The article concludes that an enterprise's competitiveness is based on the organizational pattern of the society as a whole. It is the parameters of competitive relevance at all levels of the system and their interaction that generate competitive advantages. Competitiveness is systemic.

# I

## Introduction

In recent years, attempts have been made at the Organization for Economic Cooperation and Development (OECD) to categorize the different approaches to the notion of competitiveness and to combine them in a single, integrated approach under the heading of "structural competitiveness" (OECD, 1992). The main aspects of this concept are its emphasis on innovation as a key factor in economic development, company structure that goes beyond Taylorist principles and is capable of activating the potential for learning and innovation in all the enterprise's fields of activity and, finally, cooperation networks aiming at innovation and supported by various institutions and an institutional framework conducive to innovation.

The concept of "systemic competitiveness" (Esser, Hillebrand, Messner and Meyer-Stamer, 1994) is a frame of reference for industrialized as well as developing countries. Two features distinguish this concept from others designed to identify the factors involved in industrial competitiveness. The first is the distinction between four analytical levels (meta, macro, meso and micro). At the meta level, aspects such as a society's capacity for integration and strategic action are considered and at the meso level, the creation of a support structure able to promote, supplement and further the enterprises' efforts is examined. The second distinguishing feature is the linking of factors relevant to the industrial economy, to the theory of innovation and to industrial sociology with the arguments put forward in the recent debate among political scientists on economic management with reference to policy networks.

The concept of systemic competitiveness is based on the recent discussions at the OECD. Observations on this subject begin with a phenomenon observed in many developing countries, namely the absence or inadequacy of an effective entrepreneurial environment that places emphasis on the OECD's concept of "structural competitiveness". This phenomenon may prevent structure adjustment from furthering industrial development even where stabilization at the macro level has been successful, as has been observed in member countries of the

OECD, as well as in developing countries of various stages of development.

It should be noted however that an inadequate support structure need not, in itself, preclude competitiveness. When general conditions change fundamentally with the transition from a protected domestic market to an open economy and when enterprises are faced with the choice of either increasing efficiency or leaving the market, some at least will make the necessary efforts to rapidly increase their competitiveness. This happens primarily where it is feasible to take advantage of static advantages of location. However, the absence of an efficient support structure does impair enterprises' ability to achieve lasting competitiveness. Instead of being able to focus on the main productive activity in which they have a competitive edge, they have to develop for themselves products and internal services that other enterprises are able to acquire or use as externalities. As a result, they do not undergo the continuous improvement experienced by enterprises that have achieved lasting efficiency.

The German Development Institute (GDI) employs a concept of competitiveness that goes further than the one developed by the OECD. The latter and other similar ones cover economic factors only and neglect almost entirely the political dimension involved in achieving competitiveness. Even though there is increasing acceptance of the view that the creation of an effective support structure through the collective effort of the enterprises and the joint initiative of business associations, the State and other social actors may lead to the comparatively rapid development of competitive advantages, the literature on the subject does not take sufficient account of the management models on which successful processes of late industrialization have been based (Amsden, 1989; Wade, 1990). However, with regard to industrialized countries, it is found that analyses of competitiveness and research into new management models in different areas of policy-making such as industrial structures and technology policy are hardly interlinked at all. While a detailed description is given of the enterprise support structure that

should be created, the specific policy proposals concerning the modalities and methods for identifying and dealing with problems, decision-making, im-

plementation and follow-up of results continue to be vague and imprecise (OECD, 1992, p. 84 *et seq.* and p. 254 *et seq.*).

## II

### Competitiveness in the systemic approach: levels of systemic competitiveness

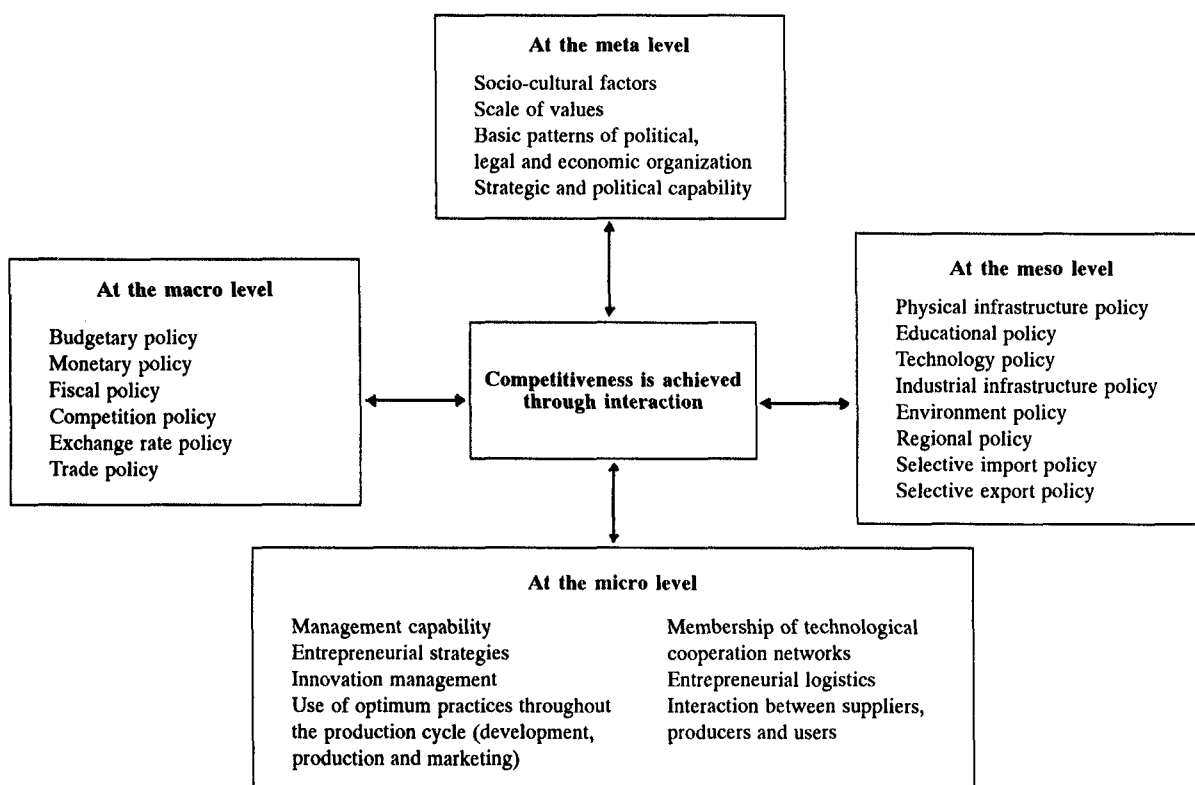
Countries cannot develop an infinite number of policies or elements of competitiveness from a finite set of factors determining systemic competitiveness (figure 1).

The most competitive countries have: i) at the *meta level*, basic structures of legal, political and economic organization, the social capacity for organization and integration, and the capability of the actors to achieve strategic interaction; ii) a *macro framework* that requires the enterprises to be more

efficient; iii) a structured *meso level* where the State and the social actors develop specific support policies, promote the establishment of structures and coordinate the learning processes at the level of society; iv) at the *micro level*, a large number of enterprises, many of them interlinked in mutual assistance networks, which aim to achieve simultaneously efficiency, quality, flexibility and speed of response.

FIGURE 1

**Factors determining systemic competitiveness**



## 1. Meta level

The State's ability to steer the economy and the existence of organizational models that help to stimulate society's creative capabilities are essential for the achievement of maximum efficiency at the micro, macro and meso levels. Economic modernization and the development of systemic competitiveness cannot yield results unless suitable structures are established in society as a whole. If macroeconomic reforms are undertaken without the concurrent development of the ability to regulate and steer the economy (State reform, coordination of the strategic actors) and without suitable social structures being established, the tendencies making for social disintegration will become even more pronounced. Systemic competitiveness without social integration is a project without a future. The development of systemic competitiveness, therefore, is a social transformation project involving more than mere adjustment of the macroeconomic framework.

In order to achieve the management capability necessary at the meta level, the following are required: consensus on the "market governance and world market" model, agreement on the actual course to be followed in the reforms, and consensus on the need to impose the interests of the future over the well-organized interests of the present.

A strategy aiming at an overall solution to the problems presupposes a clear institutional separation between the State, private enterprise and intermediary organizations. Only a separation of this kind will make possible autonomous organization, independent learning processes and the development of a well-developed capacity to anticipate and respond. Once this institutional separation has been achieved, the possibility opens up for an autonomous and efficient State to emerge and, at the same time, for groups of private and public social actors to show a readiness to cooperate and establish links with each other. These are the general functional requirements for the establishment of creative reforms in the area of policy management; their specific features, however, will vary from one country to another according to factors such as the political and institutional structure that has developed in each of them.

The most important factor for coordination at and between the four systemic levels is the willingness of the most significant groups of social actors to engage in dialogue, this being a factor that helps consolidate efforts and channel society's creative

potential along agreed lines. Dialogue is essential for strengthening national innovative and competitive advantages and setting in motion the social processes of learning and communication. Similarly, it helps create the necessary readiness and skills for implementing a medium- to long-term strategy aimed at competition-oriented technological and industrial development.

Achieving competitiveness demands a well-developed capacity for organization, interaction and management on the part of the national groups of actors, whose ultimate aim should be to achieve systemic management embracing the whole of society.

## 2. Macro level: stabilization of the macroeconomic framework

The existence of efficient factor, goods and capital markets is essential for the effective allocation of resources. This is a requirement wherever the concept of management is multidimensional and supported by competition, cooperation and social dialogue directed towards channelling national potential and developing the necessary capability for successful operation in the world market. The experiences of the 1970s and 1980s have shown that an unstable macroeconomic framework is highly detrimental to the efficiency of these markets and has a negative effect on economic growth.

Macroeconomic stabilization should be based primarily on the reform of fiscal, budgetary, monetary and exchange-rate policy. However, the transition from an unstable to a stable macroeconomic framework is difficult for the following reasons:

i) Attempts to combat inflation through restrictive budgetary, tax and monetary policy not only contribute to limiting consumption in many cases but also act as a brake on investment, thereby reducing still further the national economy's capacity for growth and improved distribution. Hence, the latent tension between the objectives of stability, growth and distribution;

ii) Stabilization measures at the macroeconomic level are usually effective if accompanied by structural reforms carried out in parallel over a long period, such as the reform of the State-run economic sector, the development of an efficient financial sector and the reform of foreign trade policy;

iii) While the costs of the adjustment are felt immediately the benefits are not, with the result that production, investment and employment usually decrease in the initial phase;



iv) Social groups are not all affected in the same way by measures to stabilize the macroeconomic framework and the accompanying structural reforms. In fact, the process has winners and losers and therefore gives rise to bitter disputes at the level of domestic policy (Haggard and Kaufmann, 1992).

Consequently, stabilization of the macroeconomic framework not only requires a conceptual basis that is coherent in technocratic terms but also calls for considerable political effort. Success will be guaranteed only if the Government is determined to implement difficult and controversial reforms, if it manages to rally national reforming forces in support of the cause of restoring the domestic and foreign economic balances, and if it also manages to win international support.

### 3. Meso level: the active formation of structures

In a recent analysis, the World Bank attributed the successful economic growth and high level of international competitiveness of the countries of East and South-East Asia to sound macroeconomic management and an active export-promotion policy, combined with a moderate tariff policy (World Bank, 1993). According to this analysis, macroeconomic policies aiming at stability particularly encouraged savings, making for significant public and private investment. In addition, the extensive opening up of the economies to foreign technology, accompanied by a system of export incentives, contributed significantly to the development of a dynamic private sector.

However, it would be overstating the case and hence misleading to attribute the successful growth and high level of international competitiveness of these countries entirely to their adherence to fundamental macroeconomic principles and a relatively liberal foreign trade policy. This is because, unlike economies with small populations (Singapore and Hong Kong), medium-sized economies such as Taiwan and the Republic of Korea heavily protected their domestic market from foreign competition until the end of the 1980s or even later, combining tariff barriers with other, mainly quasi-tariff, barriers and only admitting imports that were complementary and not particularly competitive.

Not only was this policy essential to prevent major foreign trade imbalances in these economies, but the fierce protectionism coupled with a selective trade policy allowed industry to benefit from an

undisturbed learning process for 30 years. Furthermore, the first generation of newly industrialized economies, with the exception of Hong Kong, have consistently promoted the development of internationally competitive industries by creating dynamic comparative advantages, the protection of infant industries being only one of several strands of a complex macro and meso approach. This explains the heavy criticism of the World Bank for asserting that selective interventions in the Republic of Korea and other economies have had no significant influence worth mentioning on either industrial structure or the productivity of industrial enterprises. When the battle for competitiveness in world markets begins to intensify, that is precisely the time when Governments would be well advised to combine stabilizing macro policies with the active formation of structures.

### 4. Micro level

Today, enterprises are facing an increasing number of requirements as a result of various distinct trends (Best, 1990; OECD, 1992), which include.

- i) The globalization of competition in an increasing number of product markets;
- ii) The increasing number of competitors, as a result of successful late industrialization (especially in East Asia), the success of structural adjustment and an orientation towards exports (for example, in the United States);
- iii) The differentiation of demand;
- iv) The shortening of production cycles;
- v) The introduction of radical innovations such as new techniques (microelectronics, biotechnology and genetic engineering), new materials and new organizational concepts;
- vi) Big advances in technology systems which make it necessary to redraw the boundaries separating different disciplines, for example those between information technology and telecommunications (telematics) or between mechanical engineering and optoelectronics (optomechatronics).

In order to meet the new challenges successfully, significant readjustments have to be made to the enterprises themselves and to their support structures. For this purpose, incremental changes such as those planned in the 1980s with intensive automation and the creation of data-processing systems (under the motto "automating Taylorism") are not sufficient. The simultaneous acquisition of efficiency, flexi-

bility, quality and speed of response calls rather for profound changes at three different levels:

i) Organization of production: the objective is to shorten production time by, for example, replacing the traditional assembly lines and transfer systems with manufacture and assembly cells and islands in order to respond rapidly to the client's wishes and decrease warehouse stocks, thereby reducing working capital costs;

ii) Organization of product development: in many cases, the strict separation of development, production and marketing increased the costs involved in product design; in other cases, the products were not to the client's taste. The parallel organization of the different stages of development, and the reintegration of product development, production and marketing (concurrent engineering) helps to reduce significantly the time involved in development, to manufacture products more efficiently and to market them with greater ease;

iii) Organization of supply arrangements: enterprises reduce the scope of their production activities in order to concentrate on the speciality that guarantees their competitiveness. They reorganize supply by introducing, in particular, just-in-time production systems and reorganizing their subcontracting pyramid, reducing the number of direct suppliers and raising some of

them to the status of suppliers of subsystems integrated in the product development process.

The creative combination of organizational as well as social and technical innovations is the task to be undertaken at the three levels. Reorganization tends to be the starting point that creates the conditions necessary for efficient use of the new computerized equipment. Social innovations (reduction of hierarchical levels, delegation of decision-taking to the operational level) are a prerequisite for the success of the new concepts of organization.

The increasing requirements imposed on enterprises are accompanied by ever-increasing demands on their support structure. Enterprises which are operating in the world market do not compete in a decentralized and even isolated manner, but as industrial clusters, i.e., as groups of enterprises organized in cooperation networks. The dynamics of their development depends, to a large extent, on the effectiveness of each industrial location in terms of close and ongoing links with universities, educational establishments, scientific and technical research centres, outreach institutes, technological information and financial bodies, export information agencies, and private sectoral organizations, to name but a few.

### III

#### Development of structures at the meso level: the importance of selective policies

The enterprise support context –i.e., institutions and political structures at the meso level– has been acquiring greater significance in the 1990s as a result of technological and organizational change and the move away from the traditional Fordist production model. The cumulative effects of learning and innovation go together with the formation of enterprise-to-enterprise cooperation networks at the macro level and with both informal and formal cooperative links between enterprises and the groups of institutions connected with clusters of firms. The establishment of these institutional groupings is the key to any active location policy. Technological capacity as a basis for competitiveness is, in turn, based on stores of knowledge and accumulated learning processes

which are difficult to transfer and often not codified, processes which become apparent in the interaction between enterprises and institutions. Thus, specific patterns and competitive advantages that are not easy to imitate are emerging for each country and region.

Political actors who, when framing national policy at the meso level, fail to develop a strategic perspective to direct the activity of the State and enterprises and rely first and foremost on spontaneous reactions and processes of trial and error underestimate three factors:

i) The importance of timely and selective development of the physical and, more particularly, the non-physical structure for the international competitiveness of enterprises;

ii) The length of time necessary for the development of human capital and technological infrastructure, i.e., the key factors in international competitiveness;

iii) The negative effect on aggressive business strategies of technological insecurity (Dosi, 1988) and risk situations which a single enterprise alone is unable to assess in their entirety or to turn to its advantage.

## IV

### The State, enterprises and intermediary institutions at the meso level: the traditional dichotomies break down

As enterprises develop ever more sophisticated products, the demands on the local, regional and national environment increase accordingly. The idea that the State, viewed as society's main guiding force, is alone capable of steering technological and economic processes, and the dogma that the State of must be subordinated to market forces are both wide off the mark. The successful cases in the world economy indicate that there is a broad margin of action for the implementation of policies that strengthen the competitiveness of industrial locations, and this margin of action lies between two extremes: *dirigiste* State intervention and the *laissez-faire* approach limited to establishing the general conditions necessary for economic operation. New forms of organization and management are being defined at the social and political levels, in the same way as in industrial production.

Demand conditions conducive to competitiveness are often the result of initial measures such as deregulation, privatization of State enterprises and external financial support. It is also essential to build a physical infrastructure for exports (for example, transport and telecommunications systems). What is more difficult is to reform and develop, educational, research and technology establishments in order to further competitiveness, as well as to implement policies supporting industrial location that are aimed at structuring the meso level. It is not only a matter of deciding which tools should be used (figure 2) but also of ascertaining how to select and combine them and determining which decision-making processes could serve as a basis for the development and implementation of location

policies geared to the complex nature of industrial production. It follows that the structuring of the meso level is primarily a problem of organization and management.<sup>1</sup> What is required is the creation of an efficient institutional structure (hardware) and the promotion, in particular, of a capacity for close interaction between private and public operators within a cluster (software) (figure 3).

The new industrial location strategies differ fundamentally from the traditional State approach to industry, industrial planning and investment management. They also differ from the neo-corporative approaches of the 1970s involving only the leaders of business associations and trade unions. Today, the two approaches have no further use because at the level of location policy and the development of meso policies, the potential for action, the knowledge necessary to develop long-term policies and the capacity for implementation are shared among several State, private and intermediary operators: enterprises, associations, the scientific sector, State institutions, private intermediary institutions and trade unions (Mayntz, 1993). During the period of Fordism and highly standardized industrial patterns, it was still possible to successfully establish large, vertically integrated enterprises based on the

<sup>1</sup> This aspect of meso policy, which is linked to the theory of economic management, is not mentioned at all in publications on the meso economy such as Peters (1981). In that study the author clearly moves away from the orthodox macroeconomists; he points out the importance of structural policies for the structural reform of the economy and puts forward a wide range of means which could be used, but he does not say whether these means could achieve this, or how.

FIGURE 2

**Industrial location policy in Germany:  
technology policy tools**

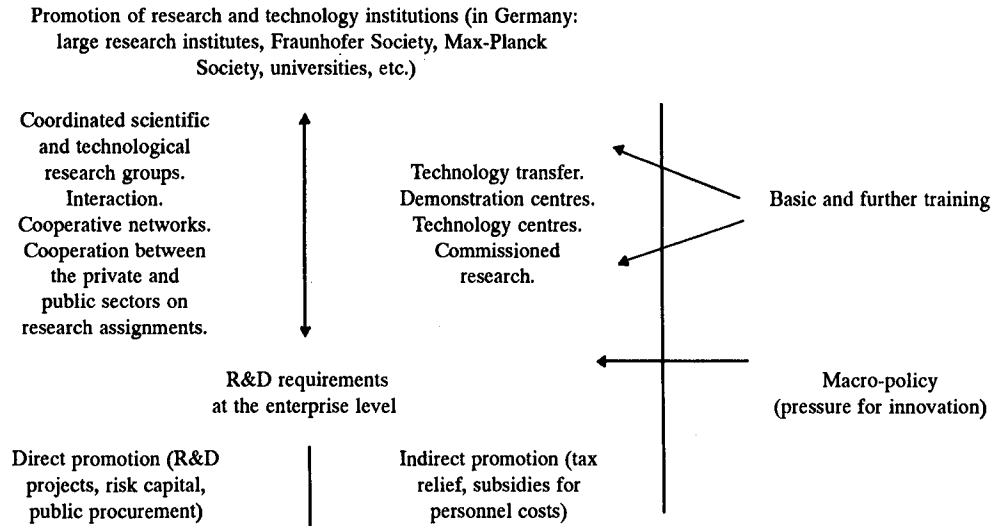
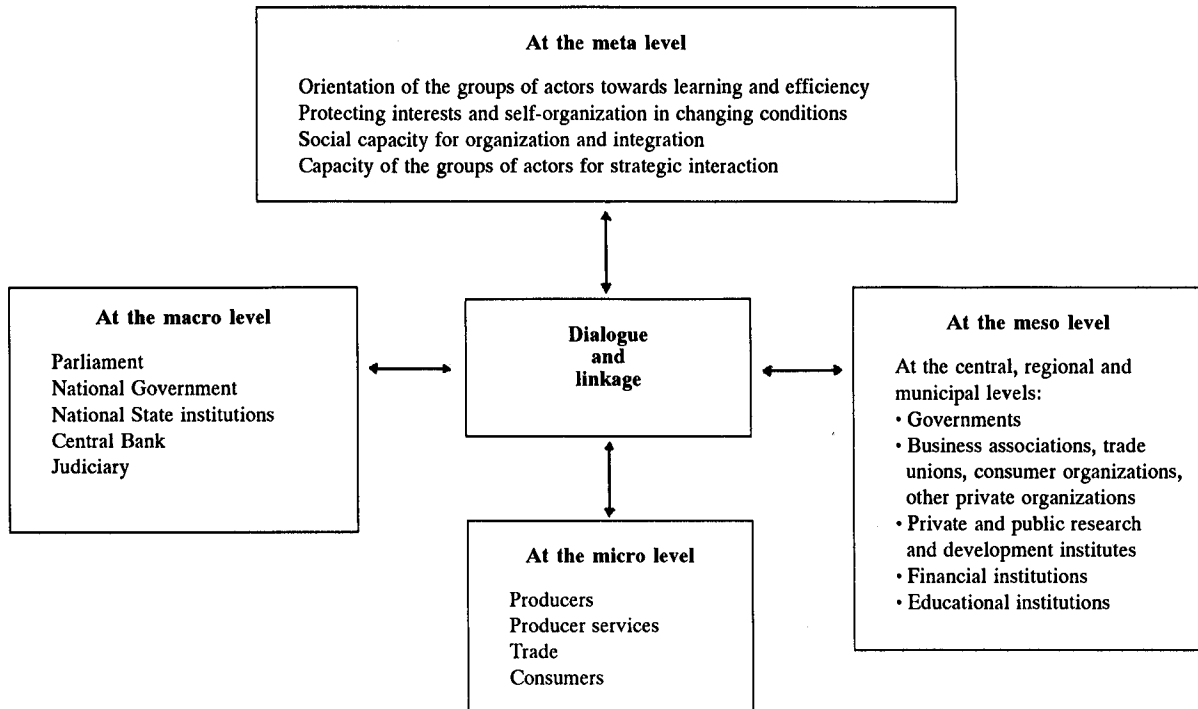


FIGURE 3

**Determinants of systemic competitiveness:  
strategic capacity of the groups of actors**



centralized State planning of industry (as in the former Soviet Union, India and even Brazil). Today, however, centralist and unidimensional regulation patterns are doomed to failure when the objective is to develop and support the creation of complex enterprise networks and groupings of specialized institutions.

Patterns of social organization, the rapid flow of information, open channels of information, and inter-linked structures and communications are becoming competitive factors in themselves. "Soft" management media (Krumbein, 1991, p. 49), such as information flows, the integration of interests and the establishment of procedures are acquiring increasing significance as a result of changed structural conditions.

These means have two functions: on the one hand, State meso policy is dependent on the resources offered by the technical know-how of enterprises, the scientific sector and other strategic actors; on the other hand, the new management means are consistent with the interactive nature of innovation and the systemic nature of competitiveness. Thus, meso policies gradually take on the nature of a process. The formation of structures at the meso level (in contrast to macroeconomic policies) is not only promoted by public policy, since the enterprises, intermediary institutions and associations (individually or together) can and should contribute to shaping industrial location policy (for example, by offering training opportunities, developing information systems or speeding up information flow).

These new management methods have gained ground in countries such as Japan since the 1970s, when classical industrial policies prevailed, with tariffs and quasi-tariff barriers, the promotion of imports through tax incentives, subsidies for scientific and technological research and the creation of compulsory cartels (Hilpert, 1993; Vestal, 1993). The plans and forward-looking strategies set forth by the Japanese Ministry of International Trade and Industry (MITI) are the result of a lengthy and thorough process of dialogue with representatives of the private sector and members of scientific research circles. These plans, which are regularly drawn up for a period of three to ten years, have nothing in common with the directives of a centralized economy since

their implementation is not obligatory for either enterprises or public bodies. The views of the future outlined by the main social actors give a general idea of the direction that macroeconomic development should take: a direction which is desired and felt by many to be correct. These plans also set short- and medium-term objectives for different sectors, by means of an overall analysis of bottlenecks, strengths and possible radical changes. They also provide guidance to help banks to decide on the granting of credit, to aid enterprises in decisions on long-term investment, to help the private sector to decide on the allocation of resources to research, and to enable intermediary institutions (educational and research establishments) to readjust and correct their management aims. Such a policy reduces insecurity and stimulates innovation and investment in scientific and technological research, enabling enterprises to pursue long-term strategies aimed at growth and the acquisition of market shares.

Another example of the increasing importance of "soft" management media and effective communication channels between relevant social groups, institutions and organizations is to be found in the "regional conferences" which have become institutionalized in some federal states of Germany, particularly in critical areas where extensive reconversion work has been or is being carried out, such as Nordrhein-Westfalen (Jürgens and Krumbein, 1991; Voelzkow, 1994). Here, many of the social actors involved try to reach agreement on future development opportunities in the region, seeking to identify obstacles to the modernization process and to predict the environmental and social costs of this process in order to develop guidelines for decision-making at the political and enterprise levels. In the regions involved, complex cooperation networks including business organizations, trade unions, associations, local government, technological institutes and universities are emerging. These networks are situated between the State and the market. They develop visions or, in more pragmatic terms, scenarios for regional development. They prepare major strategic decisions and open the way for non-governmental policy management of the programmes for economic restructuring as well as the participatory development of industrial location structures, both regional and national.

# V

## Courses of action in situations of radical change and of consolidation

The search for promising economic areas with a high potential capacity for generating value added and the development of an anticipatory structural policy are ambitious undertakings. In general, this type of precisely focused approach is likely to be successful only in consolidated economies with experience of coordinating the action of enterprises with that of government and the scientific sector.

Focused approaches and selective meso policies go hand in hand with the development of a complex monitoring system. It is precisely during the different stages of economic restructuring that strategic focusing by the public institutions (ministries of the economy, teams of advisors) is a key factor. Business associations and groups will primarily defend their own interests and press for their respective industries to be defined as strategic focal points. During stages of radical change, actors who are following a strategic course of action must cooperate in public bodies with independent experts and advisers in order to be able to identify industrial focal points with development potential. In the stage of economic consolidation, the main task is to establish a more extensive monitoring system based on a broad range of agencies and institutions. For their part, economic research institutes, university research centres, sectoral technology and advisory institutions, business associations, research centres in the private sector, trade unions and consultancy firms help to continually improve the information on the dynamics of the productive sector. They all interact through the publication of papers, scientific debate, conferences and joint research.

The technical know-how built up in the institutions and the formal and informal interaction which they permit (cooperative network) enable all the

social actors to undergo an ongoing learning process regarding the economy and industrial location, while showing up more clearly the strengths and weaknesses of the national economy and the challenges facing it, and enhancing the ability of enterprises and private and public institutions to adjust their courses. The first thing that many developing countries have to do is to set up institutions providing a context for the acquisition of technical know-how linked to the productive sector. In the industrially advanced countries, however, the accumulation of such knowledge is, to a large extent, an autonomous process since the aforementioned operators communicate with each other through the exchange of reports, seminars, joint research projects, advisory councils, and a wide range of other means. Apart from the existence of this autonomous horizontal dimension, it is the research-promotion institutions that usually set the corresponding priorities.

It is clear that what is lacking in order to translate this technical know-how into economic policy is an action-oriented strategy. Here also, State institutions dealing with economic policy and industrial location must undertake the important tasks of gathering and processing the existing technical know-how, exploiting channels of development, and cooperating with strategic actors with a view to developing visions for the medium-term so as to obtain, on this basis, the best possible blueprint for industrial location. The formation of new patterns of social organization and of "procedures for intervention and regulation that are more compatible with autonomy" (Scharpf, 1992) at the meso level facilitates at the same time the management and shaping of market processes, reducing the shortcomings of purely commercial regulation and of State planning.

## VI

### The national, regional and local dimensions of the meso level

In addition to a general framework conducive to innovation (basic education, tax incentives for scientific and technological research), the implementation of specific and selective meso policies is required for the creation of competitive advantages. Unlike "horizontal promotion", which is so widespread, selectivity at the meso policy level is aimed at "strengthening the strong" with a view to the rapid construction of dynamic industrial focal points and efficient localized industrial structures that will radiate an effect outwards onto the less developed areas around them.

The selective approach has three main aims:

i) The focusing of meso policies on industrial clusters with development potential;

ii) The development of an efficient support structure for these clusters, i.e., a framework conducive to innovation, a set of instruments designed to advance the best performers (i.e., the "winners") and encourage them to employ the best international practices as quickly as possible, and the formation of structures which help the enterprises with development potential to catch up with the best;

iii) The strengthening of the developing regions where dynamic enterprise groups or clusters are emerging.

The policies which make up the meso level have a national and a regional or local dimension.<sup>2</sup> At the national level, meso policies are aimed at developing the physical infrastructure (transport, ports, rail and road networks, telecommunications, energy, water, supply systems, waste disposal systems, etc.) and non-physical infrastructure (education systems, etc.) appropriate to the clusters. Also of significance are the selective policies and activities in the area of foreign trade (trade policy and strategies for market penetration) as well as the active protection of inter-

ests at the international level (for example, those of the developing countries in the face of the protectionism of the industrialized countries).

As this systematic improvement of the national meso level takes place, policies specifically designed to support the clusters assume importance at both the regional and the local levels. Given the increasing importance of spatial structural factors for the competitiveness of enterprises, it is necessary to implement decentralized policies and to re-examine the powers of national, regional and local political bodies. It is essential, in this context, to extend the powers and funding of the regional and local administrations and support the formation of other structures at the local and regional levels (development of structures from the bottom up).

Decentralization should not be seen as a schematic delegation of responsibilities to subsidiary decision-making levels and, still less, as a dissociation between the regions and the State. As is the case in modern enterprises—where the increased autonomy enjoyed by the most profitable units does not imply the elimination of managerial levels but rather increased ability to control and the acquisition of new tasks for central management (the organization of cooperative networks and the development of strategic visions for the enterprise as a whole instead of centralized management of all its divisions)—efficient decentralization of the public sector will bring about complementary changes at the central level. The State will continue to be important in bringing together dynamic groupings within a national development strategy, in ensuring productive feedback between local and regional groupings and in implementing an active foreign trade policy (development of structures from the top down).

Structuring the meso level in order to create capacities is an ongoing task for the public and private sectors. Meso policy should be viewed as a cross-sectoral undertaking directed towards the continual improvement of economic location. Furthermore, a well-structured meso level not only serves as a means

<sup>2</sup> Within the context of the European Union and, to a certain extent, within that of the Common Market of the South (MERCOSUR), there is a multilateral dimension to technology policy which is not discussed in detail in this paper.

of increasing and maintaining the international competitiveness of the economy but also forms the basis

for the effective implementation of accompanying social and environmental policies.<sup>3</sup>

## VII

### Cooperation network structures and their operation

The structures based on cooperation networks and autonomous horizontal coordination are situated at the meso level. This is where hierarchical management interacts with management based on these networks –“self-coordination in the shadow of hierarchy” (Scharpf, 1993, p. 145). The mechanisms based on cooperation networks predominate at the meso level because management resources are spread widely throughout this entire policy area (the ability to identify problems, knowledge of the causal links which affect management, and the capacity for implementation). The meso level is distinguished by the phenomenon of “shared sovereignties” (Meyer, 1994), which affects public institutions, enterprises and intermediary organizations alike shaping an economic location through a set of technological, innovative, educational, industrial and regional policy measures therefore depends on the social actors of the micro and meso levels being closely interlinked. The meso level is where government actors operate (from the local up to the national level), together with public and private intermediary institutions (educational, advisory and technological bodies, and also chambers of commerce and other associations). Their interaction gives rise to cumulative processes which boost the capacity of all the parties involved, including that of the meso level as a whole.<sup>4</sup>

Against this background, three points are relevant: first, the specific relationship between the meso and meta levels; second, the scope of meso policies, and third, their importance for the development of international competitiveness.

#### 1. The relationship between the meso and meta levels

As mentioned earlier, different patterns of organization and management are superimposed on top of each other at the meso level, so that the task of developing this dimension depends on the organizational and strategic capability of many different social actors. Thus, the capacity of the organizational patterns situated at the meso level and based on cooperation networks is closely linked to the deep-rooted structures of each society involved and, hence, to the meta level. It is at the latter level where attempts should be made to identify the factors determining whether or not the collective actors will be able to address themselves to finding solutions to the problems.

Any attempt to implement a management strategy based on cooperation networks will be doomed to failure if the actors involved have a tendency to operate as lobbies, if they have no previous experience of dealing with conflicts or working out consensual solutions (in which case structures based on cooperation networks can easily result in “endless disagreement”), or if the absence of the securities inherent in a State governed by the rule of law hinders the creation of “general trust” among the actors: an important prerequisite for management based on cooperation networks (Messner, 1995).

When conditions are favourable at the meta level, the tasks to be undertaken at the meso level are as follows: to strengthen the capacity of the actors involved as far as possible (enterprises, business clusters,

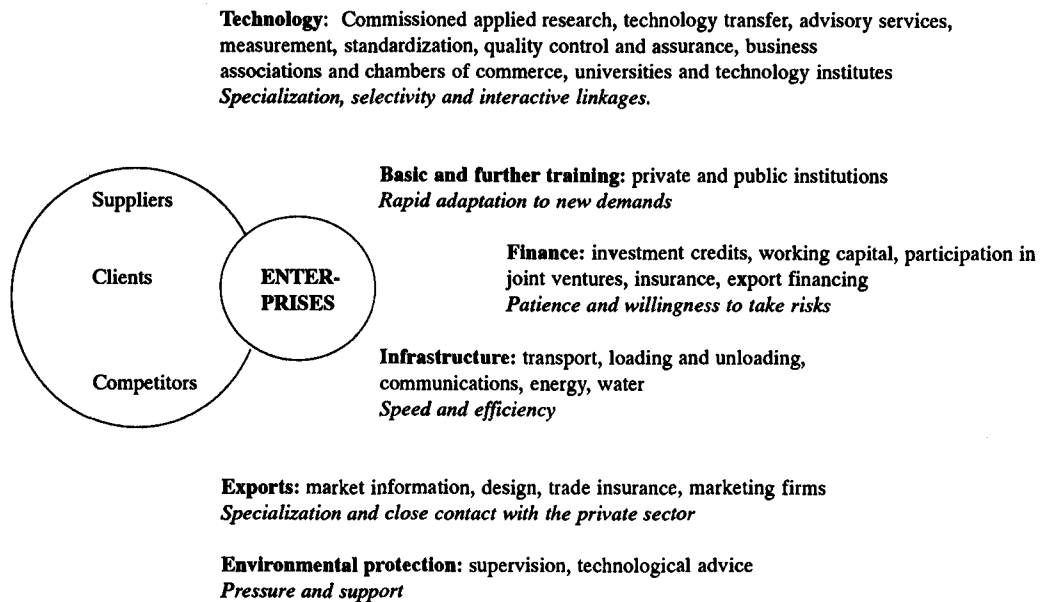
<sup>3</sup> See Esser, Hillebrand, Messner and Meyer-Stamer (1994), p. 82 *et seq.* In future development research it would be essential to link theories on competitiveness with the new approaches focused on equity. One of the questions raised refers to the dynamics of the modern sectors, oriented towards the world market, and to the contributions to development made by the informal sectors in relatively weak economies.

<sup>4</sup> This formation of the meso space at the national level may have its counterpart in location policies at the multilateral level (those of the European Union, for example). At this level however, it is customary to take strategic decisions (discussions about the sectors with potential) or to implement joint research projects, whereas the institutional formation of the meso space is carried out in an increasingly decentralized manner in each of the economic regions.



FIGURES 4

**Selective policies and specialized factors: What are the institutions and approaches that make up the meso space?**



employers' and employees' associations and other interested groups, and intermediary institutions); to encourage coordinated action among them with a view to generating synergistic effects and uniting widely dispersed management resources without undermining the relative autonomy of the actors; and to achieve a balance between individual and collective interests.

What is also needed is a system for balancing powers which prevents the environmental, social and economic costs of the meso-level cooperation networks from being unloaded onto society. The formulation of this level places great demands on societies, and is a difficult task for developing countries or countries in transition. This is why the structuring of the meso level is such a test of the organizational and managerial capacity existing in a given society.

**2. The scope of policies and private activities at the meso level**

In contrast to the situation at the macroeconomic level, where scope is limited in some areas by the globalization of the economy (for example, through loss of sovereignty concerning interest rates), the meso level offers greater room for manoeuvre and is increasingly important. If we allow that the effectiveness of this level depends on the coordinated action

of the social actors, and that the local, regional and national dimensions do not lose their relevance,<sup>5</sup> since there tend to be national competitive advantages (Porter), and if the creation of competitive advantages is linked to industrial locations, then it would seem to be the case that while the demands on the meso policies are great, there is sufficient leeway for their development. Although it is possible to take advantage of external potential (such as foreign know-how and participation in international technological networks), the meso level remains limited to a single geographical area, since it is an interlinked organizational and institutional system that cannot be exported or imported. The patterns of organization and management based on cooperation networks which predominate at the meso level particularly encourage the clustering of enterprises.

**3. The importance of the meso level in the creation of systemic competitiveness**

The situation described above gives a clear indication of the importance of the meso level in the creation of national competitive advantages. Whereas macro

<sup>5</sup> As indicated in studies by Porter, OECD, advocates of the theory of *industrial districts* and other works.

level policies are becoming increasingly similar world-wide, the localized industrial clusters differ significantly from one country to another. The design of these localized structures is determined mainly by the set of institutions existing at the meso level (figure 4). This is where institutional and organizational competitive advantages are generated, as are the specific patterns of organization and management and the national profiles which sustain the competitive advantages and are difficult for competitors to imitate.

## VIII

### Demands on countries and regions

Not only does the ability of countries to respond to the needs of the different social groups and to the demands of technological change, the world economy and the sustainability of the development process vary greatly, but it also changes according to the different stages that each country goes through. The world economic situation therefore undergoes relatively frequent readjustments. The recessionary processes that take place in countries whose ability to adapt is declining are mirrored by technological progress and successful late industrialization in other countries. Moreover, the capacity to anticipate and react to new demands at the technological and organizational level and in the world economy varies significantly.

Highly competitive and innovative countries, in particular, are developing regional groupings for trade and integration, resulting in the formation of interlinked systems in which industries cooperate closely on the basis of division of labour. Open regionalism enables new technologies to be tested in a large regional market before efforts are made to win shares of the world market. Furthermore, it also allows for a flexible response to the changes taking place in the world economy –such as the dispropor-

This approach contrasts sharply with the arguments of authors such as Knieper (1993) who maintains that an increasing number of uniform localized groupings “without their own distinctive features” are emerging in the world economy and that, when taking decisions, investors pay greater heed to the wage levels and tax rates prevailing in the host country. Most probably, it is precisely global competition that leads to the development of highly diverse and specific national patterns of competition within the world economy.

tionate progress of other countries in the competitive battle— while softening the impact of the adjustment on the national economy. Regionalism may lead to the establishment of regional blocs or the stimulation of world trade.

It remains to be seen how far the traditional industrialized and the newly industrialized countries will involve the other countries in a dynamic world economy and how far the latter will be capable of setting in train dynamic learning processes to permit rapid adjustment to the demands of the corresponding technological and organizational paradigm and to strengthen national enterprises and the national competitive advantage. Undoubtedly, national potential should be strengthened through cooperation and regional integration. It is only within the framework of integration projects that disadvantages of scale at the market level can be offset in the enterprise and in scientific and technological research activities. Only integration around countries with a firm economic and political basis will create a market dimension that arouses strong and sustained interest in economic growth among national and foreign enterprises.

(Original: Spanish)

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# Education in basic *skills and training* for productive work

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The success of global policies and strategies aimed at training for productive work depends to a large extent on the level of development of basic skills among the work force and, likewise, training costs will vary according to the level of general preparation of those entering on the process. In view of the close relationship between the structure of the school system, the development of basic skills and actual training, different options are available for attempting to resolve imbalances between training for productive employment and previous basic education. These range from expanding and upgrading formal education to hiring persons with a low level of education and compensating for their weaknesses through training, with a number of variants that lie somewhere between those two alternatives. Our conclusions, based on the available information, are that training cannot replace basic education, that the process of technological change goes hand in hand with an increased demand for workers with a high level of education, that substituting training in specific skills for good basic education is not the most efficient option, and that one of the favourable effects of primary education is that it facilitates after-school training. Attempting to improve labour productivity solely through specific training would not appear to be the most efficient option. Basic skills development is a necessary complement, if not a downright prerequisite, for vocational training. This article seeks to identify certain dimensions of human resource training which are often overlooked in relation to both basic skills and specific training proper: namely, the imbalances existing between vocational training and previous education, and the options available for correcting them.

# I

## Preliminary considerations

Since the late 1980s, there has been evidence in Latin America of renewed interest in securing an adequate human resource base to ensure a production structure permitting high growth rates. In numerous publications, attention has been drawn to the importance of human capital to economic development. Both micro-economic analyses (Becker, 1975; Amsden, 1989) and macroeconomic studies (Romer, 1986; Lucas, 1988; Azariadis and Drazen, 1993) have stressed the importance of human resource training for increasing productivity and economic growth. These studies and the empirical data on which they are based suggest that, under certain circumstances, vocational training can help to increase personal income, enhance competitiveness through improved productivity, and lower costs without the need for wage reductions. This factor of production also occupies a key position in recent considerations on growth theory. Solow (1993) affirms that investments lead to a permanent improvement in productivity and that the adverse effects on distribution can be offset by State policies, among which policies on education and training play an important role.

The value of education and training is confirmed by studies which point to the high returns on investments in this field. However, such studies often overlook two points. Firstly, the "distribution" factor affects the benefits of education, so that the more egalitarian the access to general education of equal quality, the greater the returns on investment in education and training. Hence, in order to obtain better results it is not enough merely to increase the expenditure on education: this must be accompanied by a general improvement in the quality of teaching. This assertion is supported by the fact that although the investment per student in private schools in the region is, in absolute terms, equal to or greater than the corresponding outlays of public establishments in most countries of the Organization for Economic Cooperation and Development (OECD), which display a more egalitarian distribution, the actual educational results are inferior.<sup>1</sup> A similar state of affairs may be observed with respect to vocational training.

Secondly, experience in rural sectors suggests that, in formulating strategies for human resource de-

velopment, it should be borne in mind that "increases in productivity are only to be observed in a context of technological change; in areas of traditional technology, in contrast, no significant differences in productivity are to be noted between those who have been to school and those who have not...In a context of technological change, there is greater demand for and interest in schooling and other types of education and training" (Dirven, 1995). This is linked to the fact that the supply of technological innovations is generally endogenous to peasant agriculture (Figueroa, 1986), which leads to a demand for education.

A study carried out by ECLAC and the UNESCO Regional Office for Education in Latin America and the Caribbean (OREALC) (1992) sets out a number of these views, pointing out that the two main objectives of development in the 1990s are to achieve true competitiveness and greater equity. Education, in all its forms, is crucial to the fulfilment of these two objectives.

In Latin America, these views have aroused a great deal of interest, as demonstrated by government pronouncements and statements by employers' and workers' associations. However, many of these broad proposals, aimed at applying a systemic approach, tend to be vague and are often lost in a welter of generalizations which are confusing or difficult to apply. Policy thus remains at the level of general guidelines, to the detriment of practical considerations such as those relating to programme management, the identification of specific groups targeted for preferential treatment, the most suitable methods to be adopted, or the resources needed to implement effective strategies.

<sup>1</sup> For example: official curricula for mathematics and science, which are very similar throughout the region, are more limited in content than in the OECD (mathematics does not include analytical geometry, calculus or trigonometry, while sciences are taught in a manner that stresses encyclopaedic knowledge rather than experimental skills and do not take into account the most recent advances). In establishments affiliated to the International Baccalaureat system and to the French Baccalaureat, the curricula are similar to those in the industrialized countries, but the results are poorer.

At the same time, there is some confusion as to the most efficient strategies for building up a reasonable stock of human resources; the absence of coherent policies on the subject and the imbalance between demand for and supply of skills usually lead to inefficient use of resources.

From the institutional point of view, this can be attributed to the complex nature of the problem and to the number of organizations and bodies involved. Another factor that clouds the picture is the lack of coordination among organizations and the absence of institutions capable of implementing such complex policies. But other decisive factors are the lack of precision in defining the problems involved and the educational technologies used within the region for training human resources. Moreover, policy and strategy objectives are generally vague, the quality of results is either difficult to assess or else the measures used only assess performance within limited areas, and there is no efficient system of incentives.

Other aspects affecting strategic planning and policy formulation which are of quite a different nature yet very often affect their effectiveness and outcome include the following:

i) The demand for any type of education is very elastic, tending to rise faster than demand and immediately affecting the quality of the service. In addition, since education, viewed as a good, is both a consumer product and an investment, demand for this good is not regulated by market forces.

ii) Education is such a complex good that we should perhaps speak instead of a variety of different products with demand elasticities associated with the different levels and products available. Within each of these products there are different items that affect this elasticity. For example, both regular schools and vocational training institutions provide, in addition to the actual training which is their main product, a series of by-products –knowledge, prestige, access to higher levels of education and to specific types of employment, etc.– which may often appear just as desirable as the training itself, if not more so. Supply is much more inelastic than demand, and attempts to control the two through market forces have not produced the expected results.

A number of exogenous factors enter into the supply/demand ratio, including the following:

i) The educational system applies internal criteria, such as previous performance and certificates issued by the system itself.

ii) Education is an ongoing process which is not definitively completed within a set time-frame.

iii) Education carries prestige, and this prestige contributes to a demand for certain professions or occupations to the detriment of others.

iv) Since “wrong decisions” only become evident in the long term, such mistakes cannot easily be taken into account in subsequent decision-making or corrected in line with market trends, even when there have been drastic changes.

## II

### Imparting basic skills

The concept of “basic skills” evolves and changes in keeping with the technological progress of a society. For example, computerization has made the capacity for abstract and logical thought more important than manual skills or even highly developed motor skills (Delker, 1990). The structure of basic education in most countries of the region dates back to an era when the demands of society did not correspond exactly to those of today or to the qualifications required by those who will not be going on to the secondary or higher educational levels.

Basic skills include, among others, the ability to identify and formulate problems, the ability to work

in a team, and willingness to learn. These have been examined recently in a number of publications. However, as we shall see in section VI below, no such analysis has yet been made of the content of specific training for each trade, with a view to improving productivity and quality, in situations such as that of Latin America.

There is a close relationship between the structure of the school educational system, the development of basic skills, and training proper. This means that there is also a relationship between the State, educators and the companies (private and public) which will be offering employment to qualified

persons. Different combinations of public and private systems have generated three basic models for the organization of education and training.

In the first model, the State does not play a significant role in vocational training, which is market-regulated. The best-known examples of this model are to be found in Great Britain, the United States and Japan. In these countries, vocational training is not linked to the formal educational system, nor does it come under government control or regulation: it is directly linked to production.

In the second model, the State plans, organizes and controls vocational training; the system may be described as one of distribution or allocation, since the most widely-used policy instrument is the supply subsidy. This is the model applied in France, Italy, Sweden and in most of Latin America. Its main characteristic is a close association with the school system and a direct relationship between school diplomas and professional qualifications.

The third is a market-based model, subject to State control. This has been developed especially in Germany, Switzerland and Austria. There is close collaboration between the Government and businesses, with a clear demarcation between vocational training and public education. This system was established to meet the needs of artisans, but later it was also adopted by industry.

The first of the models described above is structured in relation to demand, the second in relation to supply, while the third seeks a balance between the two.

Supply-based systems, which are applied in the majority of vocational training institutes (the National Vocational Training Institute (INACAP) in Chile, and the National Association for Technical and Vocational Training (CONALEP) in Mexico, to name only a few), follow academic programmes whose performance criteria are determined by the educational system itself and not by the demands of the production sector or by students' need to find a place in the job market or in society. Much of the instruction provided, including vocational and technical training, bears no relationship to the needs of employers. Programmes are excessively long and inflexible. Theoretical classes bear no relation to practice and are geared more towards getting ahead within the system than to satisfying the needs of the job market outside: an attitude in keeping with assessment criteria defined from the supply side itself. The rigidity of

these systems and the emphasis on performance for internal progress mean that students are poorly fitted to meet the changing needs of the job market.

For its part, the production sector finds it difficult to convey its requirements, primarily because, despite the existence of critical demands for skills, employers do not have instruments for formulating them nor the organizational channels for communicating them. The qualifications required today are complex, imply new methods of organizing work and are changing very fast as a result of technological innovation and the importance now attached to international competition.

The supply/demand imbalance in basic education and in vocational training institutes often leads to waste and hence to a by no means negligible loss of resources. Policies for overcoming such imbalances should address two problems: defining what has to be taught, and accomplishing this at the lowest possible cost.

Demand-based systems seek to adjust and correct supply. Policies which favour demand, through consumer subsidies or other similar instruments, seek to increase its quality and quantity through market pressures. However, some policies for subsidizing demand can also have adverse effects when not accompanied by concrete steps to achieve market transparency. This is noteworthy in the case of items whose deficiencies in terms of quality or quantity can only be corrected by the market in the medium or long term, as is usually the case with non market-oriented social goods, and above all with human resource training. In such cases, demand subsidies will be effective provided they are accompanied by measures and instruments for adjusting demand.

The educational model applied in Germany, Austria and Switzerland, known as dual or alternating education, whose application in the region will be examined below, seeks to overcome the shortcomings of inflexible supply-based systems by putting the emphasis on demand and introducing mechanisms for articulating it with participation from the employers and workers who will benefit from such mechanisms: it seeks to organize school training programmes, with active participation from the production sector in the planning and management of formal education, and to design courses for developing skills and determining suitable performance standards for the trades in question.



### III

## The school system and the cost of training

Whatever form the relationship between the educational and training systems and the productive sector may take, the role of basic education is important. One of the effects of primary education is that it facilitates training outside the school. There is a direct relationship between the quality and quantity of basic education received and the extent and intensiveness of training required in order to enter productive activities and attain a level of performance equal to or approaching the average (table 1).

In table 1, columns 1 to 3 indicate the average cost of initial training of workers in different low-productivity sectors. Columns 4 to 6 indicate the sav-

ings that these same companies would have made if their workers had benefited from approximately three additional years of education.<sup>2</sup> In countries where primary education enrolment rates are close to 100%, as in the case of Argentina and Chile, the savings for the companies approach zero. In countries with lower primary education coverage, however, the savings are considerable, amounting in some cases to half the cost of initial training. But the greatest benefits for these countries are of a different nature, since additional education would create suitable conditions for raising productivity and increasing receptiveness to technological innovation.

TABLE 1

**Latin America: Estimated cost of training, and saving on that cost through extra spending on education in school<sup>a</sup>**  
(In 1990 dollars)

Countries:	Average cost of initial training needed to achieve levels of performance equal to the company average			Estimated saving on training costs through extra spending on education in school <sup>b</sup> (%)		
	Sectors Foodstuffs, beverages and tobacco (1)	Footwear, wood and furniture (2)	Earthenware, pottery and china (3)	Foodstuffs, beverages and tobacco (4)	Footwear, wood and furniture (5)	Earthenware, pottery and china (6)
Argentina	200	600	300	-	-	-
Brazil	188	450	225	48	37	41
Chile	130	390	260	-	-	-
Colombia	120	320	160	31	25	25
Costa Rica	192	516	256	27	26	24
Guatemala	103	246	123	49	40	87
Honduras	136	318	159	50	42	39
Jamaica	100	500	250	50	40	40
Panama	392	980	490	52	37	53
Peru	110	290	160	32	21	80
Dominican Republic	152	363	182	47	27	42

Source: PADI (Industrial Dynamics Analysis Programme); ECLAC; surveys.

<sup>a</sup> Prepared on the basis of minimum wages, data obtained from company surveys, and projections.

<sup>b</sup> Extra spending equivalent to three years of school coverage per student, based on public expenditure per primary-level student in 1990. Average productivity equal to 50% of the sectoral average during the period was estimated. Only wage costs were taken into account. No costs were included for materials, supervisors, loss of raw materials, etc.

“Assuming that the minimum mathematical proficiency required to handle the new technological packages is equivalent to what is learnt in the fourth and sixth years of basic education (in agriculture and industry, at least eight years are necessary), the scope

for technological innovation in the region, although better than in the past, remains low” (Dirven, 1995).

<sup>2</sup> Based on national and international inter-company comparisons.

Just to give a few examples, in the late 1980s the average number of grades successfully completed was 3.3 in Brazil and 4.8 in Paraguay and Peru; the best averages were recorded in Chile, Argentina, Uruguay and some of the former British Caribbean islands, but even then they did not amount to six successfully completed years.

Low educational levels affect not only technological innovation but also job performance. It is common for workers to be unable to convert centimetres into inches, estimate curved areas or calculate the pressure of liquids and gases, which leads to inaccurate measurements and decisions that result in wastage.

The sectors referred to in table 1 are low-productivity sectors in the region, but they currently employ a very high percentage of the industrial labour force (ranging from 40% to 70%, depending on the country). This low productivity is due mainly to the technological level attained. To achieve substantial increases in productivity, important investments in machinery, instrumentation and organization are necessary. But when such investments are made, individuals with a low level of schooling find themselves excluded because they lack the necessary basic skills. As will be seen below, developing in adults the skills they need to attain the cultural level required by new technologies is a very costly business.

## IV

### Basic skills and technological development

The option of using persons with low educational levels and making up for their shortcomings (lack of qualifications) through training demands high investments – just as high as, if not higher than, the training itself – and it is less efficient than hiring persons with at least ten years of education. Roese found companies in Brazil which adopted the first-named strategy in 1989 but subsequently abandoned it when there were signs of a recession; one of them, with a total of 3,000 workers in production activities, had 300 workers undergoing compensatory training programmes and another 300 waiting to start them; another company, with 400 production workers, had 90 in programmes of this kind (Roese, quoted in Fleury and Humphrey, 1993). Some Brazilian companies which were carrying out restructuring programmes to im-

Comparisons with Southeast Asia and with some sectors in certain European countries indicate that organizational and process improvements generated within production plants (endogenous innovations) may become a very important source of increased productivity. Within companies in the region, the factors that inhibit the production and application of endogenous innovations are educational deficiencies and unsuitable management procedures. The development model in Southeast Asia and Japan has fostered such innovations, which have been made possible, in part, because the educational levels of the labour force are consistent with forms of management which stimulate the creativity of each worker.

In all the countries studied, savings in training costs are particularly noticeable in such sectors as footwear, wood and wood products (excluding wood pulp), and furniture and non-metallic fittings, which use virtually artisanal, labour-intensive technologies learnt mainly on the job. Such technologies depend to a great extent on the initial training workers possess when they join the establishment. Savings in the food and beverages sector are lower in absolute terms, but high in proportion to the cost of initial training. The technologies used by companies in this category tend to require less highly-skilled labour.

prove quality were obliged to raise their workers' educational levels by giving them courses in Portuguese, basic mathematics and elementary statistics (Gitahy and Rabello, 1991). The same situation was observed in Jamaica in 1994. This strategy has limitations and involves risks for employers, on account of its direct and opportunity costs, but it may be used when all else fails.

Preparation for the use of more complex technologies, such as those employed in more capital-intensive production functions, supposes a higher cultural or educational level than that provided by primary education alone. Automobile companies established or restructured over the last few years are a case in point. A particularly enlightening example is that of two automobile plants in Argentina belonging

to Ford Motors, one situated in Buenos Aires and the other in Córdoba. The workers in Córdoba have a much higher level of education than those in Buenos Aires: those with only primary education represent barely 6% in the case of the first-named plant, whereas for the latter, the figure is 50%. With respect to non-manual workers, at the Córdoba plant over 60% have full secondary or university qualifications, while at the Buenos Aires facility only a quarter have attained a similar level of education.

In 1993, the Córdoba plant exported nearly 85% of its production to Europe and Brazil. Technologically, it is much more advanced than the Buenos Aires operation, and its installations, organization and design are more modern: for example, some operations which are mechanized in Córdoba are still performed by hand in Buenos Aires. This illustrates the relationship between the degree of technological development and the level of qualification of the work force. Technological improvements generate a demand for workers with higher levels of basic training, which can be the foundation for an efficient training process. The Córdoba plant, which is newer, represented an investment of US\$ 250 million, whereas the one in Buenos Aires still has some equipment that is over thirty years old.

On the basis of the available data, we may conclude that the process of technological substitution of capital for labour goes hand in hand with a greater demand for workers with an educational base equivalent to secondary education. When this is not available, consideration must be given to compensatory education programmes. In the best of cases, a training process for workers over 18 that makes up for the most important gaps due to lack of secondary schooling would take about 20 months, at the rate of approximately 25 hours per week (such programmes are offered, for example, by the Fundación DUOC Vocational Training Institute in Chile). At the end of this period, the individual would then normally be in a position to start initial training proper –which in high-technology industries in the region means a further two to four months– before being able to start working as a full member of the production team.

The estimated cost of programmes like these in some countries of the region is shown in table 2. This cost is the opportunity cost for the workers, if they pay directly for the compensatory programme, or, for companies with more advanced technologies, the cost compared with that of finding educated or ex-

perienced workers on the market, or, for the State, the cost if it decides to cover the expense of such training. This last scenario does not depend on the educational model implemented but rather on the role assigned to governments in human resources training. Compensatory programmes, although aimed at enabling persons to make up gaps in their secondary education, are equated with training programmes. This means that they are governed by the policy instruments which lay down guidelines for the latter and by the emphasis on supply or demand which characterizes them.

When compensatory programmes are determined by supply, it will be the State which will tend to assume a greater portion of the costs and, at the same time, establish evaluation, monitoring and certification mechanisms to bring these programmes in line with the school system. When demand is the decisive factor and there is a close link between training and basic skills education, the tendency will be for the costs to be borne by workers, companies, or by the State (through subsidies for on demand from individuals or companies). But the greatest difficulties in carrying out these programmes are not related to costs but to institutional factors including certification, the preparation of teaching programmes, and their coordination with the demand generated by production activities.

TABLE 2

**Latin America: Estimated cost of compensatory programmes versus four years of secondary education<sup>a</sup>**  
(In 1990 dollars)

Country	Compensatory programme (20 months)	4 years of secondary education
Argentina	2 285	412
Brazil	1 220	669
Chile	1 714	677
Colombia	1 372	270
Ecuador	1 437	317
Guatemala	641	185
Honduras	916	317
Jamaica	1 118	795
Dominican Republic	1 029	191

Source: UNESCO, 1992.

<sup>a</sup> Present value of schooling estimated using a discount rate of 10% per year compared with 1990 expenditure. The present value of opportunity costs was based on 1994 minimum wages, with a monthly discount rate of 0.8%.

Table 2 shows the present costs of compensatory training. In each case, the opportunity cost is assumed to be equivalent to the minimum wage for workers: a very conservative assumption not only when dealing with workers in high-technology companies but also in many cases with self-employed workers too. A productivity level of 50% is assumed for the compensatory training period. These values are compared with the present cost of four years of conventional secondary schooling, in line with each country's expenditure on education: i.e., on the assumption that current quality levels are maintained<sup>3</sup>

This information suggests two possible options for attracting investments in the most productive sectors, which are generally capital-intensive and require a workforce trained to carry out complex tasks, or for upgrading the educational level of firms using advanced technologies. The first option is to increase the coverage of the school system in order to improve the education of young people before the age of 18, and the second is to encourage the extension of special compensatory programmes to make up for gaps in secondary education.

The present value and externalities of each option would suggest that preference should be given to improving school education, since it costs between 0.5 and 8 times less than compensatory programmes for those over the age of 18. Nevertheless, if this were the sole and exclusive option, it would mean ignoring the existence of a very important contingent of older workers in the region who lack the basic skills for modern industry and who would benefit from compensatory programmes.

It is also necessary to consider the problem of the quality of education, which has not been touched on in the previous considerations and estimates. Given the characteristics of education in the region,

for the most part highly unsatisfactory, some quality deficiencies could be compensated for by extending the coverage of basic education when lack of resources, technology or time prevent the introduction of substantial qualitative improvements.

It would be a matter of achieving universal coverage of at least eight years of schooling, assuming that the more appropriate alternative –better quality schools– is not possible. An average increase of three years of basic schooling could reduce training costs appreciably. But an increase in schooling would be of benefit not only in terms of reducing the cost and duration of training; other incomplete information suggests that it would also improve professional performance, improve career prospects for workers, ensure absorption of implicit knowledge on the job, and help the adaptation of knowledge to new working situations, thus facilitating the introduction of new technologies or moves from one job to another. In addition to these considerable benefits, a sound basic education would enable workers to make the most of subsequent educational opportunities and would offer collateral benefits such as a reduction in vagrancy, delinquency and unemployment among young people.

Thus, it is imperative to create conditions whereby the entire population will have access to what society defines as basic education. In the member countries of the Organization for Economic Cooperation and Development (OECD), no profitability studies have been carried out for primary education because the economic profitability variable does not enter into policy considerations at this level of education. The Latin American countries also hold that all persons have the duty to undergo basic education, which consequently creates the right to receive it, quite apart from the economic benefits that it may procure.

<sup>3</sup> Compensatory programmes cannot be completely equated with four years of secondary schooling, so that strictly speaking they

are not interchangeable goods. However, the comparison is useful as it provides valuable background information for policy formulation.

# V

## Human resources in low-productivity sectors

The sectors represented in table 3 are low-technology industries operating within the region on a labour-intensive basis requiring, supposedly, a workforce with the equivalent of at least six years of complete primary education. Not all countries have a workforce with this level of education, however (the average of grades passed in the region is 4.2 years; in Chile it is 5.6 –the best average–, in Argentina, 5.3, in Brazil 3.3, in Peru, 4.8 and in Mexico, 4.9).

Even though a good general education is a profitable asset and employers are aware of the fact, they are reluctant to make the necessary investments because the returns are visible only in the medium or long term. Moreover, the actual benefit may be zero

because basic skills education facilitates a high turnover of workers.

Assuming that the relationship between primary and secondary education and integration in the workforce is maintained, table 3 shows the effect of investments aimed at upgrading the level of education in segments of the population with low levels of schooling. Their integration in the job market would be enhanced by improvements in primary and secondary education. Increased rates of coverage at the secondary level would have more significant results than at the primary level. Improvements would be perceptible both in occupational status and in the level of remuneration.

TABLE 3

**Latin America: Additional costs involved in extending schooling by three years at the primary and secondary levels, and hypothetical effects on integration of population segments of 15 years and over into the workforce<sup>a</sup>**  
(1990 dollars)

	Extra cost of increasing primary-level schooling (grades 0-6) by 3 years (US\$'000)	Improvement in occupational status through increasing expenditure on primary-level schooling (simulation) (%)	Extra cost of increasing secondary-level schooling (grades 6-10) by 3 years (US\$'000)	Improvement in occupational status through increasing expenditure on secondary-level schooling (simulation) (%)
Brazil	105 542	18.3	670 928	2.3
Bolivia	2 162	6.9	173 377	5.8
Colombia	58 013	9.8	219 871	-
Costa Rica	6 435	14.5	56 037	25.2
Chile	16 731	7.1	56 027	23.0
Guatemala	14 935	24.3	66 750	26.0
Mexico	49 878	19.7	1 439 123	20.4
Panamá	12 600	17.5	40 242	31.9
Paraguay	2 070	12.2	34 907	34.7
Uruguay	13 740	13.8	21 325	18.3
Venezuela	22 134	17.3	58 163	21.2

Source: ECLAC, Special tabulations of household surveys of the respective countries; UNESCO, 1992.

<sup>a</sup> Employment in more productive activities.

## VI

### In-company training

A great deal of emphasis is now placed on the importance of basic skills education as a means of improving worker productivity. This is a justifiable concern, since limitations in terms of productivity and scope for applying new technologies are due in large part to deficiencies in this area.

The tendency in the region today is to assign to companies all kinds of responsibilities, including that of basic skills training, which traditionally has been provided by the public educational system. Peres (1994), however, suggests that although this may be unavoidable in the current economic situation, it seems to be due less to any non-interventionist virtue on the part of the State than to omissions in the fulfilment of some of its essential functions. Similar trends can be observed in the health sector and in the development of national science and technology systems.

Innovations in human resource education and training of young people through the school system, dual education and courses offered by vocational training institutes are not going to benefit workers already engaged in productive jobs. It is highly probable that over 80% of the persons currently employed will still be working 10 years hence, at least 60% 20 years hence, and over 50% 30 years hence. To these numbers must be added all the young people now entering the job market and those who will be entering in the next few years without having benefited from possible progress in the school system. The effects of any reform in the general or dual education systems will not be apparent until at least five years have passed. This is why the issue of on-the-job training is so crucial if there is to be any serious attempt to improve productivity levels.

With respect to those currently working, one may well ask whether, to what extent, and under what conditions this training can compensate for their deficiencies. In various countries of the region, it has been observed that training is not a substitute for basic education. The latter has specific features and develops skills which are taken for granted when training proper is started.

Companies concern themselves almost exclusively with specialized training, since they do not

have any incentives to invest in the teaching of basic skills. The greatest hindrance to investment by business in such training is the turnover of qualified workers. This is facilitated by the level of training and the professional experience of a worker, which increase his value on the job market: a worker with experience and qualifications can find a job with more attractive conditions. Businesses are therefore reluctant to offer general training to the workforce, preferring to give specific training defined as the practical expertise required for operating the tools of the trade. In order for businesses to get involved in basic skills training, they would have to be offered incentives in excess of the cost associated with staff turnover and the risk that such investment implies. Such a policy would be difficult to implement. A more useful proposal seems to be that of Ramos (1994) who, following the same track as Becker, suggests a private loan market for investments in human capital. According to Ramos, the lack of loans leads to poor allocation of resources in the economy, which is detrimental to efficiency and equity; in this regard, he suggests the establishment of a loan system using pension rights as collateral.

Training schemes with a general training component would appear to be very attractive in firms with a very large conventional capital component. In the Hermosillo motor plant in Mexico, initial expenditure on general training amounts to between 0.5% and 1% of total investment (US\$ 500 million). However, a similar training scheme does not have the same effect on the total investment structure of firms (including those with a similar-sized workforce) that are more labour-intensive but have lower fixed assets. Trying to apply this scheme to firms that have not made or are not in a position to make capital-intensive technological changes would mean allocating a higher proportion of total investment to human capital development.

This raises the question of whether capital/labour mixes in which the labour component is predominant require, or can benefit from, such intensive training processes; and secondly, whether an investment with a higher than usual human resources training compo-

ment is cost-effective. These questions have a direct bearing on decisions regarding the advisability of investing directly in training, independently to some extent of fixed capital investments.

Although there is no information that allows for a definitive answer, there are some indications that may serve as guidelines in this type of decision-making. With respect to the first question, what was achieved in the case of the Hermosillo plant in Mexico was the teaching of basic skills, together with the development of specific know-how required for working in the automobile industry. This is necessary in order to bring workers up to a level of actual production similar to that of comparable industries in the industrialized countries (Shaiken, 1990) by upgrading their general and specific training. This level would thus be comparable to that of workers in many German or Japanese firms who have completed the initial training course.<sup>4</sup>

In the industrialized countries, it is not only the leading companies that have workers with this level of education, and nor are they the only ones that offer intensive specialized technical training to their workers. In those countries, the productivity of firms—whether old or new, large or small—is attributable primarily to the qualifications of their workforce. In Japan, for example, the training period does not necessarily depend on the companies' production function. In Germany, the educational level and level of qualifications in production units are famous for their high standards, whatever the size of firms or the sector in which they operate, and the same is true of their labour productivity.

In the industrialized countries, it is not only productivity which is associated with high levels of training, but also the industrial sector's capacity to introduce technological innovations. The scope for continually incorporating new production technologies is dependent, among other things, on such excellent levels of training.

If the experience of these countries is applied to our own region, it might be concluded that this kind of training could also benefit companies with less capital-intensive production functions. However, it is

necessary to determine under what conditions such schemes can be applied in firms less committed to building up their human capital.

First, there is the cost. In Hermosillo, the initial expenditure per worker on training during the first years of operation was US\$ 1,555 dollars merely in terms of wages; in addition, there are costs for materials, teaching staff and the premises used, not to mention the opportunity cost involved in bringing the workers up to average productivity levels, once they have completed their training. It would be difficult for labour-intensive businesses to make similar outlays and, even if they were able and willing to do so, it is doubtful whether they would thereby attain a level of productivity which would place them in a sufficiently competitive position to offset such investment.

As mentioned above, investment in training may not appeal to employers since it contributes to labour turnover. This was one of the most serious problems encountered by the Ford plant in Mexico: in the early years, the turnover rate was 40%, which naturally meant a high additional cost. The cause of this high worker mobility was precisely the training they had received, which encouraged them to seek better-paid jobs or to opt for self-employment in the same sector, but outside of the company.

Employee mobility in the region is a chronic problem. The development of skills does not help to solve it unless it is accompanied by social benefits such as some industries have offered (child-care centres, production bonuses, long-service awards, training incentives, etc.).<sup>5</sup> These measures imply additional costs and, undoubtedly, important management changes.

Lastly, raising the basic educational level of workers may be counter-productive in so far as it leads to ambitious expectations as to the type of job to which workers can aspire. Fleury and Humphrey (1993), basing their study on a sample of companies in São Paulo and Rio Grande do Sul, report that in Brazil workers who upgrade their education and obtain certificates expect to "move up" to an administrative job. In order to keep workers with high

<sup>4</sup> In the Japanese automotive industry, new workers receive an average of 340 hours of training (Krafcic, 1990), which is only half of that received by workers in Hermosillo. The reason why extra training is needed in Mexico is that the workforce has a lower level of education on entry.

<sup>5</sup> Examples of such firms are Fantuzzi in Chile and Hofab in Jamaica.

educational levels in production operations, Fleury and Humphrey recommend raising the overall coverage of the educational system. If this is not done and only a few workers improve their educational level, then they are going to seek jobs outside of production.

This confirms the relationship that exists between the educational level of production workers

and the school enrolment ratio of the population. The type of mobility described is more common in countries like Brazil which have a low enrolment ratio than in Chile or Argentina, where the ratio is in the vicinity of 90% for the 7-14 age group, and it is even less common in the industrialized countries, where there is 100% school coverage.

## VII

### Investment in training

Even though the present level of investment in training is very low, employers have little control over its benefits. These emerge over the medium or long term, are not always obvious, and employers may well reap only a fraction of the benefits, given the high rate of turnover in the workforce. Human capital is a factor of production whose behaviour is difficult to predict and even more difficult to control in view of the numerous social, economic and political considerations that come into play.

In some cases, the additional investment in training does not always produce an additional benefit. Very frequently, benefits are achieved only when all workers in the plant are trained. In other cases, there may be a temporary gain, but without technical and motivational training, or without on-going refresher courses, whatever progress is achieved is soon lost.

In the region, an apparently contradictory situation has emerged: on the one hand, there is a high degree of consensus among employers and employees as to the value and desirability of more and better education and training (Fleury and Humphrey, 1993; Ferraz, Rush and Miles, 1992), but on the other, economic decisions do not encourage expenditure in this area.

An easy but at the same time contradictory response would be to assign greater responsibility in this field to governments. This is not a convincing solution, however, because many experiments of this kind in the region have given unsatisfactory results; because centralized State training does not take into account the specific needs of each industry and does not systematically take account of on-the-job training; and finally, because it is necessary to improve on-the-job training without removing it from the context of actual production and without separating the companies from it.

Every strategy to improve this training should take into account the amount that companies are able and willing to spend on human capital training. The response is not the same in all sectors or all sizes of firms, and it is influenced by the degree of technical progress attained or aspired to.

Companies which use capital-intensive production methods and are introducing new technologies plan their investments in training as a vital component of their overall investment portfolio, especially when the latter is large. In this type of company, on-the-job training is given preferential treatment through human resources departments or through the services of specialized agencies; these companies seek their own solutions and allocate funds on the basis of their technical requirements.

The situation is more difficult in the case of companies whose production methods are labour-intensive, without much technological innovation in production or management, and the problem is even more complicated if the firms are small or medium-sized. The kind of training schemes used by big motor companies with highly advanced technology are beyond their reach. The fiscal incentives applied in many countries of the region (tax rebates of 1 - 2% of the payroll for training expenses) have not yielded the expected results: often employers do not make use of these allowances even when they recognize that it is desirable to have a well-trained workforce, and the allowances are often used for other purposes.

This situation is an obstacle at least to i) efficient operation of the technologies in use; ii) the introduction of new technologies; iii) reducing the disparity between modern companies and traditional ones, and iv) reducing the disparity between the countries of



the region, on the one hand, and the Southeast Asian and industrialized countries on the other.

If many businessmen either cannot or will not spend 1 - 2% of the payroll on workforce development, even when tax exemptions are obtainable, then it is difficult to imagine what contribution they *would* be prepared to make, and what underlying economic rationale they follow.

Many medium and large-scale enterprises using conventional technologies reduce the training period for basic skills training and on-the-job specialization by using workers who already have some experience in the sector. This strategy allows them to operate with some degree of efficiency, but is not always conducive to the creation of suitable conditions for technological innovation or for bringing productivity levels more in line with those of more advanced sectors inside and outside the country. Moreover, these practices contribute to higher rates of mobility within the workforce. The advantage is that their training costs are reduced, even when they pay higher wages than those of the companies the workers came from. They achieve economies by shortening the training period, they do not need to develop basic skills, and they reduce the initial period of low productivity, while they also limit the waste of materials due to the mistakes characteristic of workers who are novices in the sector. And lastly, they do not need costly human resources departments.

Hiring workers with experience is also a strategy used by large enterprises, sometimes in complementation to others. The most noteworthy case is that of the Ford plant at Hermosillo mentioned earlier. This company changed its hiring policies, and hence its training policies, in response to the high turnover that it experienced in its initial years of operation, which was partly due to its own human resources training strategy. Because of this problem it decided to train older workers, with less formal education but with working experience, and was thus able to cut back basic training from four to two months, spread out over a longer period. No decline in productivity has been observed as a result of this new hiring and on-the-job training strategy.

The Nissan plant at Aguascalientes (Mexico) also employs workers with some schooling and work experience and trains them for a period of approximately two months, obtaining high standards in terms of quality and productivity (Shaiken and Mankita, 1994); it would appear that this strategy offers more

advantages for companies than Ford's original scheme in Mexico which was based on intensive initial in-plant training programmes.

The economic value of on-the-job experience is corroborated by profitability estimates: Butelman and Romaguera (1994) estimate that in Chile, working experience provides an average return of around 3% per year, which indicates that the know-how acquired with practice yields particularly high returns. The biggest drawback of policies based on hiring experienced workers is that when such human resources are scarce, all companies are competing for the same workers in a short space of time.

In highly productive, capital-intensive sectors, training costs are higher than in companies that use less advanced technology, but the requirements for previous education are also higher. In the high-technology motor industry, such as the Ford plant in Mexico or Transax in Córdoba (Argentina), the educational level of most workers is appreciably higher than in less technologically advanced companies.

A technologically advanced industry will only decide to invest in training programmes that are specific to its production needs if its workers have a level of schooling equivalent to secondary education. Such specific programmes are quite complex, and generally very costly.

It does not seem efficient to pursue higher levels of productivity solely through specific job training, since the cost-benefit ratio is less favourable than that based on a mass education modality.

In companies with traditional systems of organization and technologies, training is currently quite informal. On the shop floor, it is the supervisors who show the workers how to use machinery and instruments and who teach company procedures. The more limited or poorer a worker's previous schooling, prior job experience or vocational training, the longer the learning process will be.

In companies of this kind within the region, no manuals, textbooks or methodologies are used for systematic training. Often, the training process is simultaneous with production work itself, in which trainees are involved from their first working day. The visible costs of training include workers' wages and wastage of materials due to inexperience, while invisible costs mainly consist of the time devoted by supervisors to the task. Given the informal character of these arrangements, training periods (and hence costs) vary significantly between countries and sectors and even between firms in the same branch.

The factors that affect training costs most directly seem to be the worker's educational level and previous experience, the complexity of the technology used, and the level of wages in each locality. Thus, the training period is shorter in the garment industry than in the woodworking industry, where the more complex machinery usually used requires a longer training period, and moreover it has not been feasible to simplify or mechanize tasks to the same extent as in the garment industry. The level of prior schooling of workers influences the time needed for their training. Another factor that affects training costs, which is not reflected in the figures in table 3, is the wastage of materials. This is particularly important when the materials are not recoverable, as with wood or textiles, but may be somewhat less serious in the metal-working industry, where scrap can be recycled and used as raw material.

Training costs do not necessarily vary in the same direction or the same proportions as labour productivity. Indeed, some of the least productive sectors, such as the leather and footwear industry in Colombia, Panama and Venezuela, have higher training costs. The machinery sector, for which training costs are not available but which are usually the highest of those represented here,<sup>6</sup> does not always post the highest productivity rates.

The available information does not reveal the relationship that must exist between capital structure and training costs. Nor does it allow for an accurate assessment of the true impact of marginal expenditure on human capital training. It does, however, at

least allow us to formulate the theory that in the sectors mentioned, which are for the most part labour-intensive, additional expenditure on initial training offers little scope for improving productivity unless, at the same time, there are parallel investments in traditional capital which lead to technical substitution and general development of the workforce within the production unit. It may also be assumed that it is more advantageous to spend money on the development of general basic or sector-specific skills than on an ongoing training process.

In these sectors, it would probably be more worthwhile to improve the *effectiveness* of current expenditure on training rather than increasing such spending. This would mean modifying the informal training structure, improving educational technologies, coordinating business efforts by sector with support from training organizations, and systematically incorporating know-how acquired on the job.

Lastly, consideration should be given to a dimension that has to do with bargaining mechanisms, business practices and macroeconomic factors which are often beyond the control of employers and workers. Some authors<sup>7</sup> point out that in order to ensure that the results of training are reflected in labour productivity, there should be certain understandings, the most important being the principle that employers should offer job stability in return for worker loyalty. In the region, job stability is not usually a matter for collective bargaining, so that many of the agreements on this issue are implicit and hence precarious.

## VIII

### Vocational training options

The school system's difficulty in establishing links between the content of the training provided and the demands of the production sector can also be observed in the vocational training institutes. Like the schools, these often have an orientation that is determined more by their own supply than by demand, and only the areas of administration and management

designed for big business concerns seem sensitive to real demand.

How can one establish a better balance between the demand generated by the production sector and the supply of trainees coming out of vocational training institutes? One alternative is to use the method applied in the United States and Mexico, where studies were

<sup>6</sup> Training periods in this sector are longer than, or at best equal to, those in the woodworking or footwear industries, and wages are higher.

<sup>7</sup> Such as Coriat (1991), Fleury and Humphrey (1993) and Roesse (cited in Fleury and Humphrey, 1993).

carried out on skill requirements, through analysis of different types of work. However, this strategy is very costly and its findings only hold good for a limited period of time. Furthermore, it requires the establishment of coordinating and executive bodies.

Another strategy would be to privatize vocational training, to seek optional financial arrangements, and to allow the market forces to regulate supply. INACAP, in Chile, has followed this strategy. One of the most noticeable effects has been the more "elitist" trends in training, since institutes run on this basis tend to focus on technologically advanced sectors and on jobs in the higher brackets.

In outlining a strategy for vocational training institutes, it should be borne in mind that they have greater access to private funding than other types of institutionalized training, their total income and income per student exceed the average levels for technical and secondary vocational training in the region, and they can generate income of their own by selling services.

The dual education modality has characteristics different from those of other types of training. It originated as a variant of technical education within the school system, because doubts as to the effectiveness of this latter type of training led many countries in the region to seek other ways of organizing technical secondary schools. According to some studies, the earning capacity of students from technical schools is similar to that of students from general schools in Lima (Mooock and Bellew, 1988), and similar findings were reached by Butelman and Romaguera (1994) in Chile. Schiefelbein and Farrel (1982), in another study on Chile, point out that the lack of incentives in technical schools for students to pursue academic goals adversely affects their performance. Psacharopoulos and Loxley (1985) found that both in Colombia and Tanzania, students graduating from technical schools did not have any advantages over those coming out of the general secondary education system in terms of finding jobs or obtaining better wages. Another series of studies carried out by the World Bank between 1965 and 1988 both inside and outside the region (Haddad, Carnoy, Rinaldi and Regel, 1990) suggests that investment in technical secondary schools is not the best strategy for stimulating economic development and that this form of training is not the most efficient for providing the requisite skills.

It has also been observed that in the majority of countries in the region, technical secondary education is of poor quality. The inadequacies of voca-

tional education are most keenly felt by companies with highly advanced technology and workers trying to enter such firms. On the other hand, artisans, some microenterprises and some self-employed workers who usually use lower levels of technology still benefit to some extent from the know-how and skills developed through this type of training.

The above considerations, and the limited redistributive effect of technical education as imparted in the schools, have pointed to the need to seek a way of restructuring this modality, bearing in mind existing budgetary constraints.

Schools offering dual training represent a possible alternative. In Latin America, no dual training systems have been developed that are comparable with those in Germany. There are dual modalities within the school structure and in some vocational training institutes, but their development is different in the nine countries where this system exists. In Argentina, Guatemala, Paraguay and Venezuela, businesses play an important role, while in Argentina and Venezuela educational establishments are also heavily involved. The training period lasts between one and three years. An exception is Chile, where a four-year programme is being developed within the technical secondary schools and a six to eight month programme for adults.

The experience of Germany, Austria and Switzerland in dual education is valuable for the region, since it has shown that it can be implemented by involving enterprises of all sizes. In Germany, 25.7% of trainees work in companies with less than ten employees, 29.8% in companies with 10 to 49 workers, 16.9% in companies with 50 to 199 employees and only 17.5% in companies with a staff of 200 or more (Greinert, 1993).

Vocational or technical/professional training is probably the educational sector in greatest need of radical modernization. It caters for a sizeable contingent of young people in secondary education: for example, 58% in Argentina, 42% in Brazil, 35% in Chile, 29% in Colombia, 23% in Costa Rica, 35% in Ecuador and 22% in Guatemala (UNESCO, 1992). Dual education is one possible form of organizing this sector.

In 1994, only a fraction of those receiving vocational or technical education in the region were enrolled in a dual system. Currently, this system does not account for the training of large numbers of workers, but it does provide relevant background information and raises issues regarding its possible application in the future.

# IX

## Conclusions

The available information suggests that there is a close relationship between the basic skills possessed by individuals and the training that they need in order to successfully enter the job market. Basic skills affect training costs and workers' ability to find productive employment, and they help to determine the effectiveness of vocational training and define the environment for technological innovation.

In order to formulate effective strategies and design policy instruments which take account of the relationships outlined in this study, it is necessary to combine an assessment of the available or potential means for achieving these aims with a thorough analysis of the specific demand for human resources generated by the technologies which will make it possible to increase productivity in the various sectors.

This analysis involves determining the degree of development of basic skills in the different categories of the work force –the most important of which would currently appear to be those already involved in production and trainees– and in the young people attending school. Each one of these groups has specific needs and demands.

Based on these observations, a set of measures may be suggested for developing basic skills in workers and in students who will soon be entering the working world. These measures may be translated into separate policies for each of these categories, for the different sectors, and for the different scales of enterprises. The formulation of such policies also implies defining the participation which the State, the private sector and individuals should have in formulating and implementing these measures and securing the resources for making them possible.

i) *Policies affecting school students.* The two most popular strategies are to extend universal school enrolment to eight years of basic education and to improve the quality of the education provided, which entails reformulating study programmes so that they will provide the skills required for modern production processes. The main problem which these strategies come up against is that of obtaining the funds needed to extend the system, while improving the quality and integrating the whole population of

corresponding ages. It would appear that the educational technologies currently in use are not the most efficient for achieving this dual objective, so that it is imperative to undertake a review of the functions of educational production that involve an increase in capital-intensiveness (Labarca, 1995).

For practical reasons, and in order to ensure equitable distribution of the benefits of education, the task of improving and increasing education should be implemented or controlled directly by the State, even though the beneficiaries are those who will be attending school and the employers who will have a better-qualified work force.

ii) *Policies affecting trainees.* Bearing in mind that any modification in the educational system aimed at promoting basic skills education will take several years before it has any effect on the work force, it is necessary to formulate two different strategies: one for young people entering the job market who have not gone through the improved school system, and another for those who will have benefitted from the improvements. In both cases, forms of teaching should be sought which link the acquisition of skills and specific know-how at the workplace with education in educational establishments, for a period of two to four years, based on an adaptation of the most successful experiences with the dual system.

It is necessary to emphasize basic skills education and a more direct relationship between on-the-job training and school education, by incorporating specialized and technological training into the school curriculum. Furthermore, the State, employers' associations, or a combination of the two should set up mechanisms for the quality control and certification of education, in accordance with strict norms and standards.

The costs of this training should be borne by the State as far as the school system is concerned, by the enterprises, and by the individuals who stand to benefit. The latter should have access to loans with security from their future provident funds (Ramos, 1994), so that they can help to pay part of the costs of their training. This would mean making changes in the legislation of all the countries of the region.

iii) *Policies that affect workers.* This is the group that poses the most problems with respect to basic skills education. These workers can hardly benefit from changes in teaching and even less from modifications in the school system. Neither the training deficiencies displayed by these workers nor the problems associated with them have been resolved to any significant extent in the region.

There is a need to go beyond the concept of "adult education" as a means of providing education for persons over eighteen years of age who have not completed secondary school. Teaching basic skills to adults can be achieved more effectively through informal corrective systems adapted to actual job requirements.

It is probably more effective to allocate resources for training of this kind in the form of loans to workers rather than as incentives to companies, al-

though the latter system may be retained as a means of complementing suitable policies adopted by the companies themselves.

iv) *In-company policies.* Companies should develop the capacity to formulate their own human resource requirements, not only in relation to specific posts but also in more general terms. This is particularly important in technical substitution processes.

In order to make an accurate assessment of basic skills requirements and evaluate the most pressing needs, it would be desirable to set up local coordinating bodies (at the municipal level) between the education and training systems and companies, giving such bodies the authority to formulate and implement education and training policies within their spheres of competence.

(Original: Spanish).

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# Social *investment funds* in Latin America

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Subregional  
Headquarters in Mexico.*

This article deals with various aspects relating to social investment funds, especially their financing, the sustainability of the resulting projects, and the role of funds *vis-à-vis* ministries and the political authorities. The links between such funds and non-governmental organizations and the role played by external cooperation are also examined. Social investment funds were set up in order to relieve poverty and soften the effects of the adjustment policies of the 1980s. They have proved to be effective means of channelling flows of external finance and ensuring that they result in concrete projects. The main strategy used for transferring resources to the poor has been the creation of temporary jobs in connection with the execution of projects in the areas of social and economic infrastructure, as well as projects designed to satisfy basic needs. A smaller proportion of the financing obtained has been invested in direct production activities, usually through non-governmental organizations. Generally speaking, social investment funds have indeed served to relieve poverty. Although they were not conceived as a means of tackling the structural problems which lie at the root of poverty, they have made it possible to deal with acute economic and social problems.

# I

## How social investment funds came on the scene

Concerned about the rising poverty in their countries and the social impact of the stabilization and structural adjustment policies applied during the late 1980s, many Latin American governments were moved to establish emergency social investment funds, designed to alleviate poverty and cushion the impact of government austerity measures. These funds represent a new mechanism for government action in this field, incorporating under one roof the financing and promotion of projects and the securing of financial backing from external organizations and friendly countries. The first fund, Bolivia's Emergency Social Fund, was created in November 1986 and greatly influenced the institutional and operational structure of the funds subsequently established in other countries.

Social investment funds have shown themselves to be good channels for converting flows of external financing into tangible projects. The central strategy for transferring resources to the poor has been the creation of temporary employment through the execution and management of social and economic infrastructure and basic needs projects. In addition, the projects themselves—particularly infrastructure works—are designed to provide long-term benefits for poor communities. A small fraction of the available financing has been oriented toward direct production projects, generally utilizing NGOs as intermediaries.

The funds are autonomous institutions. Since they are freed by statute from most normal bureaucratic hiring and procurement constraints, they have been able to adopt more dynamic private-sector methods in their operating procedures, functioning alongside but independently of government ministries in the relevant sectors. Government bureaucracies are often viewed as being bogged down by red tape and incapable of mounting a large, efficient

operation for the rapid disbursement of project financing. The funds have been fortunate in securing high-quality management and have built up qualified, results-oriented teams which have striven hard to meet objectives.

The social investment funds were conceived as financial intermediaries essentially limited to project evaluation and supervision. Project design and execution is left to the private sector and to the relevant ministries. The project portfolio is determined by requests from communities and NGOs or, in some cases, by government agencies. To foster the selection of projects that benefit the poor, as well as to secure transparency in fund operations, information and management systems based on eminently technical criteria have been instituted.

Although the funds were originally conceived as temporary ventures, there has been a tendency to extend their life, and several funds have already been converted into permanent investment institutions. A number of them are still in the initial stages of operation but are already striving to carve out permanent roles for themselves.

Responding to the needs and demands of the countries, external donors<sup>1</sup> and financial institutions have played a catalytic role in the establishment and orientation of the social investment funds and in providing resources for their operation. The extensive cooperation granted has been of a concessional nature. Financing by international development banks has been largely in the form of soft loans, while cooperation by donor countries and United Nations agencies has primarily consisted of grants.

The World Bank has been a leading financier and active promoter of these initiatives. Moreover, it is only fair to say that the original conceptual and operational framework, while devised by the

□ This article is based on a study prepared for the Swedish International Development Authority (SIDA). The opinions expressed in this paper are the exclusive responsibility of the author.

<sup>1</sup> Including Canada, the European Economic Community, Germany, the Netherlands, Sweden, Switzerland, the United Kingdom, and the United States Agency for International Development (USAID), to name only a few.



founders of Bolivia's Emergency Social Fund, was confirmed and developed in greater depth during the course of the initial dialogues with the World Bank. In addition, the Bank has been quite flexible in experimenting with new forms of project lending, such as providing funding for the creation of temporary employment and relaxing normal procurement procedures.

The Inter-American Development Bank has also been a major financier of social investment funds in Latin America, and the institution's influence has been felt in their design. Similarly, USAID has given substantial financial backing to a number of Latin American funds. In some cases, USAID has been highly instrumental in getting operations off the ground and in orienting their priorities. The United Nations Development Programme (UNDP) has provided technical cooperation financing for the funds in nearly all countries and has been very influential in the establishment of the Central American institutions.

On balance, the social investment funds have definitely shown themselves to be a step in the right direction for alleviating poverty. While they do not squarely address the problem of structural poverty, they certainly represent a better approach than merely ignoring the countries' paramount economic and social problems. It

should be recognized that the architects of the funds did not pretend to achieve an optimal solution, based on an analysis of the historical causes of poverty in the region, but rather adopted a pragmatic approach to see what good could be accomplished right away under the present circumstances in some of the poorest countries of Latin America.

Social investment funds can play a role as a link between external financial organizations, governments and communities. They can help to translate governmental development strategies and normative guidelines into concrete applications at the regional and local levels. Through their contacts with NGOs and other grassroots organizations, funds can elicit projects that reflect the real needs of the poor, and they have proven capable of establishing good working relationships with community organizations which are conducive to good projects. Funds also tend to be more attuned to the concerns of external donors and financiers and can allay fears that resources are not being used effectively by stressing transparency in financial operations. Although it is true that funds have not always played this pivotal role, they can at least represent the governments, country donors and international financial organizations *vis-à-vis* the community, and vice versa.

## II

### The most salient issues

#### 1. Some shortcomings of the funds

Officially, the emergency funds were established to compensate the poor for the burden placed on them by stabilization and structural adjustment programmes. In practice, however, this objective has not been pursued, and the funds have simply served as schemes for giving temporary relief to some of the poor. Indeed, the effects that decreases in employment and real wages have had on the income of the poor have generally not even been identified. The compensation provided is not specific to the people affected or to their actual needs (employment, food, etc.).

This is not to imply that the resources have been squandered. In countries where the vast majority of the population is poor, all social programmes reach some people in need. Moreover, it is by no means

evident that priority should have been given to the newly impoverished when there are large numbers of people who have been poor for generations.

In this respect, it is worth noting that there is no doubt that the adjustment process is not the main cause of poverty in the region and that the poor have not borne the entire burden of the austerity measures.<sup>2</sup> In the countries examined, more than half of the population was already below the poverty line before the economic crisis of the 1980s, although this

<sup>2</sup> Moreover, some effects of the stabilization and adjustment programmes have clearly benefited the poor, even in the short term. I refer particularly to the curbing of rampant inflation, which was perhaps the greatest scourge of the poor during the last decade and the most socially and politically destabilizing force.

added significantly to their ranks. The effects that the stabilization and adjustment programmes have had in terms of increasing the proportion of poor in these countries is marginal when viewed in the context of the countries' massive structural poverty.

Enthusiastic officials sometimes give the impression that much is being done for the poor and even, at times, that the funds are something like a panacea ("the country is in dire straits, but now we have the Fund"). Moreover, inasmuch as the funds become the centre of attention, they tend to supplant the broader policy dialogue on social issues, both domestically and with the international community. Undoubtedly, things are being done in a different way: the funds tend to be dynamic, well-staffed organizations housed in modern buildings which are a far cry from the dingy offices where social matters are traditionally handled. It is also true that substantial external cooperation has materialized that has been translated into expenditures and investments useful to the poor. Nonetheless, it is well to keep in mind that, at best, the funds have disbursed US\$20-\$30 million per year, or perhaps twice that much in some years in the case of Bolivia. For the larger funds this represents, in peak periods, about US\$10 per year per poor person. These are not trivial sums, but they are not even enough to offset the cutbacks in per capita expenditures in the social sectors that occurred in many countries during the last decade or to compensate the working classes for the fall in real wages.

Moreover, the funds are not reaching the very poor, particularly those living in remote communities. This is partly because the indigent have little capacity to formulate projects or plead their merits. This is one of the weak points of "demand-driven" schemes for generating projects (quite apart from the fact that, at least conceptually, they are sub-optimal for project selection and sometimes generate spurious projects). In general, projects tend to be formulated by those who have experience in this area, and these often turn out to be the not-so-poor.

An evident weakness of the funds is that they concentrate on physical infrastructure projects whose employment-generating function tends to bypass women. This bias is very important, for women (together with children) constitute the poorest group in these societies, and a high proportion of households are headed by women. Various studies have shown that the pattern of household consumption depends on who brings in the income, and women tend

to be more responsible administrators: that is, earnings that come into their hands are generally spent judiciously on satisfying the family's basic needs (largely food and clothing) and women also tend to be more provident. Moreover, women have proven to be good leaders and co-workers in grassroots ventures and communal financial organizations.

## 2. Are social investment funds the solution?

The funds were designed to bring quick relief to some of the poor, not to combat the countries' structural poverty. Thus, they cannot be blamed for their failure to address the broader problem –nor indeed are they well fitted to do so. A step forward has been taken in moving away from solutions based on the paternalistic distribution of food and medicines towards employment-creation schemes, but the idea of increasing the income and resources of the poor on a permanent basis has not been central to the agenda.

The very notion of utilizing low wages, equal to or even below the minimum wage (sometimes for the most menial jobs), as a way of screening jobs and targeting them towards low-income groups is, to say the least, hardly an acceptable development concept. It is obviously a survival strategy that may relieve social pressures but will not lift the poor out of the subsistence level. Furthermore, the employment thus created has, by design, been kept temporary and outside the government apparatus, so as not to increase the size of the bureaucracy. While this may be the best that can be done under the circumstances –and it is certainly better than doing nothing– it is not a programme for combatting poverty.

It is true that projects are generally selected on the basis of standardized technical criteria, and this has fostered competition for project preparation –and for project money– by the private sector and NGOs. However, too little stress has been placed on community development and self-sufficiency, which are indispensable for a genuine solution, and sometimes contributions have turned into outright patronage. Teaching communities, through their involvement in the identification, design, and execution of a project, that they can do things for themselves, while at the same time generating a sense of responsibility and the dignity that goes with it, is often the most important benefit that a project can provide. In this regard, the systems of self-help or food-for-work have been largely ignored in favour of work by contract, al-

though labour is often the only tangible contribution that community members can make to a project. When communities regard a project as their own, they participate more readily in its execution, the project is implemented more rapidly, and there is a greater likelihood that it will be followed up by arrangements for maintenance and services.

The funds' investment programmes have concentrated primarily on economic and social infrastructure. Direct production activities have been ignored or given very low priority, thus turning the poor into passive beneficiaries rather than active participants in the productive process. In countries where the vast majority of the people are poor, a frontal attack on poverty must emphasize the generation of permanent employment and the production and productivity –and hence income– of the poor segment of the private sector. Important as they are, simply rationalizing macroeconomic policy and targeting social expenditures in basic needs will prove insufficient to address the mass poverty found in very poor countries. The stabilization measures called for by the large imbalances in these economies leave little room for manoeuvring, and social sector budgets are usually insignificant (often less than 5% of GDP) in relation to the vast majority of the population that is poor. In addition, the satisfaction of “basic needs” does not solve people's equally basic need to have a job and a steady income.

In this respect, little has been done to change the pattern of capital accumulation, which is still largely in the hands of the rich. With few exceptions, little attention has been paid to fostering capital formation by the poor and raising their productivity (e.g., by developing microenterprises, improving “minifundio” operations, modernizing informal-sector ventures, etc.). It should be noted that it is the small entrepreneurs who are often dealt a crippling blow by structural adjustment programmes, yet they are left out of the benefits of compensation programmes. If the social investment funds will not or cannot attend to the credit needs of microenterprises, then some type of financial vehicle must be created to do so.

It goes without saying that stimulating those aspects of production which are in the hands of the poor is a very difficult and complex task, but it lies at the very heart of the development process. The solution calls for emphasis on the individual –not just on broader social sectors– and the consideration of a number of extra-economic factors. More specifically,

it requires a myriad of actions by government and non-governmental organizations, external cooperation agencies and financial institutions, together with direct efforts and tenacity in the pursuit of complex and often risky solutions. Moreover, the generation and follow-up of a wide variety of small production projects entails higher administrative costs. In an effort to achieve rapid results, the funds have generally taken the easiest way out, namely, financing mainly infrastructure and assistance projects.

### 3. Ensuring project sustainability

A major weak point of social investment fund operations is project sustainability. The crux of the matter is that the funds are temporary mechanisms, but the works they create aim to be permanent. Many projects have operational service components, and all require maintenance. In fact, it is often more urgent to maintain projects than to build new ones; maintenance operations typically have very high cost/benefit ratios.

By nature, however, the funds are doers, not planners, and they are not prone to giving adequate consideration to future recurrent costs. Moreover, maintenance operations are not very glamorous (there are no inauguration ceremonies with ribbons to cut). It is more expedient to get involved in clear-cut, tangible projects and leave the cumbersome task of providing for maintenance to someone else. Furthermore, maintenance costs are high; over the years they can add up to sums larger than the initial cost of the project.

Clearly, the provision of maintenance services and operational support often presents serious difficulties. Nevertheless, for projects to deliver the expected benefits –or even to survive– the problem must be squarely faced. The building of infrastructure should be considered merely the first phase of a project. This is even more obvious in the case of basic services such as health and education projects. Clearly, unless explicit arrangements can be made for the financing of the entire project –including its operational component– it should not be started at all.

In practice, many of the projects executed by the funds in the social sphere consist of the rehabilitation of existing facilities that already have State budgets assigned to them (e.g. an existing school). In this situation, the funds can go ahead with social infra-

structure projects without relying on additional budget allocations. In some cases, parallel government programmes to institutionally strengthen and broaden education, health, or other welfare-type services have been established. Often, both domestic and external financing have been justified under the rationale that these are actually investments in human capital, and in the expectation that increases in fiscal revenues will eventually result and offset what are considered to be temporary budget shortfalls. The social investment funds can then fulfill the complementary functions of providing infrastructure for the expanded services.

In theory, it is appropriate to make beneficiaries responsible for the recurrent costs involved, through user fees that can be collected, for example, by the municipalities. This implies the design of a programme of levies and the provision of institutional support. In practice, user fee systems are hard to implement in the case of poor communities and are sometimes unreasonable.

It is relevant to note that all of these alternatives for ensuring an operational follow-through presuppose close interinstitutional coordination of the social investment funds with relevant ministries, municipalities, and other governmental agencies; clearly, projects should be integrated within the government's sectoral plans and budgets.

Finally, whenever possible, perhaps the best way of ensuring that the maintenance and operational components of projects are not abandoned is to involve the communities themselves in the projects. A town association or an NGO that has generated a project or participated in its implementation can be instrumental in ensuring its sustainability. However, making sure that communities take responsibility for projects takes considerable time and effort and has often been considered to be outside the purview of the funds.

#### **4. Role of the funds in relation to relevant government ministries**

A central justification for the creation of new instruments to combat poverty is the institutional deficiency of the relevant government ministries in carrying out projects and effectively managing large emergency programmes. It is no coincidence that this hypothesis falls well in line with the ideology currently in vogue that the government's sphere of action

must be reduced in relation to that of the private sector and that the government planning function is counterproductive.

The argument is that the way to rapidly mount a major operation is through a pseudo-private-sector mechanism, rather than trying to reform inefficient and sometimes corrupt traditional bureaucracies. In practice, the solution has entailed the creation of novel government institutions that are largely free to act like private ventures –guided, however, not by the profit motive but by social objectives.

The idea is to guarantee a steady stream of financial resources by setting up systems to bypass the weak government apparatus. However, these new arteries have gradually come to be viewed not as emergency bypasses, but as formal solutions that distance themselves from the governments and may even further weaken normal avenues of action. Inasmuch as social funds replace regular channels, there is a tendency to undermine existing institutions and a temptation to usurp relevant ministry functions, such as the formulation of social policy.

There has also been some concern that the funds will syphon off resources from ministry budgets. This has not generally been the case, for funds have had ample financing from outside sources, and the governments' contribution has been used in most cases as seed money to get operations off the ground or to advance financing under negotiation. Moreover, up to now, it does not appear that resources are being syphoned from external financing that would otherwise have been available for other social projects. In other words, indications are that most of the external financing has been additional.

Although the operations of some funds have been constrained by delays in the availability of external financing, resources do not appear to be the binding constraint for the countries as a whole; rather it is the capacity of government agencies to absorb external funds and translate them into investments. Paradoxically, government ministries in the social sectors often have meagre operational budgets that sometimes barely cover salaries and inputs for basic needs.

Finally, it is pertinent to note that creating a separate unit to provide government services to the poor tends to set it apart from the rest of government action: one policy and programme for the poor, and one for the rest of the economy. However, government policy is necessarily one; there can be no dichotomy

between social and economic policy, no subordination, no sequentality. The old excuse, "First put the house in order, then move into a sustainable growth path, then attend to social needs" is not valid, and under the present circumstances, not viable. Focusing attention on the welfare and income of the poor must be an integral part of a *comprehensive* economic development policy.

Clearly, the State has a crucial role to play in designing and implementing this policy. Government, by definition, has an income redistributive function (which is particularly important in Latin America, where income distribution is extremely skewed), the authority to set wage and price policies, a duty to provide basic education and health services and establish a social safety net, a role to play in the creation of a climate for healthy and equitable private-sector development—all responsibilities that cannot be delegated. Obviously, the establishment of an institution that can efficiently channel external funds toward the poor does not relieve the State of its obligation to carry out urgent socioeconomic programmes; neither does it dispense with the need to reform the government apparatus itself.

##### 5. Politicization of the funds

One of the principal strengths of the funds has been the strong political backing that they have received. However, close ties to political authorities at the highest levels have often created growing pressures to politicize fund operations in favour of the party in power.

All social investment funds claim to steer clear of partisan politics—that is, in distributing project funds, they try to stress efficiency considerations and not to favour any particular constituency. However, inasmuch as they alleviate social pressures and cushion the negative impact of stabilization and adjustment programmes, they cannot help but engender political gains for the incumbent President and the party he represents.

In an effort to make austerity programmes palatable, funds have stressed quick, visible results that can show that something is being done for the poor. Thus, a rapidly disbursing fund is understandably a highly tempting political plum at election time. However, for a fund to succumb to the pressure to become a cog in the partisan political machine and shift to a pattern of patronage would be a most damaging blow

to its operational effectiveness and its image in the eyes of foreign donors—and possibly, the "kiss of death" if the administration in power loses elections. In theory, one way to ensure that funds are less tempted to stray from their service function and can survive beyond an electoral cycle is for them to be administered by bipartisan directorates. Another practical step that could be taken to depoliticize the funds' image would be to limit propaganda about their accomplishments to simple information bulletins and full disclosure of their financial operations. These suggestions, however, are obviously naive; governments by nature take political actions that have political payoffs. Perhaps the most that can be expected is that the social investment funds be kept under the direction of non-partisan leaders of such personal prestige that they can withstand the pressures from their own governments to politicize fund operations and say "no" to ministries when a project is unjustified.

The active involvement of communities in fund projects can often counter politically-motivated patronage. A community that has awakened to the realization of its own civic potential will not be easily manipulated. However, there is a fine line between promoting community participation and fostering paternalistic control of the community. For example, in an effort to gain effectiveness, social investment funds have attempted to decentralize decision-making to the local government level and make resources available to the municipalities. This is clearly a positive step, as long as it is not aimed at reinforcing the mayors' political control of municipalities and discouraging the emergence of natural community leaders and independent community organizations.

##### 6. Funds' linkages with NGOs

There is a long tradition among charitable organizations and other NGOs of assistance to poor communities to improve their welfare. Church groups in particular reach isolated areas that government ministries do not or cannot. Similarly, much international "people-to-people" cooperation in a variety of areas has been accomplished through NGOs. By definition, these organizations operate in the realm of civic action and thus have a different focus on social problems—and they play by different rules—than governments. NGOs generally stress the structural nature of poverty and the social injustice that gives rise

to it. Closer to local communities, they are acutely sensitive to the costs of the stabilization and adjustment policies borne by the poor and view with apprehension the overtures of a mushrooming government investment fund of uncertain duration that is moving into a turf previously abandoned to them. Conversely, some government officials regard the NGOs' institutional and financial autonomy and growing sphere of action with suspicion and even hostility. It is relevant to note, however, that it is precisely their independence from government control and their overt bias toward the cause of the poor that has made the NGOs attractive to external donors, whose interests lie more in helping the poor than in aiding the governments.

It is true that NGOs' natural resistance to government control often results in uncoordinated action and uneven effectiveness. However, the best of them have proven to be good intermediaries in conceiving and executing small projects and ensuring that resources reach the neediest, and this has been an important discovery of the social investment funds. In particular, the funds have profited from tapping the experience of NGOs in small health services projects. Their operations emphasize flexibility and pragmatism and are catalytic in stirring grassroots participation by the communities that are being benefited. This mode of operation is not, however, very conducive to a rapid expansion of activities, and there is a limit to how much resources NGOs can absorb. Moreover, there is a danger that overly abundant financing could render NGOs dependent on or even subservient to government authorities and other interests or corrupt their traditional altruism, turning them into simple profit-making ventures.

While NGOs have been successfully used to execute projects, they have not been allowed to participate in conceptual or organizational aspects of the funds, which has led to their common complaint that they do not feel represented. Clearly, the NGOs have a role to play in the formulation of projects and something to say about the priorities that are set, but the definition of government economic or social policy is obviously outside their purview, as is partisan politics or the furthering of foreign interests. Their legitimate function lies in the sphere of civic action, a domain outside that of the State. On the other hand, governments can and should create the conditions and provide a stimulus for the development of civic action but should not attempt to control communities or de-

mand subordination. In dealing with civic issues and community organizations, government must necessarily curb its political nature. However, both governments and NGOs have much to gain by establishing a permanent dialogue to coordinate actions, and the social investment funds have begun to bridge this gap.

#### **7. External cooperation: a stimulus or a substitute for domestic effort?**

Bypassing traditional government channels, external financing provided to the social investment funds has rapidly managed to translate a great number of deeply-felt needs into concrete realities. This arrangement has been effective in that it can actually reach the poor and be reasonably efficient; the donors are pleased, the recipient governments get some relief from social pressures—and much of the credit for any achievements. However, external cooperation has in some cases compensated for a lack of domestic effort and even for the absence of political will. How long can governments continue to rely almost exclusively on external handouts to alleviate critical social conditions, without fully assuming their responsibility for combating poverty and fostering equitable development? Undoubtedly, a number of fund operations would come to a screeching halt if external resources were not available. The excuse that “the treasury lacks funds to invest in social projects” is a reflection of the degree of external dependency that some countries have acquired—a dependency that was exacerbated over the course of the long recession of the 1980s. To depend on foreign intervention in such a very internal problem as critical poverty is obviously not a desirable state of affairs and can only be tolerated as an emergency measure.

#### **8. Emergency funds versus permanent investment institutions**

There is considerable debate as to whether the funds should remain temporary instruments designed to have a quick impact at a critical juncture or evolve into permanent bodies with long-term attributes and functions.

To begin with, it must be recognized that the life-span usually assigned to an emergency fund (3-4 years) is too short. It takes a year or more to get a fund institutionally and operationally off the ground,

and external financial agencies often take even longer to approve a financial package.

There are other practical arguments for prolonging the life of the funds. It is certainly true that competent staff teams have been organized and that it would be a pity to disband them. Similarly, the emergency funds are doing good things for the poor, and this line of action cannot simply be abandoned. The funds have proven to be good channels for foreign aid and technical cooperation, and their output orientation has allayed donor fears that they are simply being used to finance or expand State payrolls.

Furthermore, the macro-objectives that gave rise to the creation of compensatory mechanisms have not been met. Structural adjustment is far from over, a firm growth path has not been established, and the stabilization process is fragile in a number of countries. There is abundant justification now as there was a few years ago to attend to the needs of the poor and ease social pressures. Likewise, ministries that traditionally handle social matters have not been restructured, and it is not clear that their capacity to assist the various social sectors or perform their legitimate income-distribution functions has improved.

On the other hand, there are negative tendencies that argue against extending the life of the funds. As funds mature, their original drive and mystique wears thin, and they tend to become just one more bureaucracy. In addition, given their exemption from normal civil service and procurement controls, there is always the danger of cronyism and even corruption creeping in. Moreover, as the political benefits that a fund can provide become evident, politicization pressures tend to build up.

In any case, regardless of conceptual considerations, once these organizations are well established, there is a natural tendency toward self-perpetuation, as in all bureaucracies. All indications are that the funds are here to stay.

Assuming that emergency funds are to be converted to permanent institutions, there is a need to find an appropriate niche for them. Social investment funds could broaden their horizons and focus squarely on poverty alleviation. If the decision were made to mount a broad development effort centred on combating poverty, permanent institutions would obviously be required. Clearly, temporary mechanisms are not well suited to handle structural poverty, nor can they be held responsible on this account. Ultimately, the role of the funds will hinge on decisions made regarding national socioeconomic policy.

## 9. Some macro issues

In the financing provided to the social investment funds of the countries examined, wages absorb roughly one-third of the total cost of the projects and local materials more than one-half. Only a small part of the external financing is absorbed directly by imports. Thus, in the first instance, the foreign exchange provided by the external financing serves mainly to support the countries' balance of payments.

However, as the foreign exchange is converted into local currency and used to purchase goods and services, successive rounds of income and expenditures are generated, and they in turn give rise to additional imports. Moreover, successful projects eventually generate a stream of production and income—and that also induces a corresponding stream of imports. These additional imports tend to have a negative effect on the balance of payments, because the projects carried out by the social investment funds are not the type that generate exports.

In sum, although over 90% of the initial round of external financing may be going to balance of payments support, estimates of the effects that the original expenditures have as they work their way through the economy indicate that the imports that are generated in the process rapidly absorb a large proportion of the available foreign exchange.

At the same time, the expanded monetary financing created by the transfer of external funds will stimulate demand and very likely put pressure on prices. Its effect on income and imports tends to be short-lived; most of it will exhaust itself within a year because of the high propensity to import.<sup>3</sup>

<sup>3</sup> It is relevant to note that the macro-effects of social investment funds on the whole economy of each country turn out to be negligible, except in the case of Bolivia's Emergency Social Fund. In this case, disbursements represented about 16% of total public investments during its four years of operation. Temporary employment was directly provided for an average of 19,000 workers; and further employment was also generated in line with the induced growth of the economy (an additional 21,500 work posts). Fund estimates indicate that GDP increased during that period by an average of 0.6%. According to a UNDP estimate, GDP rose by more than 1% during 1990 as a result of Fund activities, but the boost to the economy was short-lived, for the increase in GDP in 1991 fell to just 0.3%. Various estimates indicate that inflation increased by less than 2%.

An interesting question is, "What proportion of the income generated by the funds accrues to the poor?". Even under the generous assumption that one-third of the new income generated by all these transactions goes to hire poor workers, more than two-thirds of the total income generated by the social investment funds will wind up in the hands of importers, businessmen, and salaried staff –few of them poor. Thus, paradoxically, in countries with extremely skewed income distribution, the major proportion of the benefits derived from any income-generating schemes –even direct handouts– will tend to accrue to the upper echelon earners (although not in a proportion large enough to further concentrate income).

#### **10. Can an emergency safety net for a few lead to a broad strategy to combat critical poverty?**

In the aftermath of a long recession –the deepest since the 1930's– Latin American governments have had to introduce painful adjustment programmes to "put their houses in order" and achieve some degree of stability. In addition, they have adopted structural adjustment policies based on greater market orientation, private-sector activity, and openness to the outside world.

In the process of implementing this common course of economic policy, it has become evident that, in a democratic political framework, the market-oriented model is incompatible with mass poverty. In any case, "stabilization amidst poverty" and "elections amidst misery" are certainly not desirable goals.

Economic considerations and political pressures –exacerbated in fact by the emergence of democratic regimes –have shaken traditional apathy concerning the plight of the poor and led governments to search for ways to ease social tensions. The focus of government attention is changing from economic efficiency policies to poverty issues. At the same time, international financial organizations and some donor countries, increasingly aware of Latin America's critical social problems and concerned about the survival of the structural adjustment programmes that they are sponsoring, have also recognized the urgency of improving the situation of those sectors of the population that have been hardest hit by the crisis and by the adjustment process itself. Indeed, their influence has been catalytic in setting up and getting poverty

alleviation schemes off the ground. Thus, the coincidence of domestic and external concerns, coupled with the possibility of obtaining donations and soft financing in foreign exchange, has been conducive to the establishment of emergency social investment funds in a number of poor countries in the region.

Perhaps their main accomplishment has been to show how much can be done –and how rapidly– when there is the political will to do so. A corollary to this would appear to be that poverty is more a consequence of a want of political will than of a shortage of resources, and that the vicious cycle of lack of donor trust and bureaucratic incapacity can be broken.

Undoubtedly, bringing the issue of poverty to the forefront and showing that governments are beginning to do something about it represents a significant step forward. However, if political will and foreign aid can trigger such a rapid response, is it not possible to broaden the scope of the emergency funds or create new schemes that can focus on the whole of the countries' abysmal poverty? Conditions appear ripe for the governments to advance in this direction by introducing broad, long-term programmes to combat poverty, not only for the sake of social justice and political expediency but as a requisite for the countries' economic viability and growth.

The ideology and cobwebs of the East-West confrontation have been swept away. At the core remains not a capitalist system to be perfected but the age-old social and economic dilemma of most Latin American nations: large, impoverished masses that participate little and benefit less in their countries' economic growth. The solution to this enormous problem requires first of all, the participation of the poor themselves. The State will also have to play a leading role. It cannot be bypassed. Thus, resolute measures will have to be introduced to modernize the State and make it "leaner and meaner". Finally, a broad programme for combatting structural poverty in extremely poor countries will necessarily require a strong infusion of external financial aid and the political backing of the international community.

Notwithstanding their many shortcomings, the social investment funds are creating technology in the sphere of social action. Their very existence can be used to pave the way for the adoption of broader social policies and programmes and institutional reforms.

(Original: English)



# Water rights

## *markets: institutional*

# elements

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Water is a scarce resource which has an economic value and fulfills important ecological and social functions. For this reason, it is normally considered a public good of the State, which grants user rights to private individuals. These rights are usually protected by constitutional provisions regarding private property, since it is assumed that the private sector will not make investments unless it has guaranteed ownership rights. On the other hand, the water in respect of which user rights are granted must indeed be used for socially beneficial purposes: otherwise the rights are revoked. There are some systems where the user rights are unconditional, but this is not usual. The legal elements affecting the stability of water rights are of a structural nature: they include rules ensuring stability, those concerning the transfer of such rights, and rules on the recognition of prior uses and rights. These latter rules are of fundamental importance, since they recognize established economies and ensure social stability. Since water has an economic value, its transfer is an important aspect for ensuring its optimal economic use; professionals in the water management sector must be open to the idea of the transfer of rights. As such transfers have an impact on third parties, on social stability and on the environment, countries with mature systems of transfer suitably regulate such impacts. The regulations are also designed to protect the means of subsistence of the most under-privileged sectors of the population, including aboriginal groups. This is in keeping with the economic, ecological and social progress pursued in our days.

# I

## Introduction

Fresh water is a scarce natural resource which, because of various phenomena, is becoming increasingly valuable in economic terms and ever more essential for social services and needs.

Its proper management and conservation call for suitable legal instruments which, on the one hand, will ensure private investment in developing the economic potential of this resource, and on the other will permit its adequate control in the light of environmental and social objectives.

The institutional and legal frameworks of the various countries determine the ways in which the private sector will be motivated to invest in the development of water resources. In this respect, the legislation plays a structural role of economic and social engineering, since it shapes the way in which the economic agents relate to the productive resources. This function of the legislation is highly important, because it impels the economic operators to carry out certain types of tasks and influences the way they effect them (if these activities are economically beneficial to them, the operators will carry them out of their own free will, without any need for public coercion). This set of rules determine the stability and flexibility of the water use rights of the economic agents. They are termed *ground rules* because they determine the basic matrix of rights over the resource.

At the same time, because of the physical, chemical and biological features of water –it is a resource which is constantly flowing and has a great potential for generating negative externalities or serving as the agent for their transmission, it has a crucial ecological role, and it can serve multiple uses if suitably planned– water legislation includes a number of *regulations*<sup>1</sup> over the way private individuals use their water rights, in order to ensure that the forms of use do not lead to the wastage or deterioration of the resource,

do not encourage speculation or monopolies, and do not cause irreversible rigidities in its allocation.

The challenge –and virtue– of water legislation is to strike a proper balance between the ground rules and the regulations. The former seek to maintain the stability and flexibility of water rights in order to ensure, or at least promote, the greatest economic benefit from their application. The latter seek to ensure efficient and orderly use of water resources, to preserve their production capacity, ecological role and quality, and to prevent the formation of monopolies and speculation. The ground rules must not end up permitting monopolies or environmental degradation, while the regulations must not stifle the economic system.

The present study seeks to identify the various ways in which the legislation of different countries in the world has tackled these aspects. To this end, an analysis is made of various topics such as water rights systems, protective measures, water rights markets, information systems, the expiry of rights, information management systems, the organization of water management, etc.

Normally, water rights systems are not bodies of laws which reflect absolute ideological positions. The need to cope with concrete problems has led legislators to adopt the measures called for by the concrete situation, the general good and public ethics. Thus, for example, all the systems –except for a few isolated cases which are in the process of being changed– recognize private water use rights but make them subject to certain conditions (payment of fees, use in accordance with permits granted, restrictions in the light of environmental and social aspects, etc.). Some systems authorize the trading of water rights, but all of them demand that the water in question should be used in an effective and beneficial manner, in order to avoid monopolies and speculation: indeed, it is often required that transfers should be authorized by administrative or legal authorities, be duly publicized, be officially registered, and possibly be subject to conditions which did not affect the original holder of the rights. The right to transfer has no legal value unless it is associated with the effective and beneficial use of the resource.

<sup>1</sup> These terms, and the substantive and functional differences which the various rules imply, have been accepted in various documents published by international agencies, including those of the seminar on water legislation organized by the World Bank and ECLAC in September 1994 (World Bank/ECLAC, 1994; United Nations, Economic and Social Council, 1993 and 1994).

## II

### Structural elements in water legislation

As already noted, the structural aspects of water legislation deal with the stability of water and land rights assigned to private citizens, recognition of customary rights and uses, and the transferability of water rights.

#### 1. Stability of water rights

In most countries' legislation, with few exceptions, water belongs to the State public domain. There is a growing tendency to consider that water forms part of the stock of national wealth and that a declaration that it forms part of that stock takes the place of and is equivalent to a declaration that it forms part of the public domain, so that it is no longer necessary to mention this specifically.

This concept, which seems to equate public domain with national wealth, is mistaken. National wealth is an accounting term which can at most be considered a generic term whose accepted meaning is different from that of public domain. If it is believed that the two terms are synonymous, it would be better to use the accepted term "public domain". Otherwise—without wishing to do so or without understanding their actions in this way—legislators could be taking water resources out of the public domain. This terminology has been used in draft water legislation in Peru. In France, where the term "national wealth" has been used with reference to water, this obviously does not convert private water rights into public domain water. In the

opinion of the author of the present article, it would be advisable to continue using the accepted terminology unless drafters of Bills, Congress, the Executive and the entire population of the country concerned have it perfectly clear in their minds that they do not want water resources and their various forms—such as the river Marañón, the Amazon, the Bío-Bío or Lake Titicaca—to come under the public domain.<sup>2</sup>

However, in the great majority of systems, the water use rights granted to private individuals enjoy the fullest protection of the constitutional provisions on property, provided they comply with the objectives and conditions under which they were granted and recognized.

Stable and dependable water rights systems tend to increase the productivity of the resource, because users know that their investments in water conservation and development will mean future gains for them. This is why prior uses are generally recognized when changes are made in the legislation. This is a traditional principle in water law, going all the way back to Roman law on the matter,<sup>3</sup> and is designed to avoid disturbances in the economy and in existing uses (United States, Supreme Court, 1984; Argentina, Corte Suprema de Justicia, 1987).

Respect for uses and rights which existed prior to changes in the legislation is a necessary requisite for social stability. Failure to observe this principle gives rise to instability, and possibly tension, in society (Conac, 1989; Peritt, 1989).

<sup>2</sup> This is the terminology used in, among others, the Argentine legislation (art. 2340 CC); the Chilean laws, which refer to national goods (belonging to the nation as a whole) for public use (art. 589 of the Civil Code and art. 5 of the Water Code); the Ecuadorian legislation (art. 2 of Water Law No. 369), and the Spanish laws (art. 2 of Water Law 29/1985). It is also the terminology used by the American States (United Nations, 1972, p. 16). This terminology has a precise meaning which is universally understood in line with legal science. As the public domain is expressly defined, when the link between water and the public domain is eliminated it could be argued that this means that the resource has been removed from that domain. At

least two other authors appear to concur with this appreciation: Gazzaniga (1993, p. 6), in his comments on the 1992 French water law, and García Montúfar (1995), with reference to the draft water legislation for Peru.

<sup>3</sup> According to *Lex Coloniae Genetivae Iuliae* (43 A. D., period of the Republic), water resources connected with public land opened up to settlers are subject to the same uses and charges as under their former owners. With regard to the period of the Republic, see Costa's explanations in *Le Acque nel Diritto Romano*, cited by Caponera, 1992, pp. 30 and 50.

Stability of rights is an element which promotes investment in the economy and conservation of the resource in question. Without legal stability, there is no incentive for long-term investment and conservation (Cyriacy-Wantrup, 1951; Cohen, 1967; Commons, 1950; Lee Gray and Nobe, 1975).

## 2. Consuetudinary rights and uses

The question of prior rights and uses is of great importance in the case of indigenous peoples, especially when those rights and uses are based on consuetudinary rules or agreements or laws of the countries where those peoples dwell.

Special consideration and protection have been given to the rights of such peoples in the United States and Canada. Thus, for example, Canadian judges have ruled that treaties and laws must be interpreted in favour of indigenous people in an equitable, broad and liberal manner. The United States Supreme Court has adopted a similar interpretation, holding that it would not be reasonable to believe that Congress deprived the indigenous peoples of the means for continuing with their traditional way of life, yet did not give them any possibility of changing

to new habits and customs (United States Supreme Court, 1908; Barlett, 1987).

The South American countries have not yet made a detailed analysis of the question of the water rights and uses of their indigenous populations. Recent legislative proposals, events and legal decisions in the region, however, would appear to indicate that the interests of the indigenous population have not been given the same priority in government decisions and actions as their opposite numbers in the United States and Canada (see the draft Peruvian water law; Latin American Weekly Report, 1994; Enríquez Vázquez and Real López, 1992).

## 3. Transfer of water rights

Because of the relative shortage of water, considerable changes have taken place in the forms of transfer of water rights as demand for this resource has increased. The acceptance of such transferability as a basic principle is important for making water use more flexible, dynamic and efficient. At the same time, it is necessary to make a more detailed analysis –so far lacking in the region– of the main factors and conditions of water rights markets in systems with experience in this field.

# III

## Regulatory elements in water legislation

The most important regulatory elements in water legislation are those designed to protect the quality and quantity of the natural resource base and to avoid the transfer of negative externalities among users of this resource. These regulatory elements include the following:

i) Public control of the resource through the police power of the State or, in its representation, of the public sector. This control takes the form of the requirement for permits for water use and dumping or discharges into bodies of water.

ii) The assignment of water rights on condition that effective and beneficial use is made of the resource, including in some cases rules on its re-use. Failure to fulfil this condition usually leads to revocation of the right.

iii) Definition by law of what is meant by beneficial use, including in some cases the demand that

minimum flows must be maintained in line with ecological requirements.

iv) The establishment of systems of preferences and priorities among the various possible uses of the resource.

v) Public control of water quality, including rules on the absolute, joint and several civil responsibility for damage to the environment, standards on the discharge of effluents and the quality of the recipient bodies of water, control of the use of products which affect water quality, technical requirements, and regulation of the use of soil and spatial areas.

vi) Public control of water use in order to ensure that it complies with the water rights granted. This control includes the execution of follow-up and monitoring activities: rights of entry and inspection; extraction of samples; the right to demand information and records; faculties for granting approval for

the execution of works of a certain size; the right to demand that water use practices should be of an acceptable nature; suspension of water rights in the event of unacceptable or unauthorized practices; and revocation of rights in cases of infringement of the rules or non-use of the resource.

vii) Protection of water sources, supply points and watercourses; protection and management of river basins; prevention of deforestation; preservation

of catchment areas; integrated planning of water use, and joint use of surface and ground water.

viii) Right to reassign the resource in cases of emergency.

ix) Fixing and collection of financial fees and charges for water use.

x) Expeditions procedures for the settlement of disputes and special rules for coping with emergency situations.

## IV

### Conditions for water use

Some basic aspects of modern water legislation are described below, as taken from a selective sample of laws adopted during the last ten years.

#### 1. General aspects

The German water law, as amended on 23 September 1986, lays down a number of conditions for water use and for the granting of permits and licences in that connection. Thus, the law requires the effective use of water rights, the prevention of harmful effects, payment of compensation, prior preventive evaluation of the effects of certain water uses, designation of supervisors, adoption of measures to correct harmful impacts, and payment of the common costs of overall control (article 4). The German legislation allows for the imposition of *ex post* conditions subsequent to the granting of a permit or establishment of a condition. Such *ex post* conditions may be the result of economic or ecological factors necessary for proper water management (article 5). The system of water use control is extremely strict: water rights may be revoked if they are not used, if they are not necessary, if there is an unauthorized change in water use, or if more water than the allocation specified in the permit is used. Permits are required both for water use and for the discharge of effluents into bodies of water; applications may be rejected, and permits and licences are always granted for specific purposes. The granting of a permit does not mean that the State undertakes to ensure that the permit-holder will always enjoy water supplies of a given quality or quantity. Water use by owners or riparian dwellers must not adversely affect third parties, the

water itself, water flows or the water balance (articles 15 and 24).

In Europe and Asia, permits are now required for water use, and the validity of the rights granted depends on the effective use of the water in question, the payment of fees and charges, and the absence of any damage to the environment. Such permits are often subject to changes and new conditions, as required by current circumstances and ecological needs. In the latter respect, it is worth noting that the recent French water law (1992) allows for the introduction of changes in water rights without compensation when required by public health or safety, when the water environment is under major threats, and in cases of neglect or faulty maintenance of works or installations (article 10(iv)). Other laws worth mentioning in this respect are the Chinese law of 1988, the 1991 British law on water resources, and the 1985 Spanish water law. This latter legislation makes water rights subject to effective and beneficial use, on pain of cancellation (article 64) and it also allows for the modification of rights after they have been granted, "for supervening reasons" (article 63). The new Mexican water law also includes a clause requiring effective water use, on pain of cancellation (Télliez, 1993, pp. 110-111).

#### 2. Effective and beneficial use

Among the most important provisions in water legislation is the requirement that effective and beneficial use should be made of water. As water is a scarce resource, there is no reason whatever to allow a private individual to acquire water rights and not use

them, since this would open up the possibility of speculation and possible enrichment through the mere passage of time, at the expense of a scarce public good which is in ecological, social and economic demand. Not requiring the beneficial and effective use of the resource would mean favouring monopolies and management of the resource as a means of unfair economic competition: blocking access to the resource means blocking the entry of new competitors and impeding expansion of the supply of goods and services.

This latter point is particularly true in the case of mining in arid regions and power generation. This is why the United States legislation on arid regions, which originated precisely in the needs of the mining sector (prior appropriation), places fundamental emphasis on the effective and beneficial use of this resource. Without use there can be no rights. The use must be clearly identified and must not contravene the public interests involved in water use. This is considered so essential that in the event of changes in the legislation (a matter which will be dealt with below), the only uses which are recognized and protected are those which have effectively been carried out. Uses must be efficient and reasonable. Avoiding monopolies and speculation is a fundamental concern. The authorities have the constant and ongoing faculty to demand greater efficiency in use of the resource, in order to ensure the fullest possible use of natural resources. This system is applied in Colorado, Kansas, North Dakota, South Dakota, Arizona, Montana and other states. In South Dakota, the law provides that optimal use of the state's water is a matter of public importance. Water uses must not lead to speculation or waste, and they must be socially accepted and reasonable. The methods used must be efficient. It is not desired to give anyone an absolute monopoly over the resource by giving them more rights than they need for effective and beneficial use: in short, water is not a suitable element for speculation, especially in view of the fact that the allocation of water rights is the result of a public act.

For reasons of limited space, we will not enlarge further on this subject, but it is recommended that a profound analysis of the matter should be made before adopting water legislation which does not demand the effective and socially beneficial use of the resource. It is suggested that a close look should be taken at the United States legislation, which has stated this principle most clearly, especially as re-

gards mining, energy and the irrigation needs of the most arid areas of the country (Beck and Goplerud, 1991, p. 105 *et seq.*).

The requirement for effective and beneficial use of the resource is so important that in the United States legislation, too, it has been an accepted criterion for recognizing and legally protecting prior uses in the event of changes in the legislation. In many states of that country, the status of riparian dweller was used as a criterion for allocating water use rights. This system, however, which does not ensure the best use of water in the economic sense, has tended to be gradually replaced by the system of permits. When this happened, many riparian dwellers complained that their property rights were being affected, because on account of the changes in the law a resource which had previously belonged to them as part of their land ownership rights could now only be obtained through administrative permits. United States courts and judges repeatedly found that the changes in the law affecting water rights represented a legitimate use of the State's police powers and a legitimate form of regulation of the public domain, and the only limitation that must be applied in order not to infringe the constitutional right to own property was the need to respect established rights, but only in so far as there was effective use of the resource. Some states (such as Kansas, Oregon and Washington) laid down time limits for the effective use of water, after which unused rights would be cancelled without the right to appeal, in the absence of such effective use (Beck and Goplerud, 1991, vol. 1, p. 366 *et seq.*).

All the foregoing is extremely useful for the Latin American countries, whose legislation currently permits the existence of water rights without demanding their effective use. When shortage of water resources makes it necessary to use them more effectively and changes are considered in the legislation, these countries would do well to bear in mind what was said above about the United States legislation.

In the case of countries which are in the process of implementing new legislation on the matter, it is suggested that under no circumstances should they grant water rights without the requirement that they should be used in an effective and beneficial manner within a given time limit. The comparative legislation offers any number of examples of the problems generated by omission of this requirement and the opportunities provided for the speculative manipulation of such a fundamental resource as water.

The Chilean water law does not currently demand the effective and beneficial use of water. In this respect, it is interesting to cite some examples of the application of this law in the context of the large-scale privatization of water-related public services – a process in which great institutional actors come to play leading roles in water use, so that this resource becomes a basic element in the strategies whereby the services enterprises seek to dominate the market:

As noted by Bitrán and Sáez (1994, p. 50 *et seq.*), the regulatory system is based on the idea of competition in energy generation, but in practice this competition does not exist in Chile, since ENDESA has approximately 65% of the generating capacity, while CHILGENER has 14%. The water rights belong fundamentally to ENDESA, which has an incentive to evaluate projects in the light of the profitability of its intra-marginal capacity and obtains a long-term monopolistic equilibrium by putting off investments. No new entrepreneurs can enter the market, because they do not possess water rights to tackle the most efficient projects. Water rights should not be privatized along with the companies, but should be returned to the State for re-allocation subject to the condition of effective use within a given time limit.

Thus, the Chilean experience appears to confirm the reasons why other countries make the principle of effective and beneficial use a fundamental element in their water rights legislation.

Monopolization by way of the creation of entry barriers through control over essential production inputs and natural resources is a classical element in the economic literature (Sullivan, 1977, pp. 25, 31

and 77). The existence of water rights markets does not necessarily solve the problem, since crucial production inputs are often not placed on the competitive market (Armstrong, Cowan and Vickers, 1994, p. 117 and footnote on page 22).

In view of the foregoing, it would appear that the lack of requirements for effective and beneficial use of the resource, on the one hand, and of mechanisms to counter the cornering of a resource, on the other, have a negative effect on water markets and hence on the efficient allocation of this resource. It is therefore asserted that, with few exceptions, the empirical evidence shows that in Chile the water markets have not operated at their full potential. Bauer, in a seminal work on this subject, notes that the absence of criteria based on the public interest in the Chilean legislation has been seen by some as an element that favours monopolies and speculation, and that the Government virtually guarantees the under-valuation of water rights by not imposing any obligations in the interest of the public good (Bauer, 1995, pp. 2, 57 and 171).

Moreover, in the absence of any institutional mechanism providing for the expiry of rights or the obligation to put them on the market, the incentives for the big institutional users to sell such rights are less than the strategic advantages offered by controlling an essential production input in the context of corporate policies aimed at market control. For this reason, in the public discussion of the future energy policy of California in a market framework, emphasis is placed on the need to prevent monopolization of generation sources.<sup>4</sup>

## V

### Quality controls and environmental protection measures

#### 1. General

For the same reasons underlying the efforts to ensure effective and beneficial use of water resources, measures have to be taken to protect the environment. These measures are applied through laws of general and binding effect, combined with systems of punishments and objective, absolute, joint and

<sup>4</sup> See California: R.94-04-031, I.94-04-032 COM/DWF DRAFT (WP6.1) p. -xxxvi and also paragraph 68 of the "Findings of Fact" of the same document, in which it is concluded that the concentration of generating units is a matter of serious concern to the Government. See "Draft Policy Decision COM/DWF", R.94-04-031, I.94-04-032 COM/JJK/JLN, p. 32, whereby rights holders possessing a concentration of generating units would be obliged to transfer them.

several responsibility for damage to the environment. In some cases, this responsibility may be retroactive and may include not only those directly responsible for the damage but also their investors, financiers, and, in the case of subsidiaries, the enterprise controlling the holding company of which the firm causing the damage forms part.

In some cases, responsibility for pollution may extend to public officials and employees of the legal entity guilty of pollution. Punishments may also be applied which consist of cumulative daily fines for every day an offence is committed; systems are set up providing for the rights of inspection, taking of samples, and demands for information; quality patterns are established for effluents, treatment processes and recipient bodies; permits are required for the discharge of effluents and special rules are established for the control of toxic pollutants; financial charges are made for contamination, and the systems of quality and quantity control are unified in a single body, organized in the case of the European countries at the river basin level.

The systems are governed by some key principles which include: i) the principle of prevention (control of pollution at its source); ii) the principle of taking advance precautions (once the possibility of serious pollution has been established, control measures are required even if there is no definitive proof of the cause); and iii) the principle that "the polluter must pay".

## 2. Some examples of legal doctrines established in order to protect the environment

In Germany, the 1986 law imposes the general duty to avoid pollution of water or detrimental changes in its properties and requires economy in its use in order to conserve natural water resources (article 1a). It also requires that discharges into bodies of water must not contain more than a certain content of pollutants and must be regulated in accordance with technological treatment standards. It demands the use of the best available technology for controlling toxic pollutants (article 7). Control programmes will be under the direction of the *Länder* (states or provinces). Responsibility for damage due to pollution is absolute, objective, joint and several (article 22). The law also stipulates the maintenance of suitable flow conditions, the maintenance of suitable conditions for navigation, attention to ecological needs, and protec-

tion of morphological characteristics, river banks, and the self-cleansing capacity of rivers.

There is also a supplementary law, of 6 November 1990, on charges for the discharge of effluents. These charges take account of the levels of danger of effluents, their toxicity for fish, the quality patterns established for the recipient body, and downstream pollution units. The charges for pollution must be paid by any person who discharges wastes into any body of water in the country.

The Netherlands also applies a pollution control policy aimed primarily at making the country a safe place to live in by developing and maintaining healthy water systems which guarantee the sustainable use and development of the resource.

Three main principles have been established for controlling water pollution: reduction of pollution at the source; suitable hydraulic design, and properly guided and rational use of water resources. The control system includes the control not only of specific points of pollution but also of general potential pollution, in the latter case through the control of certain products and the use made of space. The costs of pollution control are paid for from the general budget (the taxpayers) and also from specific contributions by polluters.

## 3. Public trust

Before concluding this brief analysis of the main points, mention should be made of the doctrine of public trust developed by the United States courts.<sup>5</sup>

In 1869 the Illinois legislature granted the railroad company rights over the bed of Lake Michigan. Four years later, however, the legislature revoked the law on which the granting of rights over the bed of the lake had been based. The railroad company argued that this revocation adversely affected its property rights stemming from the previous law. The United States Supreme Court found that the first-named law was invalid because it violated the principle of public trust whereby the state of Illinois had rights of ownership over the bed of the lake. Such trust cannot be renounced by the State through the transfer of ownership.

<sup>5</sup> See *Illinois Central Railroad Co. vs. Illinois*, 146 US 387, 1982.



This case is very interesting because the same principle could be applied when the functional manner of granting water rights is equivalent to the transfer of title and of public domain over the resource. An example of the possible application of this principle is the granting of water rights without any time limit and without any obligation to make effective use of them. This would be a violation of the principle of public trust, since in functional terms the State divests itself of its duty and faculty to control the proper use of a good in the public domain, by granting perpetual rights which are not subject to any conditions as regards the use made of them. If one of these two elements is not present (obligation to make effective and beneficial use of the resource, or limited duration of the right), then the legislation would be invalid, since it would violate the principle of public trust.

This principle has also been applied for environmental motives. In the United States legislation, the national environmental protection law takes the concept of the environment in its broad sense, so that it can include not only the natural environment but also social elements (Roger and Farber, 1992, pp. 28-29).

The principle of public trust has also been applied to limit the diversion of water flows covered by water rights when such diversion would result in the drying-up of a natural lake. This has been considered a notable aspect in view of the near-sacred status given to water rights in the Western states (Sullivan, 1977, p. 295 *et seq.*). Here, again, this application of the principle could be useful in connection with the handling of water rights which have already been granted, when the use of such rights has an adverse environmental impact.

## VI

### Water rights markets

#### 1. General

The trading of water rights is seen as a good alternative for optimizing the use of scarce resources. It also provides a way of putting off costly civil engineering works through the reallocation of the existing available water to more profitable uses, at a price.

Water rights markets are a distinctive feature of the legal system of the Western United States. In California, Nevada and Utah, water rights can be transferred separately from land rights. In other states, such as Arizona, water rights can only be transferred as an ancillary element to land rights. With the sole exception of water quality problems, the reallocation of water rights is the most important political issue in the arid Western United States (Beck and Goplerud, 1991, vol. 2, p. 234).

The United States system for the transfer of water rights displays fundamental differences from the system adopted in the Chilean legislation or in the code currently being proposed for Peru, which is inspired by the Chilean system. In the United States system, as already noted, it is considered inconceivable that valid water rights could be divorced from the effective and beneficial use of the water in ques-

tion: water which is not being used cannot be transferred, because it is not covered by any right. In the United States legislation, effective and beneficial use is the source, cause, means, *raison d'être* and fundamental condition of water rights. Rights which are not effectively used cannot be transferred, because they simply do not exist. This principle seeks to avoid the speculative enrichment of persons or firms through the sole fact of acting as intermediaries in the marketing of a good which is part of the public domain of a State or nation. Aspects relating to the prevention of monopolies have already been mentioned earlier.

#### 2. Requisites of water rights markets

According to Anderson, the highly respected United States expert on this matter, if a reallocation of water rights is to be justified, it must comply with the following fundamental requisites: i) the water must have been used effectively and beneficially before the transfer, and must continue to be used in the same manner after it; ii) the reallocation must not adversely affect other users, and it must be in the public interest, as certified administratively or judicially in

accordance with the system applied in the state in question.

Transfers beyond the area of origin (river basin) are not always authorized. Moreover, not all states permit transfers of water rights.<sup>6</sup>

### 3. Arguments in favour of the regulation of water rights markets

The question of water rights markets is by no means free of controversy. While a considerable number of highly reputed experts advocate their establishment, other equally reputed experts express some reservations on the matter, especially because of their concern over the possible effects of concentration of rights, since it is usually the richest and most powerful users who buy the rights of the less economically favoured users. Although this satisfies the objectives of economic optimization, the social and ecological effects of such processes of concentration are a source of concern. This is very clear in the Western United States, where conflicts have arisen over transfers of water rights from farmers to the big cities. The interests at stake are the growth of the cities, on the one hand, and the culture, lifestyle, environment and future of agriculture-oriented rural communities on the other. Thus, it has been asserted that the current system of water rights markets in that country is incapable of settling conflicts over water rights transfers in an equitable manner (Ingram, 1989, p. 10).

Water rights markets are very complex, so that the transfer processes are affected by various factors, including: the priority of the rights traded; the characteristics and profiles of the buyer and seller; the geographical flexibility regarding the use of the rights transferred; the economic importance of the operation; the reliability of the rights involved; the volumes of water transferred; the overall water management system, and the economy of the area where the operation is being carried out (Colby, Crandall and Bush, 1993, pp. 1565 to 1572).

Because of the complex elements involved, a considerable number of experts demand that water rights markets, where they exist, should be suitably regulated. Thus, Babbit says that the absence of control and regulation of water markets results in econ-

omic Darwinism: it is the biggest and most powerful actors that survive.<sup>7</sup>

These cautious positions are reasonable and understandable, since economic laws are rarely absolute (a Californian judge said that in the view of the court the idea of rational maximization of utility was an economic construct which has no counterpart in the real world, so that it was not a suitable basis for arriving at a decision on the case before the court).<sup>8</sup> It is perfectly true, however, that cases can also be cited where the rigidity of the water allocation system (together with other institutional, macroeconomic and social factors) has led to inefficient resource allocation, to levels of production which exceed effective demand, to unnecessary investments in infrastructure, and in some cases to widespread breakdowns in certain Latin American regional economies.

### 4. Regulation of water markets in United States law

Mature water rights transfer systems accept the possibility of such transfer under specific conditions, and subject to administrative and public control.

Among the United States controls over transfers, mention may be made of the laws of some states (appurtenancy statutes) which prohibit the transfer of water rights in order to obviate land speculation; the requirement that transfers should be approved by administrative or legal bodies, which give their permission only under certain conditions; the requirement that transfer applications must be publicized before their approval, so that they can be opposed if necessary by public or private interests; the requirement that no damage must be caused to the interests of third parties; the requirement that all transfers must be officially registered; the obligation to relieve adverse effects on the environment; compulsory evaluation of the environmental impact of all proposed transfers; the possible imposition of conditions which did not apply to the original water rights, and the obligation to provide proof that effective and beneficial use was made of the resource before authorization of the transfer of formal water use rights to the new purchaser. If the application is not approved,

<sup>6</sup> For a more detailed description of this matter, including the complex and detailed United States regulations governing this question, see Anderson and Simmons, 1991, pp. 233 to 399.

<sup>7</sup> See quotation from Babbit in Ingram, 1989.

<sup>8</sup> See the case "Natural Resources Defense Council vs. Duvall", 777F, Supp. 1533 (E.D. Cal. 1991).

then the rights are cancelled and may even give rise to penalties. In the case of irrigation districts, approval must include the authorization of the district in question, when the resource is transferred outside it, and in the case of indigenous water rights, federal government approval is required (Blumm, 1991, p. 119 *et seq.*).

Transfers must be in the public interest and are subject to review in the light, *inter alia*, of their effects on the economy, hunting, fishing and public health; the loss of alternative uses; damage to the interests of third parties; loss of public access to public bodies of water; and the qualifications of the buyer. An important element is the protection of local public interests and those of the area of origin of the resource. Finally, it may be noted that in order to obviate damage to the interests of third parties and the sources of supply, transfers must be limited in principle to the volumes consumed in the past and not expressed in terms of nominal allocations.

The foregoing reflects the present situation as regards water rights markets in the United States, which is the country with the greatest experience in this respect.

## 6. Water rights transfers in South America

This issue is still at an incipient stage in South America. In some countries, there has been large-scale development of irrigation systems with absolute prohibition of the transfer of water rights, but an adjustment would now appear to be called for, since demand has increased and diversified.

In other countries, such as Chile, the transfer of rights is permitted. The proposed water law for Peru also provides for transfers. These two models, however, do not incorporate the meticulous and detailed considerations of a public, social and environmental nature which were described earlier in connection with the United States legislation. This fact, together with the absence of any requirement for the effective and beneficial use of the resource, could result in monopolies, concentration of water rights in a few hands, restrictions on competition through the accumulation of rights for oligopolistic purposes, and also adverse social and environmental effects, if it

is the poorer sectors which transfer their rights to those with greater economic power. This could happen because only the market elements of the system of prior appropriation applied in the Western United States were adopted and the elements of public interest which are so important in such a system were left out.

With regard to the Chilean experience, it has been said that few transfers have actually been made, because of the limitations associated with the institutional system, the nature of the water rights deeds, and the physical basis for regulation of the resource, and also because of the transaction costs involved, the lack of legal knowledge, and the resistance on cultural grounds. The Chilean Water Code has also been criticised as suffering from a critical fault in its economic logic: the fact that water rights are free (Bauer, 1993, pp. 1 - 4). Supporters of the system, however, claim that this is irrelevant because it only concerns the initial distribution of the rents and not the economic efficiency of the allocation through a market system (in other words, all that matters is that the rights can be freely transferred).

It has also been said that the Chilean Water Code is a failure in its economic aspects, and that the elements which have really helped to raise agricultural yields are the irrigation subsidies (Law No. 18450) and the marketing system. As regards the equitability of the system in Chile, Bauer argues that its effects may have been negative, since small users did not have the information or resources to benefit from it. The same author criticises the limited operativeness of the markets, claiming that the institutional system created conditions which gave little incentive for water rights transactions. He also claims that the system may have helped to cause small users to lose their rights (Bauer, 1993, p. 3). The question of equity is currently a matter of concern for agencies such as the World Bank and its consultants (Simpson, 1994, pp. 30 - 33), who wonder how the system would operate in conditions of subsistence agriculture and consider that unsuitable distribution of access to substantial proportions of production resources contributes to environmental degradation (World Bank, 1990, pp. 42 - 44).

## VII

### Conclusions and recommendations on legal policy

In most countries of the world, there is serious concern to ensure integrated management of their water resources, their conservation, and the prevention of monopolies based on them. In South America, however, there is a tendency to believe that granting unconditional water rights ensures that the market will automatically solve any problems which may arise. Practical experience seems to show that this is not so, however. In Chile there are problems of monopolies, of the settlement of conflicts involving several parties, and of the subordination of environmental aspects to the economic exploitation of the resources.

This is why there are proposals for the reform of the water legislation in Chile. The proposed changes include both the possibility of establishing conditions for the cancellation of rights and the introduction of permits or charges for water use, in order to avoid blockage of markets through the cornering of water for speculative reasons. As the rights granted so far in Chile have been free of any type of condition –and especially without any requirement for effective and beneficial use– however, some experts hold that measures to change the conditions governing such rights would require a reform of the Constitution.

The present author does not agree with this view, since the practical effect of such changes would be to give water a functionally private character in Chile. As we have seen earlier, similar situations in the United States were settled through the imposition of conditions on water rights as part of the government's legitimate exercise of police rights over a good in the public domain. Indeed, in the Lake Michigan case the granting of property rights over a good in public trust was considered to be null and void, since the State cannot renounce such trust. There is a clear analogy with the Chilean case: if goods are part of the public domain, the State must carry out its public trust obligations. If the goods are not part of the public domain because of the way in which the rights were granted, then there will have been a highly questionable functional transfer of public domain goods, since public property would be merely a meaningless label.

However, the purpose of this article is not to find a way of reversing the Chilean situation –which, leaving aside considerations of local and comparative law, is linked to the current time and space and to the prevailing political philosophy– but to show that even though there may be situations of monopoly and speculation, as several authors note, once unconditional rights have been granted it is very difficult to reverse the situations thus created. This is why it is vitally important that reforms to water legislation in South America should not permit the granting of unconditional water rights. The obligation to make effective and beneficial use of the resource and protection for effective works carried out are means for the prevention of monopolies.

Once the obligation for effective use has been established, the logical question is what will happen if this obligation is not complied with in the legal or agreed time limit. There are three options in this respect:

a) After expiry of the time limit without any use of the resource, the rights themselves expire and revert to the market through the State. The blockage of the market is thus lifted through the action of the State and the law. This is the solution which we have already seen in United States, Mexican, Spanish and Argentine law, and which in the present author's view is expedient and expeditious. It has the advantage that the State is obliged to declare the cancellation of the rights and a private individual can denounce the situation and demand legal action in that respect.

b) After expiry of the time limit without any use of the resource, the State is obliged to call a public auction, either *ex officio* or at the request of one of the parties. The procedures are simple, and the good is immediately placed on the market again, so that the blockage of the market is ended by the market forces themselves. The requirement for an auction once the time limit has expired is in the public interest, and the State cannot refuse. As the holder of the rights which have been cancelled made no investments in their use, the resources collected go to a general water

management fund or the general treasury, and the former holder is not allowed to participate in the auction. This alternative is simple, eliminates any discretionality on the part of the State, and permits the rapid return of the goods to the market through the latter's own dynamics. Furthermore, it does away with problems of inactive ownership and discourages and controls monopolies. In short, the market acts as a functional corrective.

c) Finally, it has been suggested that the problem of speculative, monopolistic or unused rights should be solved through a tax, paid permit or other type of charge for unused water resources. In the present author's view, this is the least desirable of all these systems, because: i) It would be necessary to determine the opportunity costs for each holder of rights which are not used, which would be no small task because it would require a high degree of information and follow-up and quite sophisticated regulatory machinery; ii) in order to determine the opportunity costs it would be necessary to obtain information from enterprises which would themselves be affected by the proposed taxes or other charges, so that this information would be either hard to get or distorted (it is worth recalling in this respect the inadequate or biased information on privatized public services); iii) the proposed tax or other charges would have to be set high enough to act as a deterrent. It may be assumed that the big public service enterprises which monopolize water resources have more than sufficient capacity to influence these processes and con-

trol their outcome. The phenomenon of co-opting of regulators is well known in public services, and there is no reason to assume that it would not take place in the case of water management; and iv) the whole process of determining the opportunity costs and the proposed charges, as well as their implementation, would be subject to a high degree of State discretionality and would also depend on the State's capacity to act in an expeditious manner.

In the view of the present author, water rights markets are, when properly regulated and controlled, a suitable means of promoting more efficient allocation of water resources. The necessary conditions for this include, *inter alia*: i) adequate information; ii) suitable legislation and clear and dependable rights; iii) a suitable system of management, surveying and registration of water resources and water rights; iv) an efficient system of water storage and transport; v) requirements for effective and beneficial use of the resource; vi) public scrutiny and control of transfers of rights, with the possibility of opposition as detailed earlier in this report and with special rules for the sectors with less education, information or cultural advantages.

The conditions detailed above are essential prerequisites. Without them, the implementation of a system of water rights markets will run into serious problems and give rise to economic and social problems.

(Original: Spanish).

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# The Caribbean countries *and the Free Trade Area* of the Americas

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The Caribbean countries are acutely conscious of their small size, whether judged by one or all of the criteria of land area, population or gross domestic product (GDP). Paradoxically, this impels them to join a larger trading group for fear that they might otherwise be denied a place in the mainstream of international activity. This article analyses several characteristics of small countries, with particular attention to those that seem especially relevant to the Caribbean. The paper notes that small size does indeed place greater demands on the national leadership as regards appropriate and consistent economic management, while the citizens of small countries live at higher levels of risk, whether due to the vagaries of the weather or to the turmoil of international markets. It also recognizes that the range of production options open to such countries is inherently limited and that the transitional costs of entering the Free Trade Area of the Americas (FTAA) might be high, especially as some Caribbean countries have been pursuing policies which run somewhat counter to the new requirements. Emphasis is therefore placed on the lack of preparedness of many small countries for entry into such a market, and proposals are made as to internal and external policy options which might be chosen for this purpose. It is also suggested that, in order to mitigate the short-term transitional costs of entry and enhance their ability to participate in the new grouping, small countries should try in the prior negotiations to secure some transitional arrangements regarding internal policies, measures to increase the production of exportable goods, and joint negotiating strategies.

# I

## Introduction

The Summit of the Americas, held in Miami in December 1994, committed its participants to the establishment, by the year 2005, of a Free Trade Area of the Americas (FTAA) which would seek the progressive elimination of barriers to trade and investment in the Western Hemisphere.<sup>1</sup> The participants agreed to conclude agreements on several issues, such as tariff and non-tariff barriers to trade in goods and services, agriculture, subsidies, investment, intellectual property rights, government procurement, technical barriers to trade, safeguards, rules of origin, anti-dumping and countervailing duties, sanitary and phytosanitary standards and procedures, settlement of disputes, and policy on competition.

The outward-looking character of the Free Trade Area was indicated by the pledge of potential members not to raise trade and investment barriers to non-member countries and to remain committed to the international trade rules and disciplines of the General Agreement on Tariffs and Trade and the World Trade Organization (GATT/WTO). It was stated that the aim of the FTAA was to strengthen the substantial advances already made by the countries of the Americas in the area of trade liberalization and economic integration, which are seen as key factors for sustainable development.

The Summit of the Americas also indicated that trade liberalization and environmental policies were mutually supportive and that workers' rights, as defined by the relevant international conventions, would be promoted and safeguarded. It was also agreed, however, that disguised trade restrictions would be avoided, in accordance with the GATT/WTO agreements. This reference indicated that the FTAA still needed to come to an understanding with regard to the environment and workers' rights as they affect trade liberalization in the hemisphere, since these issues were likely to resurface after the special agreements were concluded.

<sup>1</sup> Plan of Action adopted at the Summit of the Americas, held from 9 to 11 December 1994 at Miami, Florida.

At the Denver meeting, held on 30 June 1995, a work programme was adopted to prepare for the negotiations leading to the FTAA, which, it was stated, would represent a single undertaking comprising mutual rights and obligations. Several working groups were established to begin work on various specialized issues, including one to make proposals for the effective participation of the smaller economies in the FTAA.

The preparations for the FTAA are taking place in the context of a substantially freer hemispheric and world trading environment. Contributory factors to this environment are the unilateral implementation of trade liberalization policies by many countries, the recent popularity of bilateral and plurilateral free trade arrangements in the region, and the inauguration of the GATT/WTO agreement, which seeks to clarify and strengthen the rules and disciplines governing international trade and investment.

The FTAA covers a large number of potential member countries,<sup>2</sup> which display wide differences in population size, land area, economic structure, resource endowment, level of income, levels of skill and technological development, quality of basic infrastructure and productivity. The differences between the industrial countries and some of the developing countries which are potential members of the proposed grouping are quite stark. Significant differences also exist among the developing countries themselves, which include both large and small economies at different levels of development.

Small size does not of itself represent an inherent economic disadvantage, but it does limit the range of development options available to policy-makers, since small countries have intrinsically open economies which are highly dependent on foreign trade. This means that policies which encourage an efficient

<sup>2</sup> Thirty-four countries participated in the Summit: Antigua and Barbuda, Argentina, Bahamas, Barbados, Belize, Bolivia, Brazil, Canada, Chile, Colombia, Costa Rica, Dominica, Dominican Republic, Ecuador, El Salvador, Grenada, Guatemala, Guyana, Haiti, Honduras, Jamaica, Mexico, Nicaragua, Panama, Paraguay, Peru, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago, the United States of America, Uruguay and Venezuela.



interaction with the international economy are amply rewarded, while policies which do not are severely penalized. Examples of both types are to be found globally as well as in the Caribbean. Examples of the former include Singapore, Taiwan, Hong Kong or Luxembourg, while in the Caribbean examples can also be found of small countries—some of them very small—which have achieved relatively high standards of living derived from their trade in financial and tourism services. The Bahamas and the Cayman Islands provide two such examples.

Nevertheless, few Caribbean countries have consistently pursued the route of economic openness. Those that have tried to apply import substitution policies behind high tariff walls have not recorded similar levels of economic growth, since expansion has been constrained by chronic shortages of foreign exchange. Export earnings have been sluggish, unresilient to the vagaries of export markets, and in some instances industries have become dependent upon preferences for their survival. These countries must now face a steep adjustment curve, to reverse decades of inappropriate policies, if they are to mitigate the shocks that market openness will have on their economies and benefit from the opportunities which it will eventually confer.

Among the countries of the Caribbean Community (CARICOM), efforts are being made to reform domestic macroeconomic and regional trade policies. However, the rate of domestic macroeconomic policy reform has been uneven as between members, and in some of them regional policies have changed more slowly than domestic policies and have become inconsistent with them. Strains have also become evident as efforts are made by some to quicken the pace of regional trade policy reform, seen for example in attitudes to the pace and degree of reduction of the Common External Tariff (CET) and to the extent of market widening, and also reflected in attitudes toward the Association of Caribbean States (ACS) and the FTAA.

More generally, the small economies display certain characteristics which, although not unique to them, can present special problems in their efforts to achieve economic and social development. For example, they suffer from high unit costs for infrastructure and public administration and experience special difficulties in their macroeconomic management because of the fragility of their economies.

Small economies have a relatively undiversified economic base and rely heavily on exports of a few

primary commodities and services (table 1). For example, in 1994 banana exports accounted for 49.3% of merchandise exports in St. Lucia and 47.9% in Dominica. For Jamaica and Trinidad and Tobago, the dependence on bauxite and petroleum, respectively, was even greater. Consequently, these small countries are particularly vulnerable to fluctuations in the prices and demand for their exports. They also have high levels of imports for both consumption and production purposes which make them vulnerable to changing global supply and prices. Trade in goods exceeds 50% of the product in all cases. If non-factor services are included, the exposure to foreign trade is notably larger, ranging in 1994 from almost 153% of GDP in Antigua and Barbuda to about 62% in Trinidad. Exports, especially in the case of agricultural products, tend to cluster around markets where Caribbean products benefit from preferential treatment. Given the high levels of protection underpinning some of their exports, such dependence on foreign trade illustrates their excessive vulnerability to external shocks, including policy shifts.

The small size of domestic markets prevents firms operating in them from taking advantage of economies of scale or increasing returns to scale in those industries which are scale-sensitive (De Vries, 1984). Conversely, when they attempt to take advantage of such economies they are obliged to capture export markets from the outset, denying them the benefit of enjoying a familiar domestic market in which to perfect their craft. In reality, the industries which have been developed in the Caribbean tend to be highly protected and their production is destined mainly for the domestic market, or for the regional market in the case of CARICOM member countries.<sup>3</sup> The quest for lower tariffs is complicated by the heavy reliance of some countries on trade taxes for their revenues. Import taxes contribute more than half of tax revenues in the OECS countries and Belize, and the proportion is as high as 66% in Antigua and Barbuda. In Barbados, Jamaica and Trinidad and Tobago, where tax reform policies have been implemented, reliance on trade taxes is much less, ranging from about 9% to 14% in 1994. In Grenada, however, early efforts to reform the country's tax regime were set back by difficulties in collecting consumption taxes.

<sup>3</sup> The same levels of protection do not exist in Central America (see Lewis, 1994).

TABLE 1

**Caribbean countries: Selected 1994 indicators**  
(Percentages)

Country	Concentration of exports <sup>a</sup>	Trade in goods/GDP	Goods and non-factor services/GDP	Trade taxes/fiscal revenue	Unemployment rateDJ0
Anguilla	...	55.4	146.9	77.0	...
Antigua and Barbuda	...	75.8	152.6	66.1	5.7
Barbados	23.3	54.8	95.7 <sup>b</sup>	8.6	21.2 <sup>c</sup>
Belize	34.1	79.2	128.0	54.4	9.8
Dominica	47.9	79.3	124.5	56.5	9.9
Grenada	9.3	58.6	99.1	56.9	15.3
Jamaica	78.4 <sup>d</sup>	78.6	101.9 <sup>b</sup>	14.0	15.4 <sup>c</sup>
Montserrat	...	41.5	77.3 <sup>b</sup>	52.5	5.5
Dominican Republic	25.3	32.9	62.7	44.8	...
Saint Kitts and Nevis	40.7	65.2	144.5	55.2	4.7
Saint Lucia	49.3	69.3	113.9	58.7	7.2
Saint Vincent and the Grenadines	29.0	70.0	90.5	50.6	17.9
Suriname	57.4	77.1	92.8	41.7	...
Trinidad and Tobago	75.5 <sup>f</sup>	55.8	61.9	10.4	18.5 <sup>c</sup>

Source: ECLAC, on the basis of official data.

<sup>a</sup> Main exports, as a percentage of total exports of goods.

<sup>b</sup> Income from goods and tourism only.

<sup>c</sup> 1994; other figures are based on most recent data available.

<sup>d</sup> Bauxite and alumina only.

<sup>e</sup> 1993 figures.

<sup>f</sup> Petroleum and petrochemicals only.

The islands of the Caribbean are also prone to natural disasters, such as hurricanes. Given their small size and consequent specialization in a few product groups, a single hurricane could eliminate a substantial portion of their export earnings. In addition, the fragile ecosystems of small island States make them more vulnerable than others to environmental degradation.

The proposed reciprocal opening of markets under the FTAA and the potential consequences thereof present small economies with special challenges, notably the probable elimination of preferential treatment and the consequent increased competition that formerly protected products will face in the hemisphere. Such competition in international markets is sometimes seen as unfair by small economies because they are obliged to compete against more developed countries with higher levels of skill, technology and productivity. Therefore, according to this view, this can only lead to the displacement of their exports and the demise of their import substitution industries. Ironically, arguments are also being advanced in the industrialized countries against the opening of markets to less developed countries. They

fear that low wages and what they deem to be lax environmental and labour standards in the developing countries will lead to the closure of firms, lower wages and higher unemployment in the developed world.

Both the Miami Summit and the Denver Ministerial Meeting recognized the wide disparities in size existing among potential members of the FTAA and pledged to seek ways to provide opportunities to facilitate the integration of the smaller economies and increase their levels of development. Participants were therefore aware of the complex issues surrounding the division of costs and gains in the proposed Free Trade Area, particularly as these relate to the small economies.

This paper tries to clarify some of these issues. It examines some of the measures used by various trade and integration groupings to deal with the question of unequal gains among member countries. It also discusses the potential costs and benefits of participation by the small economies in the FTAA. Finally it suggests some policy actions which might help the smaller countries to adjust to the widening hemispheric market.

## II

### Approaches to the issue of unequal gains in various trade and integration schemes

It is generally accepted in the literature, and supported by experience, that the gains from a trading arrangement are not always equal. Considerable attention has therefore been paid in the various regional trading arrangements to compensating those less able to enjoy the gains from an agreement. In general, while financing arrangements such as special funds seem to provide tangible and lasting benefits, the position is not so clear in the case of differential entry requirements. Nevertheless, the approaches used by the European Union (EU), CARICOM and the North American Free Trade Agreement (NAFTA) are useful as a guide for small countries in their preparations for the FTAA negotiations. It should be noted, however, that the EU is a single market in the process of becoming a political union; CARICOM has elements of both a customs union and a common market; and NAFTA is a free trade area. The different objectives of these levels of integration might result in different approaches by these institutions to the question of unequal gains, although they all illustrate potential courses of action.

#### 1. The treatment of less developed countries in the EU

Two basic mechanisms (concessions) are used to deal with structural diversity within the Union.<sup>4</sup> The first concession is a transitional period to allow a member country to adapt its national legislation and standards to Union levels and practices. This means that sectors considered to be particularly weak in given countries might delay their full exposure to competition from other Union members for several years.<sup>5</sup> The second concession, parallel and often

<sup>4</sup> Countries singled out for special treatment are Greece, Ireland, Portugal and Spain.

<sup>5</sup> Specific sectors like banking and finance received "transition periods" of up to seven years in Portugal and Spain. The Common Agricultural Policy (CAP) is also a concession, though with Union-wide application and "permanent" status.

longer-lasting than the first, relates to the EU Structural Funds Programmes. Although the objective of reducing disparities among regions of the Community was referred to in the very preamble of the Treaty of Rome in 1957, the Funds actually came into being against the backdrop of the Single European Act's statements about "market solidarity" in 1988. They were also prompted by the increase in structural diversity in the Union after its second enlargement, to include Greece, in 1981 and its third enlargement, to include Portugal and Spain, in 1986.<sup>6</sup> In their various forms, the Funds demonstrate a real effort to achieve convergence via efficiency-improving mechanisms, to promote market conditions where they do not exist, and to assist in the provision of public goods in short supply.

#### 2. Treatment of the less developed countries in CARICOM

The principle of special treatment for its Less Developed Country (LDC) members<sup>7</sup> is also well established within CARICOM, where a special regime was created for the LDCs in order to provide them with preferential treatment in the integration process. They were allowed a 10-year adjustment period to implement the Common External Tariff (CET) –double that which was allowed to the More Developed Country (MDC) members– and they were also given a 10-year grace period before being required to engage in free trade

<sup>6</sup> The importance of the Structural Funds can be assessed by their sheer size: 60 billion ECUs (\$US80 billion) for the five-year period 1989-1993. The magnitude of the Funds can also be seen in relation to the economies of the recipient countries, where they represented 2.3% of GDP for Greece, 2.9% for Ireland and 3.5% for Portugal, for the period 1989-1993.

<sup>7</sup> The countries eligible for LDC treatment within CARICOM are Antigua and Barbuda, Belize, Dominica, Grenada, St. Kitts and Nevis, St. Lucia, and St. Vincent and the Grenadines. The MDCs are Barbados, Guyana, Jamaica and Trinidad and Tobago.

with the MDCs of the Community. They were allowed to temporarily suspend the implementation of the CET in order to promote a particular domestic industry, while they were also permitted to suspend common market treatment for imports from the MDCs if major revenue losses were likely to result from such treatment. In addition, the LDCs were given special concessions under the rules of origin, where groups of products which figure prominently in their production, such as processed fruits and galvanized sheets, were granted common market treatment on concessionary terms, whereby the permissible percentage of foreign inputs was set higher than for the MDCs (World Bank, 1990). The LDCs were also allowed to use direct and indirect export subsidies in regional trade in order to favour domestic producers. Finally, the system of harmonized fiscal incentives for investment allowed the LDCs to give investors longer tax holidays and tariff exemptions (usually 15 years, as compared to the 10 years allowed for the MDCs).

### 3. The treatment of Mexico in NAFTA

Despite the principles of reciprocity under which NAFTA was negotiated, Mexico was able to negotiate differential treatment in selected areas. For example, differential phasing periods were agreed in order to protect Mexico from surges in imports from its more developed partners. The agreement stipulated that the

proportion of Mexican imports entering duty free would only represent 43% of its non-petroleum imports from the United States and 41% of the corresponding imports from Canada.<sup>8</sup> However, it was agreed that 84% of Mexico's total non-petroleum exports to the United States and 79% of those exports to Canada would benefit from duty free entry, with effect from January 1994.

In the case of textiles, it was agreed that the United States would begin by eliminating tariffs on 45% of its imports from Mexico, while Mexico need only eliminate tariffs on 20% of its textile imports from the United States. Concessions were also negotiated by Mexico with regard to the automotive sector, where approximately 81% of the value of Mexico's exports of parts to the United States would enter duty free upon the coming into effect of the NAFTA, while only 5% of United States exports of parts and components to Mexico would enter on similar terms. With regard to agriculture, it was agreed that the United States would remove tariffs on products amounting to 61% of the value of agricultural imports from Mexico, while Mexico would be expected to remove tariffs on products amounting to only 36% of the value of its agricultural imports from the United States (Sera Puche, 1992). Nevertheless, these concessions were intended to be temporary, and the agreement included a time-limit during which liberalization of trade in all sectors would take place.

## III

### Potential benefits of market opening

It is widely recognized, though not universally accepted, that free trade improves efficiency and welfare. Simply stated, the argument is that foreign trade permits a country to specialize in doing the things it can do most productively, maximizing its earnings by exchanging a portion of its production. Imports, in turn, free a country from having to produce all the goods and services necessary for its survival, many of which it would be physically incapable of producing, while most of the remainder it could only produce at very high cost. With free trade, domestic production can concentrate on the most efficient activities, while the remaining national needs can be satisfied by the foreign countries that produce the goods

most competitively. Welfare is therefore maximized by trade, since all parties benefit. While this argument evolved in the developed countries, it is even more germane to the small and less developed nations, since they stand to benefit most from trade. Nevertheless, small countries have a relatively greater need for secure market access and stable and transparent trade rules, if they are to be able to trade effectively.

<sup>8</sup> These percentages are based on the value of trade in 1991.

It was in recognition of these principles that GATT was formed, in order to encourage the development of multilateral trade and to define and administer the rules which should govern it. This mantle has now been assumed by its successor organization, the WTO. Several regional trading arrangements have been spawned since the establishment of GATT. While they diverged from pure multilateral principles, they were usually accepted as a second-best option by GATT.<sup>9</sup> This acceptance came in part because regional trading arrangements had the potential to move member countries more quickly toward the goal of multilateralism than might have been possible by unilateral action. The FTAA also holds this potential, since it could establish a free-trade area encompassing most of the trade in goods and services for most of the countries in the hemisphere. The alternative –unilaterally achieving the same degree of trade liberalization via GATT– is less likely to be realized, given current attitudes. This is especially true for the smaller countries, since small clusters of them have long-standing commitments to limited trading arrangements among themselves. Moreover, the principles and attendant risks of multilateral trade are not embraced by all of them.

Trade liberalization is currently being reintroduced by some of the Caribbean countries which experienced the most severe economic disequilibria in the 1980s. For them, as for all small economies, export earnings play a pivotal role in their economic expansion, and increased earnings became especially critical if they were to meet their outstanding external debt obligations. Supporting evidence for this proposition was provided by the success of some other small countries which were successful in achieving export-led growth.<sup>10</sup> Improved export performance was seen as the way to establish equilibrium and achieve sustained growth. Policies to favour the production of tradeable goods and services in preference

to non-tradeables were applied, beginning with measures to increase economic efficiency and reduce the various policy biases against export activities. These measures began with restrictive fiscal and monetary policies and realignments of the real exchange rate. Subsequently, exchange rate regimes were often modified to ensure that the market would play a greater role in determining rates than hitherto, in the hope of avoiding the gross misalignments which had developed when rates were administratively fixed. Once domestic demand was contained, these governments felt sufficiently confident to focus on various medium-term policies, such as foreign investment codes and deregulation of the financial system. Labour market policies have not yet been approached in any systematic manner, although this seems warranted in view of the chronically high rates of unemployment in some countries. Nevertheless, dialogue between management and the trade unions has led to improved communication between the social partners.

Attention was also given to the trade regime, with emphasis on elimination of the remaining anti-export biases inherent in the tariff structure and the administrative arrangements governing trade. But the pace of domestic reform was uneven in some cases, since existing integration policies, based on a consensus, habitually inhibited the pace of change in those areas covered by common regional positions. In several instances trade policies lagged behind other domestic macroeconomic policies and created tensions with them. Undertakings were frequently ignored or implemented tardily, so that frustrations developed within the regional grouping among those wishing to push ahead with economic reform.

Entry as a group into the wider FTAA would probably be a more feasible means of reducing trade barriers among the small countries.<sup>11</sup> It has the benefit of providing some continuity with past policies and would permit the maintenance of soli-

<sup>9</sup> Article XXIV of the General Agreement outlines the conditions under which integration is deemed not to be in breach of the GATT regulations. Efforts were subsequently made, leading up to the WTO, to define these conditions more precisely.

<sup>10</sup> Notably in Asia, where trade liberalization was pursued in a non-discriminatory manner, rather than through regional trading schemes. Accordingly, the countries which followed this approach avoided the worst faults of Import Substituting Industrialization, which at best had only very limited utility within small market areas.

<sup>11</sup> For many, the creation of the Association of Caribbean States (ACS) is seen as a way station to the wider hemispheric market, originally via NAFTA, more recently via the FTAA. Although the timing might make it difficult, the ACS could still provide the means by which countries could unify their policies, build negotiating power and get accustomed to competition in the larger group of Caribbean countries, prior to full incorporation into the wider hemispheric agreement.

curity among the existing membership and the retention of some of the security which the existing arrangements are believed to confer. It is also seen as a means of extending the policy scope available to those seeking to maximize economic efficiency and the export thrust. At the same time, widening increases the market size, which is deemed to be necessary by some if the export thrust is to be successful.

Greater market access is seen to be desirable because the CARICOM market is inherently small and further constricted by the demand management policies needed in order to sustain equilibrium in the face of sluggish export performance. Increased market size, in conjunction with uniformly low tariff rates and liberal rules of origin, will reduce the incidence of trade diversion and provide economies of scale. Widened market access, within the context of a formal agreement such as the FTAA, is likely to reduce uncertainty in connection with the regulations governing trade in goods and services and to yield transparent mechanisms for dispute settlement. These are all factors of enormous benefit to small countries which do not have market power to bolster them in trade disputes.<sup>12</sup> Finally, for a small country facing the risk of domestic policy reversals, binding the policy fundamentals in the framework of a multilateral arrangement can have the benefit of increasing policy consistency. Trade liberalization, which has been resisted in some Caribbean countries, could therefore be reinforced or accelerated as a result of participation in the FTAA.

The payoff—to be derived from increased economies of scale, greater market security and transparency, and greater policy consistency, taken together with those market liberalization measures which have already commenced unilaterally—is likely to come in the form of increased domestic and external investment and technology transfer for enterprises in the export sector. At the same time, in view of its low tariff rates and its large market size, an arrangement such as the FTAA is unlikely to inhibit global market penetration, where such potential exists for small countries. For the medium to long term, the FTAA holds the potential for increased economic growth, employment and social equity.

<sup>12</sup> For example, the Omnibus Trade and Competitiveness Act of 1988 is used by the United States to decide unilaterally and apply, or threaten to apply, trade sanctions against those countries it regards as unfair traders.

The initiative to consolidate a single market within CARICOM might come under some pressure from efforts to enter the FTAA, since Caribbean governments have decided to pursue both initiatives simultaneously. One justification for the single CARICOM market is the infant industry argument: i.e., the argument that the protected market will stimulate investment in larger and more efficient enterprises for the production of goods and services, eventually making the region better able to penetrate the wider ACS and FTAA markets. Set against this position is the fact that entry into the FTAA will require a fairly large reduction in the prevailing CARICOM tariffs, which, to be manageable, should be phased gradually and begin early. There are therefore evident inconsistencies between the infant industry argument and the need for a smooth transition to the wider market. From a more practical viewpoint, the relative pace of convergence to the single market is currently so slow that it might not come into effect sufficiently quickly to allow this expectation to be fulfilled. Participants are therefore likely to experience some difficulty, in the single market under still high tariffs, in developing proficiency in production fast enough to take advantage of market opening. Finally, the argument for protection tends to ignore its corollary: the anti-export biases handicapping new industries which must enter competitive markets. For these reasons, rapid downward revision of the CET should not be held hostage to the creation of the single market.

The second argument is that a single consolidated market of the factors of production broadens the frontier of production possibilities. Broad agreement has been reached to reduce impediments to the flow of capital and certain categories of skilled labour in the single market, but national legislation to give effect to these decisions has been slow in forthcoming. Both activities are likely to have long-term benefits for the region, and will not be negated or reduced by the hoped-for increase in extraregional investment to be derived from market widening. This benefit is likely to be felt whether or not tariffs remain high, so it is not in any way inconsistent with market widening.

The third argument in favour of deepening CARICOM integration is the greater coordination of external policies that this would imply. One expectation would be joint negotiation to enter the FTAA as a group. In one sense this could be advantageous to

CARICOM, since it would better preserve the integrity of the group<sup>13</sup> and allow for the joint resolution of issues of common concern. It would also simplify the negotiations for all parties if the total CARICOM membership negotiated as if it were one entity. To be weighed against these benefits is the risk that

the uneven pace of economic reform within CARICOM might complicate its internal preparations for the negotiations and jeopardize the chances of entry of the whole group, unless rapid progress can be made on the major potential stumbling blocks, notably the CET.

## IV

### Potential costs of market opening

The fears expressed by smaller, less developed economies about their integration into larger economic areas fall into two broad categories: economic and political. On the political side, nations fear the loss of sovereignty implied by any international commitment having domestic repercussions. Smaller nations, which often are newly independent, fear this the most, since they are acutely conscious of their weak bargaining power. Yet as international transactions proliferate, some loss of sovereignty is virtually inevitable for all countries. One answer to the concern of limited bargaining power might be for the smaller nations to conduct their negotiations on the basis of a regional bloc, although this strategy also involves some loss of sovereignty. On the other hand, their small size might permit them to obtain concessions that larger nations dare not seek.

The political question of reduced sovereignty may also have economic implications, even in seemingly straightforward commitments. For example, a report on NAFTA notes that a country seeking to enter into a free trade agreement with the US must undertake to maintain a stable macroeconomic environment.<sup>14</sup> This requirement implies a limit on the application of counter-cyclical policies favoured by some governments, even without explicit and strict benchmarks such as those set by the European Union's convergence criteria. Similarly, the Supplemental Agreements of NAFTA, especially those covering labour practices and environmental standards, can affect the relative attractiveness of some countries for investment and entail significant costs in their application in small countries.

On the economic side, small countries are mainly concerned with the potential losses from the exposure of their domestic industries to foreign competition and with the costs of adjustment to the widened market. This is particularly true of those Caribbean and Central American countries currently operating within common market arrangements. The traditional economic literature is more concerned with the gains derived from market opening than with the losses. These gains are generated by an increase in the efficiency of resource allocation, which generates both higher output and a higher level of welfare. Nevertheless, the costs of transition are real and need to be borne in mind.

Potential losses are usually considered to be limited to the short run, since some factors of production, such as workers trained to perform distinctive tasks or factories built to produce unique goods, are specific. Specific production factors are those linked to a given production process that can be rendered uncompetitive by the opening up of an economy and are not easily or immediately transferrable to other uses. In the long run, however, all productive factors are assumed eventually to adjust to market signals, that is, they find alternative adequate uses, resulting in an optimal, equilibrium configuration. This argument recognizes that there are always relatively competitive sectors, for in the framework of the Ricardian Comparative Advantage theory, while it is possible for a country to be less competitive in all sectors in absolute terms, it is impossible for any country to be relatively uncompetitive in all of them. Therefore, even where all sectors are absolutely less competitive than the global best, all the domestic agents are potential winners from trade, since the relatively more competitive sectors can generate the resources to compensate the potential losses of

<sup>13</sup> To pursue the range of beneficial activities in areas other than trade that will remain after entry to the FTAA.

<sup>14</sup> See *Report on the North American Free Trade Agreement*, Vols. I and II (G.S.R. Associates, Port of Spain, Trinidad, 1994).

relatively less competitive sectors through various transfer schemes.<sup>15</sup>

When analyzing the trade effects of economic integration, economists usually consider three categories: trade creation, trade diversion and gross trade effects. Trade creation is defined as the development of new trade flows among members of the new economic area that displace previous high-cost domestic production, while trade diversion is the substitution of low-cost imports from third countries with high-cost imports from member countries. Gross trade effects are the result of the two, and represent the net trade effect of the preferential trading area on itself and on the rest of the world.<sup>16</sup> From the point of view of global welfare, any integration short of global integration is sub-optimal.

So far, there are few estimates of the concrete effects of NAFTA on the smaller economies. One estimate finds that the new market conditions offered to the Mexican textile producers had no negative effect on the Central American textile sector. Negative effects did arise, however, from the competition between Central American countries in an export-oriented sector with homogeneous products and a high substitution elasticity. In this particular case, the net trade effect was zero for these economies outside the trade bloc.<sup>17</sup>

Another study, quoting estimates from a World Bank report, forecast some limited static and dynamic losses from NAFTA non-membership for the CARICOM countries. The static losses were concentrated in certain countries and sectors, for example, Jamaica and the clothing, apparel and footwear sectors. Most of the NAFTA effects, however, appeared in the dynamic estimations (those incorporating the long-term effects of increased market scale and efficiency of allocation), which projected a clear

reduction of growth rates for all Caribbean countries outside the unified trade area (McIntyre, 1994).

As a first approximation, we may assume that the less competitive industrial sectors developed under the import substitution, high-tariff strategy would suffer the most in the short to medium term from external competition. The same could be said about protected agricultural sectors. However, it is likely that protective tariff structures will be gradually dismantled as a consequence of GATT/WTO initiatives.

Conclusions with respect to the services sector are somewhat less clear. The tourism industry is already relatively open and competitive, although some ancillary services in the industry could be vulnerable to external competition.<sup>18</sup> Opening the financial sector could also mean the displacement of some domestic firms, or at least trigger some form of association with foreign enterprises.<sup>19</sup> Telecommunications facilities in most countries are either foreign-owned or operated as joint ventures with foreign companies. Nevertheless, in the telecommunications sector (which has a tendency towards monopoly, especially in small countries), as well as in the financial services sector, new entrants to the market might increase efficiency and the pace of technological change. Finally, it should be noted that services were also partially covered by the Uruguay Round of GATT negotiations and are likely to undergo further liberalization waves through the WTO.

Additional concerns might also arise from: i) the fiscal importance of import taxes in some countries in the region, since any harmonization process that changed tariffs significantly could mean short-term budgetary difficulties and/or the need for concomitant tax reform measures; ii) a conflict with existing preferential structures, the most quoted but by no means the only examples being the incompatibility of the Lomé Convention or the Caribbean Basin Initia-

<sup>15</sup> The classical exception to this is the famous case of "Immiserizing Growth", developed by Bhagwati in his 1958 paper. This is today considered to be a largely theoretical possibility. See Krugman and Obstfeld, 1988.

<sup>16</sup> See Markheim, 1994, who calculates that the net trade effect of integration on US imports from the Caribbean between 1987 and 1993 was 99.9%: i.e., almost the entire increase was created by CBI preferences.

<sup>17</sup> This means that those countries could probably remain competitive in the sector in the short run, but once one of them entered the preferential trade area unilaterally, the outsiders would all be losers. The optimal game strategy would be for them to negotiate and enter as a regional bloc. See ECLAC, 1995.

<sup>18</sup> However, major changes in national market shares are likely to result from the full integration of Cuba into the region's tourism industry.

<sup>19</sup> Economies of scale are usually considered to be less important in the financial sector, where the existence of a widespread network of branches and local knowledge of domestic market conditions act as an entry barrier against major external competitors. Nevertheless, small domestic financial markets suggest a relatively small fixed investment in the network, while increasing interest in overseas operations could reduce the relative importance of domestic market knowledge.



tive (CBI) with a hemispheric free trade area, although once again these structures are already under question due to EU developments and aforementioned GATT/WTO commitments; iii) the costs related to the regularization of patent and copyright situations, which could entail increased financial transfers abroad and loss of freedom for domestic agents wishing to establish new businesses, although this too is a question that will be addressed on a global scale through GATT/WTO; and iv) the financial and human cost of administering any integration organization, although this is expected to be relatively light in the case of the FTAA.<sup>20</sup>

## V

### Policy proposals

The Denver trade ministerial meeting, in its final declaration, recognized the special concerns of the small countries and agreed "...to actively look for ways to provide opportunities to facilitate the integration of the smaller economies and increase their level of development." The Summit further mandated that the factors affecting the participation of the smaller countries in the FTAA process should be identified.<sup>21</sup> These included measures to facilitate their adjustment, trade expansion and investment, and measures to be taken to facilitate their negotiating capacity. Any other issues of special interest to the smaller countries were also to be identified so that they could be taken into account in the negotiations.

Many of the smaller countries currently enjoy preferential trading arrangements which bolster their economies but at the same time inhibit the adjustment processes necessary for their effective incorporation into a wider free trade arrangement. This is particularly true of the traditional agricultural exports, notably bananas and sugar, but it also applies to some segments of the garment industry and most of the light manufactures and agro-industrial goods produced for the regional market. In most of the smaller countries the cumulative effect of these preferences is to severely distort their production and consumption patterns. Efforts have nevertheless been made to push the adjustment process forward, including the lowering of the Common External Tariff, and

In short, there are some legitimate concerns among the smaller, less developed nations regarding short-run losses from a hemispheric integration process, but most of these losses would occur anyway, since they are being driven by historical factors of a political, economic and technological nature which are impinging on all countries. While the FTAA will probably accentuate these trends, the real issue facing the smaller countries is how to secure transitional arrangements to cushion them from its greatest shocks, so as to enable them to implement the measures needed to improve their effectiveness within the group.

some of these distortions are being reduced. However, where individual preferences loom large in the economy, the underlying macroeconomic picture may be so distorted that countries are able to postpone action on the adjustment of real exchange rates and measures to stimulate investment in unprotected exportables. At the same time, the ephemeral benefits of protection can be so great for the economy and social fabric that policy attention focusses on lobbying for their retention rather than on adjustment.

One way out of this vicious circle is to decouple the financial benefits derived from, say, banana protection from those of banana production. This might be possible if the preferences, which have a finite life, could be phased out progressively, for example over a five-year period, with the amount of preference reduced each year being transferred to an investment fund. This fund might be used for improving the efficiency of the protected industry or for investment in other exportables. Such reduction in the level of preference would encourage the least

<sup>20</sup> For example, the EU is financed by all its Member States from a portion of their Value Added Tax (VAT) and import duties, up to the equivalent of 1.21% of the Union's combined GDP for 1993. Most of these resources go to the Common Agricultural Policy (CAP) and Structural Funds programmes.

<sup>21</sup> Final joint declaration of the Summit of the Americas trade ministerial meeting (Denver, Colorado, 30 June 1995).

productive to begin to switch production immediately, while the reduced export earnings from the preference could be allocated for investment in other exportables. Even so, this mechanism might still create some distortions in the economy, and caution would be needed to ensure that adjustment measures were pushed ahead and that greater attention were paid to the real exchange rate and other measures designed to encourage a positive investment climate. Where the protection was internally derived, say within a common market arrangement, some form of assistance (including help in tax reform where necessary) might be provided which would be conditional on the more rapid reduction of those preferences deemed to be excessively high.

More generally, levels of protection might be so high and the capacity to respond to changes so low in the smaller countries that they might require a longer time to adjust than the more developed or larger countries of the hemisphere. Even in such cases, it would be important to select benefits that would not inhibit but rather encourage adjustment. This should always take the form of fairly rapidly phased reductions in protection, though with lengthened periods of supplemental assistance. Lengthened periods of assistance are always preferable to lengthened periods with high preferential rates, since the evidence clearly shows that protection prevents adjustment and encourages an anti-export bias, whereas financial incentives can be used to facilitate a transition. Aside from funds for investment, assistance might take the form of funds earmarked for improved basic education; strengthened skills training, especially directed to young people; promotion of business skills and entrepreneurial development; and retraining and other forms of support to assist workers from displaced industries to find new employment.

Small countries inherently suffer from supply constraints and, as outlined above, past incentives to production have for the most part resulted in expensive and inappropriate outputs. The first priority is therefore for new investment and production in tradeables. Nevertheless, instances of exportable and potentially exportable production will still need initial assistance in marketing to take advantage of the new enlarged trade zone. This assistance might take various forms, from private sector trade corporations to represent a range of small country products in major markets, to measures designed to stimulate in-

vestment, including investment in joint production/marketing ventures.

The issues of the environment and workers' rights are also of special importance to the small countries. However, they should not be used to impose disproportionate burdens on their production or to erect barriers to their exports. The low barriers to trade and the higher levels of economic efficiency which the FTAA is likely to bring about will help many small countries to obtain the resources and gain access to the technology they need in order to improve their environment. They are also likely to stimulate investment and employment, thereby improving the rights of a large percentage of the labour force currently unemployed. This would make a major contribution to increasing social equity. While it is recognized that the unregulated market might not be sufficient to meet all the goals relating to the environment and workers' rights, the fullest use should nevertheless be made of the wider multilateral institutions specially charged with resolving these issues.

Finally, a major limitation affecting small countries is their limited capacity to negotiate effectively in the run-up to a complex international treaty. Public sectors are small and skilled manpower scarce, so that where detailed negotiations are being conducted, especially in simultaneous working committees, some interests might fall by the wayside or resources might be spread too thin to be effective. One solution to this logistic problem, which has demonstrated its utility in the past, is for small countries to join together to form joint negotiating teams and to engage consultants jointly under the auspices of some common institution. Another solution could be to encourage private actors to help define and, in appropriate instances, defend their interests.

Several initiatives could therefore be taken to improve the participation of small countries in the FTAA. These might include all or a combination of the following measures:

i) The introduction or, where action has already been initiated, the acceleration of domestic policies designed to increase the resilience of small economies, to make them more responsive to external developments, and to allow domestic firms to be more competitive in external markets.

ii) The harmonization or acceleration of policies, as the case may be, within their respective integration

arrangements in order to make them more consistent with the domestic policy objectives outlined above.

iii) Given the vulnerability of some small States and their relatively poor state of preparedness to face greatly expanded competition, they might seek phased conditions for their entry into the widened market, so as to offer local producers a longer period of adaptation and reconversion. These concessions should be finite and limited in duration, so as to increase the urgency of action. They should also be gradual, so that shocks can be effectively absorbed and the economies progressively strengthened to confront them.

iv) In view of the extent to which some small countries still depend on protectionism, funding might be sought, in the context of an accelerated phase-out of preferences, to increase where possible the productivity of traditional exports or to stimulate alternative exportable products.

v) Since small countries face high unit costs in providing basic infrastructure, including public services, special funding might be sought to finance activities that will improve productivity across the economy as a whole: for example, to upgrade the

economic infrastructure and improve skills training and basic education.

vi) Assistance could also be sought, from the countries with the largest markets, to help small countries increase investment in exportables, to foster joint ventures or production-sharing arrangements, and to develop arrangements for marketing their exports.

vii) In view of the limited production possibilities of small countries, liberal and flexible rules of origin should be available to them so as to encourage the production and trading of goods and services.

viii) Small States might also benefit by constituting themselves into a joint negotiating group to define and agree upon their common core interests, plan their strategies, carefully prepare their negotiating positions and engage in joint negotiations to secure their common interests.

ix) The private sector should be integrally involved in the preparations and negotiations for the FTAA, since all the measures which will be applied to expand exportable supplies –the essential condition for effective participation in wider markets– will depend upon their commitment and expertise for success.

## VI

### Summary and conclusions

Small Caribbean countries face a fairly steep adjustment curve to prepare themselves for entry into the FTAA. The task is complicated by their own uncertainties about their capacity to compete on global markets: uncertainties fuelled mainly by their perception of the handicaps due to their small size. The task is further complicated because some countries need to adopt policies which go counter to practices accepted over the past three decades. Finally, action is also inhibited because the costs of adjustment are likely to be felt immediately, in the short run, while the benefits are likely to appear only in the medium to longer term.

Caribbean economies have traditionally been closely integrated into the global economy. This is not surprising, since they are small and must rely on outside purchases to satisfy the majority of national needs. Past policies, which have attempted to attenuate this external dependence, have been counterpro-

ductive. They have so distorted production structures and damaged export performance that, in some countries, global interaction has only been sustained via preferential trading arrangements. The increasing globalization taking place through GATT/WTO suggests that preferential arrangements will be gradually dismantled. Parallel developments taking place regionally –notably the formation of larger trading groups– also require that barriers to trade in goods and services, financial flows and technology should be brought down within the group. At all events, the pressures to open Caribbean markets will be intense. Several countries have anticipated these trends and initiated a process of market liberalization.

The preparations to enter the FTAA are consistent with actions which Caribbean countries would need to take to integrate efficiently into the wider global markets. The process leading up to entry into the FTAA holds out the prospect that small Caribbean

countries can negotiate a systematic set of measures, timetables and safeguards to assist their adjustment. Access to a clearly defined larger market should help to remove some of the policy and market uncertainties which potential investors now face, thus quickening the pace of the investment needed to transform these economies. This process gives small countries the chance to improve their preparedness in a climate of somewhat reduced risk.

Since the smaller countries are less well prepared and are therefore likely to experience some difficulty in taking advantage of the potential benefits of the FTAA, they should organize transitional arrangements to help mitigate the short-term costs of entry. These should focus on three categories of action: internal policies; measures to increase the production of exportables; and joint negotiating strategies. In the first category, more liberal timetables should be sought so that domestic policies and, where relevant, policies within trade groupings could

adapt to the requirements of the FTAA. Special funding should also be negotiated as a substitute for the current export preferences, so as to provide an effective transition away from them. In order to increase the production of exportables, a development fund should be established to improve economy-wide efficiency in areas such as infrastructure and training. Small countries should also seek assistance to develop joint ventures, production sharing arrangements and marketing skills, and they should also try to obtain more liberal rules of origin, given their limited production possibilities and the importance of obtaining the most cost-effective production inputs. Finally, they should strengthen their negotiating positions by forming joint negotiating teams, which should include persons having a direct interest as well as representatives from the productive sectors who possess special expertise in the areas under discussion.

(Original: English)

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# The Argentine experience: *development or a* succession of bubbles?

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(FLACSO),  
Argentina.*

This article adopts the premise that development is endogenously driven by innovation mechanisms, of which the economic elite is an eminent vehicle in that it efficiently fulfils the function of generating innovation by seeking technological quasi-rents which creative competition permanently erodes. In order for this to happen, the necessary conditions must be present so that the search for technological quasi-rents predominates over other types of profit-seeking. The interaction between the Argentine economic elite and the institutional system has enabled it to acquire non-technological quasi-rents, being essentially quasi-rents from scarce natural resources, combined with political quasi-rents. This interaction—which has constituted a major restriction on development throughout Argentine economic history—became more accentuated from 1976 onwards, owing to the weakening of institutions and of a large number of organizations following the coup d'état in that year and to the neo-conservative policies adopted in subsequent years. In the 1990s, the institutional decline and economic policies based on neo-conservative recommendations of generalized non-intervention by the State ("hands-off" approach) increased the possibilities for acquiring non-technological quasi-rents and gave rise to a bubble generated predominantly by external indebtedness and by privatizations. Prior to the processes of privatization and deregulation, the existence of opportunities for obtaining quasi-rents that did not derive from advances in technology and production had crowded out innovation and investment. Subsequently, those processes—within a context of institutional fragility and extreme weakness of the system of checks and balances—encouraged this crowding out effect to continue in the 1990s.

*What has not been properly appreciated ... is the distinction between different types of reaction to changes in conditions...*

*The interaction of institutional forms and entrepreneurial activity ... is ... a key topic for future research.*

Joseph A. Schumpeter

# I

## Introduction and summary

This article postulates as its central thesis that the policies implemented in Argentina in the 1990s, based on neo-conservatism, have led to a bubble, generated predominantly by indebtedness and privatization, rather than to development. This thesis is based on a review of the period and on a set of hypotheses concerning the interaction between institutions and the economic elite, the latter being understood to mean the group of economic agents which in each period occupied a dominant position as regards the behaviour of the other economic agents and had a greater influence on institutions (see Nochteff, 1993 and 1994).

The concept of quasi-rent is used here as a tool for analysing the behaviour of the economy. It is considered that:

i) In statistical analysis, quasi-rent is analogous to the Ricardian differential rent; in dynamic terms, by introducing technological change, Ricardian rents ultimately become quasi-rents in cases where the rent derived from the scarcity of a natural factor diminishes because of technological innovation;<sup>1</sup>

ii) Ricardian rents tend to be –at least in part– quasi-rents in that their acquisition is sustained by institutions which create supply rigidity (as occurred with the barriers to the possibility of trading in rubber plant seeds in Brazil, or with the land market institutions in Argentina, or with the Magna Carta clauses on obstacles in river beds in England);

iii) Quasi-rent which is obtained more through innovation than through other supply rigidities is a

typical development quasi-rent in the Schumpeterian sense, and it undergoes erosion from the outset through competition and imitation (its transitory nature is thus endogenous to the actual functioning of the economy);

iv) These features distinguish it from quasi-rents generated through institutional barriers to entry (reserved markets, finance privileges, subsidies), which we shall call political quasi-rents, including those arising from the scarcity of natural factors, accompanied by restrictive institutions;

v) Political quasi-rents are not development quasi-rents. Furthermore, they are not characterized by a transitory nature endogenous to the functioning of the economy but may be perpetuated for as long as the scarcity of natural factors and/or the existence of restrictive institutions endure (hence the use of the concept of “non-transitory monopolistic positions” in this article);

vi) Political quasi-rents encourage the formation of bubbles because they raise the value of assets above the long-term equilibrium level. Although they are not “transitory” in that they undergo erosion from the outset, in the long term they disappear because insufficiency of innovation and investment causes them to be crowded out, either because the restrictive institutions are not sufficient to make up for backwardness and low productivity or because the market segments that can be preserved with them diminish until they lose importance for their captors (which is what typically happens with those acquired through reserved markets in dynamic branches).<sup>2</sup>

□ This article is the outcome of a research project sponsored by the Volkswagen Foundation and undertaken, with the cooperation of Dr. Klaus Esser of the German Development Institute, by Daniel Azpiazu, Eduardo Basualdo, Adolfo Vispo and the author, who assumes responsibility for any errors.

<sup>1</sup> For a concurring approach, although it maintains the term rent, see Kaplinsky, 1995, p. 4.

<sup>2</sup> On this subject, see Napoleoni (1962, p. 1429 *et seq.*), Schumpeter (1968) and Kaplinsky (1995). Quasi-rent is analogous to abnormal profit (Ricardo, 1826). The term quasi-rent has been preferred in order to emphasize the link between present surplus and future cost, in the Marshallian sense, and institutional barriers to entry.

In short, what is being postulated is that the economy is undergoing a process of development only if technological quasi-rents predominate over the other types of quasi-rents. If this is not so, periods of expansion are regarded as “bubbles” in relation to innovation-based development.

In section II, very simplified hypotheses are set out concerning restrictions on innovation (and thus on development) in Argentina, and it is argued that such restrictions ought to be regarded not so much as an inadequate supply but rather as a scarce demand for innovation (and for public policies to promote such demand). This scarce demand has been caused by the ways in which institutions and organizations—particularly large enterprises—interact, making possible the acquisition of non-technological quasi-rents. It is contended that, at the different stages in Argentine economic history, neither the institutional system nor organizations induced the economic elites (which also differ in part) to seek technological quasi-rents; on the contrary, the influence of those elites on institutions and organizations<sup>3</sup> facilitated their acquisition of political quasi-rents. This happened both in the agricultural/exporting stage and in the import substitution industrialization stage. In the former stage, political quasi-rents were acquired through extensive exploitation of natural resources, finances, speculation in fixed assets (in particular land) and financial assets, trade and the exercise of monopoly privileges granted by the State; these activities crowded out technological quasi-rent-seeking (Nun, 1995; Sábato, 1988). In the latter stage, political quasi-rents were obtained by virtue of the effective tariff structure, reserved markets, and direct or indirect subsidies (see Nochteff, 1994, p. 79, *et seq.*, and the bibliography quoted therein).

Section III examines the period subsequent to 1976. This period resembles a new bubble of non-technological quasi-rent acquisition, generated basically by external indebtedness. It can be divided into three distinct phases. The first corresponds to the 1977-1981 borrowing phase, which gave rise to the external debt crisis. The second covers the recessionary decade of the 1980s, in which the economic elite acquired political quasi-rents through transfers of income in their favour (by means of subsidies, liquidation of their liabilities—particularly external ones—

<sup>3</sup> As regards the interaction of institutions and organizations, the approach of Burns and Dietz, 1995, has been followed.

and State purchases), in which oligopolistic markets were created for internationally tradable and non-tradable commodities, and which ended with the recession and hyper-inflation of the two-year period 1989-1990. In the third and last phase—the 1991-1995 bubble—which was generated largely by a combination of foreign indebtedness, privatization and deregulation, political quasi-rents were further consolidated, and quasi-rents from cheap labour took on increasing importance.<sup>4</sup> This section also examines the main long-term effects of what happened throughout the period as a whole—characterized by the predominance of neo-conservative recommendations and diagnoses—and puts forward more detailed arguments concerning the regressive effect which the 1991-1995 bubble had on development. It is considered that, following the liberalization of trade, the tradeable sector of the economy can in general be regarded as open and that, therefore, foreign trade properly reflects changes in the pattern of production. It is further contended that trends in foreign trade lend paramount importance to comparative advantages, which suggests a setback in terms of development and of competitiveness (or least of competitiveness compatible with rising levels of well-being and employment).<sup>5</sup>

It is also asserted that the neo-conservative policies applied since 1976, particularly in the periods 1976-1983 and 1991-1995, intensified the behaviour of the economic elite, because those policies weakened many of the institutions and

<sup>4</sup> Llach (1987) notes that quasi-rents from cheap labour—which he terms “Lewisian” because of their link with excess supply of labour at constant wages—were not important in past Argentine economic history. Nonetheless, the drop in real wages, as from 1976, to half the level of previous years and the huge increase in unemployment and underemployment, as from 1992, radically changed the labour market (Cortés, 1985; Minujin, 1993; Barbeito and Lo Vuolo, 1993), giving rise to the acquisition of rents from cheap labour. The “Lewisian” quasi-rents increased during the downward phase of the 1991-1995 bubble. According to official surveys, 76% of unemployed persons seeking employment do so without expressing any conditions as regards length of working day or job status (Marcó del Pont, 1995) and hence also as regards the real hourly wage: a clearly Lewisian situation.

<sup>5</sup> With reference to the relationship between development, industrialization and the foreign trade profile, we have largely followed the views of Klaus Esser on Latin America and those of Raphael Kaplinsky on the less developed countries, which are in substantial accord with the analysis of the Argentine economy in this article (Esser, 1991; Esser, Hillebrand, Messner and Meyer-Stamer, 1993; Kaplinsky, 1993 and 1995).

organizations which aimed to restrict the influence of this elite and its opportunities for acquiring political quasi-rents and created rules of the game that were beneficial to it.<sup>6</sup> These quasi-rents raised the prices of assets (fixed and, in particular, monetary) and expenditure programmes far above the levels of long-term equilibrium and perfect information. These expenditure budgets could have been sustainable had there been a process of development, but that process did not occur because quasi-rents which were not associated with innovation or production crowded out investment; consequently, the increase and subsequent drop in wealth were merely phases of a bubble.

In this respect, it has been affirmed that neo-conservative policies have distorted prices (Fanelli, Kacef and Machinea, 1995) and relative returns in favour of the oligopolistic non-tradeable goods sectors, with adverse effects on the competitiveness of the economy. Thus, despite trade liberalization, the economy has tended to become closed and the economic elite, composed of local and transnational economic conglomerates, has increased its acquisition of political quasi-rents. Owing to the weakness of institutions and organizations, therefore, the free-market reforms based on neo-conservative thinking did not transfer the fixing of prices and profit margins from the State to the market, but rather to a small group of major economic agents (Azpiazu and Vispo, 1995; Azpiazu, Bang and Nochteff, 1995). The weakening of government institutions (institutional shock) was essentially connected with neo-conservative principles of non-intervention by the State (hands-off policy).<sup>7</sup> No account was taken of the

<sup>6</sup> See Azpiazu and Vispo, 1995; Azpiazu and Basualdo, 1995; Esser, 1991; Esser, Hillebrand, Messner and Meyer-Stamer, 1993; Basualdo, 1994.

<sup>7</sup> It could be argued that the neo-conservative (also termed neo-liberal) recommendations linked by many writers to the so-called Washington Consensus were not restricted to the policies pursued in Argentina. Nonetheless, as was noted by Platteau (1994, p. 534), the way in which the recipe is normally presented implies or suggests that the market system can be supplanted with guaranteed success in any place and at any time. This disregard for the specific features of institutions, organizations and agencies has led—in many countries of the region—to a form of free-market economy that has given rise to an insouciant lack of regulation and direction in all sectors of the economy (Esser, Hillebrand, Messner and Meyer-Stamer, 1993). It can be accordingly affirmed that neo-conservatism was the framework on which the public policies of Argentina and much of the region have been based (Krugman, 1995; Nochteff, 1993).

fact that development which “springs” from the centre of society (endogenous development) “is the world which in reality is presupposed by neo-classical economic theory and allows its rules of behaviour and maximization to be valid; however, it is a complex historical product that cannot be achieved overnight” (Llach, 1987).

This development which springs from the centre of society, Schumpeterian endogenous development, did not occur in Argentina. On the contrary, the most powerful local conglomerates,<sup>8</sup> which are gaining control of most of the privatized assets and are representative of the economic elite, are acquiring primarily political quasi-rents. Consequently, the institutional shock constituted by neo-conservatism affects an economy totally different from that presupposed by the neo-classical theory on which that movement is based, since change “is not achieved overnight”. As a result, the strategies of local conglomerates are totally different from those employed by leading enterprises both in developed economies and in the newly industrializing countries (NICs).<sup>9</sup>

The Argentine case may therefore be seen as an extreme example of what has happened in the major countries of the region. Prior to the processes of liberalization and deregulation, the possibility of acquiring quasi-rents not derived from advances in technology and production had crowded out investment in the first two periods of expansion referred to. Thereafter, these processes contributed to the continuation of that crowding-out effect in the recent past.

Section IV attempts to identify and describe briefly some—not all—of those features of the privatization and deregulation process initiated in 1991 (Azpiazu and Basualdo, 1995) which, as indicated in section III, helped to generate the 1991-1995 bubble. Finally, a summary of the conclusions is set out in section V.

<sup>8</sup> The economic leadership which developed from 1976 onwards (Azpiazu, Basualdo and Khavisse, 1987) and became consolidated in the period 1991-1995 (Azpiazu and Basualdo, 1995).

<sup>9</sup> Compare the strategies, particularly the diversification strategies, examined by Basualdo (1994) with those studied by Hikino and Amsden (1995).



## II

### Development and technology in Argentina: expansion of the agricultural export sector and import substitution industrialization

*"... who made the discovery of the machine, or who first usefully applied it, would enjoy an additional advantage, by making great profits for a time but, in proportion as the machine [became] ... of general use, the price of the commodity produced would, from the effect of competition, sink to its costs of production, when the capitalist would get the same money profits as before..."*

David Ricardo

#### 1. Development or bubbles?

Development<sup>10</sup> is driven by innovations<sup>11</sup> (and their associated investments) which are generated by enterprises and national innovation mechanisms, of which enterprises are part and in which the economic elite is a major and decisive actor (Dosi, Freeman, Nelson, Silverberg and Soete, 1988, parts II and V). Thus, development to a great extent depends on the economic elite's efficient fulfilment of its function in the developmental process.<sup>12</sup> That function is the acquisition of technological quasi-rents which, through

innovation, create monopolistic positions which creative imitation, competition and technology dissemination continuously erode and render necessarily transitory. In the words of Javier Villanueva, when Schumpeter's monopoly is established, Walras's dogs begin to chase after it.

For the economic elite, this is a "hard option"<sup>13</sup> in terms of technology, risk, investment and social change. For society, it is what Napoleoni (1962), following Schumpeter, terms "development rent", which encourages a process of endogenously driven growth in which each cycle leaves capacities for generating a further endogenous development cycle (on the dynamic relationship between the cycles, see Kalecki, 1965, and the interpretation given in Nochteff, 1994).<sup>14</sup>

<sup>10</sup> The term "development" is used here in the Schumpeterian sense, in contrast to a process tending towards a static equilibrium, with the exception of factors exogenous to the economy itself (Schumpeter, 1968).

<sup>11</sup> In the broad sense, which includes "Baumolian" creative imitation, accelerated learning, user innovation processes and product differentiations that are significant in terms of profits and market structure (Schumpeter, 1968; Freeman, 1982).

<sup>12</sup> In order to avoid the common confusion regarding the concept of "Schumpeterian entrepreneur", it should be noted that Schumpeter (1957, chap. II) explains that he "is not concerned with the specific factors of change but rather with the methods whereby those factors act, that is to say the mechanism of change". The "entrepreneur is merely the catalyst for this mechanism" and the profit arising from innovation (technological quasi-rent in the sense adopted here) is present in any development process, even in one where the entrepreneur has been replaced by any other agent fulfilling the same function (Schumpeter, 1968, chap. IV).

<sup>13</sup> On the distinction between hard and soft options, see Esser, Hillebrand, Messner and Meyer-Stamer, 1993. In a concurring view, Kaplinsky (1995) distinguishes between what he calls the high road and the low road in economic performance, according to the type of rent being obtained ("natural resources", "skills", "human resources").

<sup>14</sup> In the tradition of evolutionist economic dynamics, these concepts are associated more with the idea of sustained disequilibrium than with the idea of alternation between periods of disequilibrium/development and of stationary equilibrium. See, in this connection, the cyclical dynamic described by Kalecki (1965) and its comparison with Schumpeterian development in Nochteff (1994).

The Argentine economy (like most Latin American economies) does not seem to have followed this development path but rather an adaptive one of late imitation (a traditional path in the sense adopted by Freeman, 1982). Its performance is the meagre outcome of passive adjustment to exogenous stimuli or external opportunities created by other economies. The Argentine economic elite<sup>15</sup> has adapted itself –and, to a great extent, forced institutions to adapt– to these opportunities, has kept itself shielded from competition by means of non-innovative and non-transitory monopolistic positions sustained by government policies and institutional barriers to entry, and has thus acquired political quasi-rents. For the economic elite, this is a “soft option” in the sense described. For the economy, it is not a process of development but rather a succession of booms or bubbles,<sup>16</sup> which are more compatible with very long-term stagnation (in comparison with economies which are developing) than with a system of organizations, institutions and production forces that are capable of generating development.

In development processes, owing to the predominance of technological quasi-rent seeking, policies and institutions that promote science, innovation, industrialization and investment are of enormous importance on the agendas of Governments, economic elites and society as a whole; and endeavours in science and technology are directly linked to patterns of production, investment and foreign trade. In an economy such as that of Argentina, which is of the adaptive, lagging imitative or “traditional” type, all these questions are secondary on those agendas, and scientific and technological endeavours are only weakly linked to such patterns. It is the acquisition of political quasi-rents (and of Ricardian rents) which makes this weakness due less to an inadequate supply of science and technology than to an insufficient

effective demand for them (Cereijido, 1990).<sup>17</sup> In short, this demand insufficiency is directly linked to the economic elite’s behaviour (choice and acquisition of soft options), which is related to the ineffectiveness of institutions in generating long-term growth, and to the weakness of social and political checks and balances that could influence, limit or change such behaviour.<sup>18</sup>

## 2. Soft options: a retrospective view

### a) *Expansion: 1880-1914*

As already indicated, the first soft option for the Argentine economic elite was the expansionary cycle –or rather the bubble– generated largely by primary exporting and the expansion of the agricultural frontier. The combination of “natural” comparative advantages with technological and economic changes in the European economies; market imperfections (such as the non-existence of a world land market); institutional barriers to entry (local land and tenancy laws, and the systems of financing land acquisition, farming and livestock production) and privileges granted by the State enabled the economic elite in that period to acquire Ricardian rents combined with and enhanced by political quasi-rents. They led to the consolidation of an institutional system and of a pattern of economic elite behaviour that seem to have endured, despite the changes in the Argentine economy and even in the composition of a good part of the economic elite. This behaviour may be characterized by a great capacity for adaptation –of a speculative nature– in order to take advantage of opportunities to acquire political quasi-rents, for the exertion of a very strong influence on public policies and institutions, –which makes the acquisition of such quasi-rents possible–, and for rapid diversification and changes of activity. In contrast, the elite kept a low profile in terms of investment, technological innovation, production efficiency and specialization (Sábato, 1988).

<sup>15</sup> The topics examined in this section are dealt with in detail in Nochteff, 1993 and 1994.

<sup>16</sup> In this article, some long periods are also regarded as bubbles i) when the increase in wealth and the value of assets in one such period exceeds that sustainable by increased investment, productivity and the pattern of production and foreign trade, and ii) when they leave institutional and economic systems that are highly ineffective for a process of development. This does not mean ignoring the fact that bubbles in the more usual meaning of the term can occur within each period.

<sup>17</sup> With the predominance of political quasi-rents, the neo-conservative recommendation regarding science and technology has a particularly perverse effect. When it is advocated that endeavours in this area should be guided exclusively by enterprise demand, it is a mistake to assume that firms have perfect technological information (Bessant, 1991); and if, in addition, the economic elite seeks non-technological quasi-rents, the error is compounded still further.

<sup>18</sup> For a case study on the failure of public policies in such a context, see Nochteff, 1995.

### b) *Industrialization*

The Argentine style of industrialization, particularly since the crisis in the 1930s that ended the first big bubble, has, to a large extent, resulted from the behaviour and attitudes of the traditional economic elite (Nochteff, 1994, pp. 52-74), which expanded, particularly after the 1940s, to include transnational industrial enterprises, giving rise to import substitution industrialization led by those enterprises. This industrialization was the second major soft option for the economic elite and gave rise to a second "big bubble" in the Argentine economy, which accentuated its characteristics of adaptation and lagged imitation, and created new restrictions on development.

Import substitution industrialization led to a heterogeneous productivity pattern or developmental Dutch disease,<sup>19</sup> owing to the path that was chosen—the "protectionist option"—largely through the influence of some leading local entrepreneurs and the transnational enterprises.<sup>20</sup>

In very simplified terms, the main features of developmental Dutch disease are as follows:

i) There is a major difference between the marginal costs of the primary sector and of the industrial sector<sup>21</sup> (in reality, between those of the sectors with

"natural" comparative advantages and those with man-made comparative advantages). Marginal costs do not increase, in a continuous manner from some primary sectors to others, and then from some industrial sectors to others, but rather in a discrete manner (there are one or more "steps" in comparative marginal costs).

ii) The exchange rate tends to be situated (partly because of the economic policies adopted) around what could be called primary-sector cost parity.

Because of these two factors, monetary prices and costs in the industrial sector have been higher than they were internationally, and industrial activities expanded because they were working with an import-only exchange rate close to the industry cost parity, shaped by tariff and non-tariff subsidies.

Since the export exchange rate was not situated around the industrial-sector cost parity (effective export prices were not equivalent to effective import prices),<sup>22</sup> the industrial sectors simply did not export (to put it very simply). The economy was basically made up of two sectors: the tradable goods production and export sector (primary sector) and the sector producing non-tradable goods requiring foreign exchange (industrial sector plus tertiary sector).

These patterns of behaviour have far-reaching effects. Firstly, they encourage a closed economy, that is to say an economy in which the tradable goods producing sector is small. This means that the greater part of the economy avoids international competition, thus facilitating the acquisition of political quasi-rents by the major economic agents, shielded in non-transitory monopolistic positions.

Secondly, the supply of foreign exchange from primary-sector exports allows equilibrium only in conditions of stagnation and high unemployment. In simplified terms, if it is desired that the non-tradables sector (industrial sector plus tertiary sector) than should grow more than the primary export sector, an external restriction is encountered. If the restriction is temporarily overcome by borrowing, future foreign exchange demand (debt servicing) increases even more, for the same level of exports (other conditions being equal), and this aggravates the problem still further. This gave rise to a "stop-and-go" economy (Diamand, 1988; Heymann, 1984).

<sup>19</sup> The name "developmental Dutch disease" was used by Schydlosky (1993), although the phenomenon had already been examined in the 1960s by Oscar Braun and by Marcelo Diamand (who referred to it as an unbalanced pattern of production). It was subsequently studied by a number of economists, such as Mallon and Sourrouille (1976), Diamand (1988) and Heymann (1984), who also presents a model that can explain with considerable precision the macroeconomic aspects of the 1991-1995 bubble.

<sup>20</sup> Nochteff (1994) examines the range of institutions, actors, limitations and opportunities that prompted the economic elite to favour the path of substitution industrialization, led by transnational enterprises, which is known as the "protectionist option", as distinct from the "orthodox", "devaluation", "export industry" or "extended neutrality" options. In his view, this last option was the one pursued by the successful economies of South-East Asia.

<sup>21</sup> It is very important to bear in mind that, to put it very simply, the primary sector includes primary and industrial activities having a very direct connection with comparative advantages provided by natural resources, while the industrial sector produces more widely differentiated goods, where highly skilled labour has a major impact on cost and where competitiveness is closely associated with inherent capacity for innovation (including rapid creative imitation). Hence, on the basis of this classification, the primary sector would include oil refineries, vegetable oil production for bulk sale, basic milk production and even basic petrochemical and iron and steel plants, while the industrial sector would include the production of capital goods, fine chemicals, the production of high-priced edible oils, milk and cheeses for export, the production of special steels, and iron and steel services.

<sup>22</sup> Unlike what happened in the NICs, where the so-called extended neutrality system has tended to bring the profitability of sales to the domestic market close to those of export sales.

Thirdly, microeconomic performance in the industrial sector is highly dependent on exchange-rate and trade policies. In general, changes in parity and in trade policy are far more significant for enterprises than almost any technological change. Technological efforts are not aimed at reaching leading-edge best practices, but rather at making relatively minor adjustments to existing (and generally backward) technologies introduced to a great extent through the importation of inputs and capital goods (largely second-hand or more or less obsolete). Learning paths tend to take the form of technological efforts to adapt to the limitations (of scale, or of availability of inputs, suppliers or infrastructure) found in a closed industrial economy and generated by the same developmental Dutch disease, but they do not eliminate the marginal cost "steps", and thus reproduce the disease.

Fourthly, policies relating to trade, foreign exchange, subsidies, and reserved and quasi reserved market concessions, and generally all policies that make possible the acquisition, preservation or distribution of political quasi-rents and Ricardian rents,

are key items on the agendas of the economic elite, Governments and society. Policies directed towards promoting innovation, the learning of best practices, investment and increased productivity are accordingly relegated to very secondary positions.

Finally, there is no synergy between the primary sector and the industrial sector, dynamic and static comparative advantages are not exploited, and the primary sector lags behind and does not move towards more differentiated products, in comparison with other economies (Esser, Hillebrand, Messner and Meyer-Stamer, 1993).

In short, import substitution industrialization was for the economic elite a sort of "big bubble"<sup>23</sup> driven by the acquisition of non-technological quasi-rents and resulting from the interaction between the institutional system and the economic elite (and other organizations and actors), rather than a process of development in the Schumpeterian sense. On the contrary, developmental Dutch disease created new economic, technological, institutional and organizational restrictions on development.<sup>24</sup>

### III

## The neo-conservative movement and the debt-promoted bubble

Even with the limitations of substitution industrialization, during its last period (and particularly between 1964 and 1974) a process of dynamic industrialization took place: in that decade, per capita GDP growth was the highest of the century and lagged least behind other countries (Sourrouille and Lucángeli, 1980; Llach, 1987).<sup>25</sup> This dynamism was largely due to the learning processes, to the partial correction of the protectionist path, to the socio-political deadlock that placed limits on the economic elite, and to the growth of global industry and trade (Nochteff, 1994). The political and economic crisis of 1975 and the

military coup of 1976 broke this deadlock, and the economic elite recovered the power that had been partly impaired during the period of substitution industrialization.

#### 1. Neo-conservatism and the big bubble in three periods

##### a) 1977-1981

From that time, the economic elite forced another period of easy options and of political quasi-

<sup>23</sup> Because –particularly during the initial phases– it maintained the values of profit margins and assets in the non-tradables sector (industry plus services) above the long-term values. As already stated, this leads to a kind of simplification in which a series of bubbles are assimilated into a single bubble according to the factors which drive them.

<sup>24</sup> This phenomenon was particularly evident in the import substitution industrialization period prior to the "partial corrections" of the 1960s (Nochteff, 1994). The 1950s were thus relatively the most backward decade, in terms of per capita gross product, of the whole period 1929-1983 (Llach, 1987).

<sup>25</sup> On substitution industrialization as a whole and in this period in particular, see Mallon and Sourrouille, 1976.

rent acquisition. From the standpoint of its main causal factor, external indebtedness, this period can be regarded as a single "big bubble". However, three stages should be distinguished. During the first stage, essentially between 1977 and 1981, the economic elite took advantage of the opportunity provided by the increase in liquidity and the drop in interest rates around the world. During this period, political quasi-rents focused on financial activity (Basualdo, 1987) and on non-tradeable goods sectors that were protected in the midst of intense trade liberalization. Furthermore, the extent of quasi-rents from cheap labour began to increase.

#### b) 1982-1990

In a second phase, after the external debt crisis that ended the first bubble (1977-1981), the conglomerates succeeded in maintaining political quasi-rents by securing large-scale transfers of income through different types of subsidies (Azpiazu and Basualdo, 1987; IMF, 1986). They accordingly continued to grow during the recessionary decade of the 1980s and built up the capital and economic power that subsequently enabled them to take advantage of the bubble generated predominantly by external indebtedness and privatizations in the 1990s. This process also made a crucial contribution to the fiscal crisis that set off the recessions and hyperinflation of the period 1989-1990.

#### c) From 1991 onwards

From 1991, with the virtual repetition of the phenomenon of high liquidity and low interest rates worldwide, the bubble that had begun around 1976-1977 swelled up once again. This time the neo-conservative policies had far more impact, since the combination of external indebtedness with privatizations, deregulation and trade liberalization helped to make possible the acquisition of non-technological quasi-rents.

## 2. A review of economic performance in the period subsequent to 1976

The performance of the economy after the breakdown of substitution industrialization can be summed up as follows.<sup>26</sup>

<sup>26</sup> The figures used in this section and in the following one were prepared on the basis of Azpiazu and Nochteff (1994a), FIDE (1996), FIEL (1996), Argentina, Ministry of Economic Affairs and Public Works and Services (1995) and ECLAC (1995).

In 1995 the per capita product was 12.7% less than in 1974. Gross fixed investment in 1995 was 18.6% of GDP: 3.6% lower than in 1974.

The real average wage in 1993 was 51.2% less than in 1974 and, although no data are available on subsequent movements, it is estimated that in 1995 it was even lower.

As regards employment, between 1974 and 1995 the open unemployment rate increased by 411.8% (from 3.4% to 17.4%), while visible underemployment rose from 5.4% to 12.0%.

With reference to income distribution, in 1995 the share of the first four deciles was 28% less than it had been 20 years earlier, that of the next four deciles was 11.6% less, but that of the two highest income deciles was 24.4% higher than in 1974. The decile that lost most during the period was the lowest income decile (-41.9%), and the decile that gained most was the highest income decile (+43.5%). If one considers per capita GDP, the absolute loss suffered by the poorest decile was 52% and the absolute gain achieved by the richest decile was 29%.

Poverty increased from 4% to 20% (i.e., 600%) between 1974 and 1992-1993.

The degree of openness of the economy ( $X=M/GDP$ ) in 1995 was approximately 15%, around 7% lower than the 1973 figure of 16.2%. The  $X/GDP$  ratio dropped by 16.7% (from 9.6% in 1973 to approximately 8% in 1995).

External vulnerability (the ratio between external debt and exports) is estimated to have increased by 164.3%. In 1974 the public external debt was equivalent to 1.4 years' exports, whereas in 1995 the public external financial debt was equivalent to 3.7 years' exports (a ratio 200% greater than that of the developing countries).<sup>27</sup>

In short, Argentina's economic and social turnaround in the period subsequent to 1976 was, to say the least, very serious.<sup>28</sup>

<sup>27</sup> Estimates concerning the public external financial debt in 1995 vary greatly. It has been decided to use the calculations of Machinea, 1996.

<sup>28</sup> Comparison "between peaks" may give rise to some doubt, but it should be pointed out that, in all cases, the adjustment of the yearly data for the period to straight-line paths by the least squares method confirms that these are long-term trends (Azpiazu and Nochteff, 1994a, figures 1 to 6).

### 3. Factors for analysing the 1991-1995 bubble

Helped by the world financial situation, the application of neo-conservative policies involving a reduced role for the State, the economic crisis, and extreme institutional weakness aggravated by hyperinflation and the decline of organizations,<sup>29</sup> the consolidated economic elite took advantage of a new bubble, this time generated largely by external indebtedness, privatizations and deregulation, in which it vigorously pursued and intensified the acquisition of political and Lewisian quasi-rents.

The combination of high peso interest rates,<sup>30</sup> the fixed exchange rate and financial decontrol prompted –as in the 1977-1981 bubble– a large-scale influx of capital. The bulk of this capital was used: i) to finance the acquisition of public enterprises by conglomerates, of which those involved in the privatization process accounted for 77% of the private external debt in 1990-1994 (Basualdo, 1994); ii) to finance a consumption boom, particularly in non-essential goods, as can be surmised from the distribution of income and the low propensity to save, lower even than the propensity to invest, given the major inflow of capital; in 1991-1994 the consumption/GDP ratio was 82.1%, while the ratio between gross investment and GDP was only 17.4% (the maximum value, in 1994, was 20%, and the figure fell abruptly in 1995).

The influx of capital and the inflation registered in non-tradable goods –boosted by consumption and high charges for privatized public services– caused the currency to appreciate. Combined with a marked liberalization of trade, they severely eroded competitiveness and shifted improvements in prices and relative profit margins, together with the small amount of investment, to the non-tradable goods sector (Fanelli, Kacef and Machinea, 1995; Kacef, 1994; Coloma, 1993).

Both domestic investment and foreign direct investment (FDI) focused on enterprise acquisition and restructuring and, to a lesser extent, on the construction of new plants. The main destinations of the investment were privatized public services and

production for the domestic market or, possibly, complementarity within MERCOSUR. Investment in new plants for tradable goods occupied a secondary place and was centred on the extraction and production of non-differentiated exportable goods, basically mining products, gas and petroleum, agricultural products and simple agriculture-based manufactures (on FDI, see Chudnovsky and López, 1994). In the industrial sectors that most improved prices and productivity, exports continued to be basically anti-cyclical, the market became oligopolistic, and investments –both actual and projected– do not appear sufficient to sustain competitiveness (see, for example, Azpiazu and Nochteff, 1994b).

Deregulation –in a very weak institutional and organizational context, with no effective anti-monopoly agencies or legislation, and during a process of privatization in which some of the largest enterprises were sold– did not transfer the fixing of prices and profit margins and the allocation of resources from the State to the market, but mainly to a group of interrelated conglomerates (Azpiazu and Basualdo, 1995). Not only did the institutional and organizational framework of the privatizations not lead to greater competition, but it actually obstructed the market mechanisms (see Azpiazu and Nochteff, 1994a, pp. 157 to 221; Azpiazu and Basualdo, 1995).

Consequently, in spite of the almost complete liberalization of foreign exchange (UNCTAD, 1995), the economy tended to become closed: the  $X + M/GDP$  ratio in 1991-1995 was in the region of 13 to 14%, one of the lowest in Argentine history; in the preceding five-year period it had been 15.8% (FIDE, 1996) and in 1969-1973, at the height of import substitution, 16.8%.

In this closed and oligopolized economy, the conglomerates forming the centre of the economic elite moved even further towards monopolistic or oligopolistic markets for non-tradable goods that were shielded from external and internal competition, enhancing and strengthening their ability to acquire political quasi-rents and diverging increasingly from the structure and behaviour of conglomerates in dynamic economies. In 1994, the last year of expansion of the bubble, almost 40% of the total profits of the 20 highest-earning firms was achieved in monopolistic or duopolistic non-tradable privatized public services sectors, a further 45% in oligopolistic activities concerned with the exploitation of non-re-

<sup>29</sup> State, trade-union, political and business organizations.

<sup>30</sup> Monetary behaviour was not totally endogenous: financial and fiscal policies tended to raise interest rates.

newable natural resources (gas and oil), and only around 13% in industry (Gaggero, 1995).

In 1994 the bubble “imploded”. The trigger was the “tequila effect”, but the main cause was the extreme external fragility of the economy.<sup>31</sup> This can be seen from the growing disparity in the foreign trade balance (which went from a surplus of 8,274 million dollars to a deficit of 5,752 million between 1990 and 1994), the fall in the X/GDP ratio (from 11.9% in 1990 to 5.7% in 1994), the rise in the current account deficit (a 40-fold increase between 1991 and 1994), the very high ratio between external debt and exports, and the increase in the net public external debt by an amount equivalent to 109.5% of exports for 1994 (Poli and Peirano, 1996), despite the Brady Plan and the receipt of 27 billion dollars during the period from privatizations. (According to Machinea, 1996, it was as though an enterprise had increased its debt while at the same time selling its assets.)

A bubble in a fixed exchange rate system with convertibility similar to the gold standard does not explode, but rather “implodes”. To date, the most reliable indicator of “implosion” is the unemployment rate. As the bubble grew, the shedding of manpower from the tradable goods sectors and from the privatized public enterprises was disguised by the emergence of self-employed workers, who used their severance payments to finance non-viable activities, and was only very partially offset by the boom in the non-tradable goods sector, so that open unemployment rose from 6.9% in 1991 to 10.7% in 1994. When the “implosion” occurred, the workers shed by the non-tradables sector joined those from the tradables sector and the assets from the redundancy payments ran out, with the result that the figure reached 18.6% in 1995, i.e., an increase of 73.8% in one year (Kacef, 1994), in a situation of full employment flexibility and labour supply with diminishing wages and conditions (Marcó del Pont, 1995).

All the foregoing confirms three points: i) the economic policies based on neo-conservatism, combined with institutional fragility, the weakness of political and social checks and balances and the

behaviour of the economic elite, led to a bubble and not to a process of development; ii) the economic elite squeezed the bubble still further in order to acquire political quasi-rents, Lewisian quasi-rents (particularly from 1994 onwards) and, to some extent, rents from non-renewable natural resources (which, in the sense adopted in this article, and given the extent of government concessions in those activities, are to some extent political quasi-rents); iii) as a result, policies and efforts aimed at the acquisition of development quasi-rents have been thrust even further into the background than before. One indicator of the scant importance attached to them is the expenditure on science and technology. Its share of public spending fell from an infinitesimal 0.27% (1980-1987) to 0.24% in the 1990s, and its share of GDP has steadily decreased since 1992. In 1994, total expenditure on scientific and technological research was 0.29% of the product: ten times less than the percentage in the developed countries and between four and seven times less than in the Asian NICS (Chudnovsky and López, 1995).

#### 4. Bubbles, political quasi-rents and patterns of production

In a closed economy with low competitiveness,<sup>32</sup> exports tend to follow an anti-cyclical trend: thus, when the implosion occurred exports rose by 46% in the first quarter of 1995. As might be expected, this increase was not linked to greater penetration in open and developed economies,<sup>33</sup> but was brought about rather by the fall in internal demand, which boosted exported units, by the increase in the prices of basic commodities and by the recovery of the Brazilian economy, coupled with the rise in the value of the Brazilian real. Almost 52% of the increase in total exports and 75% of the increase in industrial exports were to MERCOSUR, essentially to Brazil (Porta, 1995).

With no figures available on GDP per branch, and following trade liberalization, the pattern of trade is a good reflection of techno-productive performance: i) the trade balance showed a surplus only when the

<sup>31</sup> For a macroeconomic analysis of the bubble, see Fanelli, Kacef and Machinea (1995).

<sup>32</sup> For a concurring analysis of competitiveness, see Messner and Meyer-Stamer (1994).

<sup>33</sup> In this connection, it is worth noting that in 1993-1994 Argentina had only 30 enterprises with ISO 9000 certificates of quality, whereas Brazil had 500.

“implosion” occurred and there were favourable (and fragile) exogenous conditions and ii) high priority was allocated to exploiting comparative advantages.

While other countries of the region were entering the “second export phase” of an open economy (Díaz, 1995), Argentina tended to regress to a more closed economy and a “first export phase”. In the view of Beckerman and Sirlin (1996), Argentine foreign trade’s revealed comparative advantages (RCAs) indicate that during the period these advantages diminished in manufacturing activities compared with primary activities (in particular those connected with non-renewable natural resources), in industrial manufacturing compared with agriculture-based manufacturing activities,<sup>34</sup> and in medium- and, in particular, high-technology activities in comparison with traditional industrial activities involving low-technology inputs in widespread use (non-differentiated). Comparative advantages in manufacturing activities also decreased in direct (although not proportional) relation to their use of skilled labour (Bisang, 1995).

Taken overall, analyses of foreign trade show a major technological and industrial decline,<sup>35</sup> which is consistent with the contentions in this article and, in particular, with the view of an increasing movement on the part of the economic elite towards the non-tradable goods sector and towards the acquisition of political quasi-rents: an attitude which imposes further restrictions on development.

##### 5. Observations on the privatization and deregulation process

The privatization and deregulation process,<sup>36</sup> as implemented in Argentina, was one of the key elements

in the application of policies based on neo-conservative thinking, in the 1991-1995 bubble, and in the acquisition of political quasi-rents.<sup>37</sup>

This process was the main plank of the reform of the State. In contrast, in the countries of the Organization for Economic Cooperation and Development (OECD), the reforms focused on a set of measures that included the introduction of market mechanisms, changes in the functions of the central administration and management bodies, and decentralization, far more than on privatization (OECD, 1993).

The speed and scale of the process were far greater than those generally seen in the Western world: within four years, virtually all State service and industrial enterprises were privatized.

Government action and approaches displayed very marked changes and breaks in continuity that affected the State’s negotiating capacity.

In general, the establishment of regulatory frameworks and bodies took place almost simultaneously with or, in some cases, subsequent to the privatizations.

The privatizations were used mainly as part of short-term macroeconomic policy, particularly in order to offset the fiscal and current account imbalances and to create conditions that would make it possible to maintain a fixed exchange rate, sacrificing long-term objectives.

There was ongoing and recurrent renegotiation of the rules governing privatization, in most instances in order to gain the confidence of the big firms. This increased the social costs, because of the benefits which the State granted after acknowledging that the enterprises possessed acquired rights and that the changes could affect their future profits.

<sup>34</sup> Beckerman and Sirlin (1996) show that, between 1990 and 1994, primary goods exports increased their positive contribution to RCAs by 60% and agriculture-based manufactures by 10 per cent, while energy exports’ share of trade rose from an insignificant level to a relative contribution close on 12% of positive RCAs. At the same time, the negative contribution of industrial manufactures to RCAs rose 1.5 times. These results are made worse by the fact that agriculture-based manufactures tend not to form techno-productive clusters. For example, while by-products of vegetable oil extraction have been used in Brazil to develop an intensive poultry breeding industry, Argentina exports them as “food industry waste” (one of the country’s main export items).

<sup>35</sup> For concurring results obtained using different methodologies, see Cepeda (1995a and b).

<sup>36</sup> This section identifies some of the traits of the privatization and deregulation process that contributed to the 1991-1995 bubble and to the acquisition of political quasi-rents. Consequently, it is not and must not be taken as an overall assessment of that process. No analysis is thus being made here of the substantial improvement in the provision of services or other aspects of the deregulation (for example, the increased competition in markets, such as those for professional services, or the reduced cost of services, such as port services). Nor is any analysis made here of the sharp increase in the prices of most privatized public services (Azpiazu, Bang and Nochteff, 1995).

<sup>37</sup> This section is based on Azpiazu and Vispo (1995); Azpiazu and Basualdo (1995), and Azpiazu, Bang and Nochteff (1995).



The complete disregard for expanding ownership—contrary to international recommendations and experiences—gave rise to marked economic concentration, both within the privatized companies, where the purchasers have guaranteed control, and in the economy as a whole. One small group of conglomerates diversified into completely heterogeneous activities and achieved a major presence in virtually the entire range of privatized activities. This “heterogeneous diversification” hampers microeconomic efficiency and techno-productive specialization.<sup>38</sup>

The regulatory weakness and the features mentioned above were decisive factors in strengthening the positions from which political quasi-rents can be acquired. Thus, the big conglomerates have achieved: i) a very significant increase in assets, which strengthened their capacity for self-financing abroad at rates far below domestic rates; ii) conditions in which the risk is very slight or nil; iii) ample scope for price fixing; iv) considerable leeway to increase their costs by transferring profits to associated enterprises (for instance, in the purchasing of equipment or the hiring of services), and v) a significant influence on relative prices and profit margins in the economy. One indicator of this is the very large share of the privatized oil complex and public services in the profits of the 20 highest-earning enterprises.

This concentration of economic power and the consolidation of reserved markets with political quasi-rents are obstructing the emergence of a new and more competitive entrepreneurial class. Moreover, the concentration of the ownership of privatized enterprises, intensified by cross shareholdings and inter-firm agreements, combines with the weakness of the regulatory bodies and frameworks to produce constraints and restrictions. Of these, mention should be made of: i) planned investment that is even below

the very low level of the 1980s; ii) the increased risk of co-opting of the regulatory agencies, aggravated by the establishment of specific agencies for each service, with little or no coordination between them; iii) the intensification of barriers to entry other than techno-productive barriers; iv) the increasing imbalance in negotiating capacity between the State and the conglomerates, since the latter control the public services but the State still has ultimate responsibility for the service; v) the loss of negotiating capacity of the other private agents *vis-à-vis* the conglomerates; vi) a growing opaqueness of the markets and the consequent risk of transfer price practices. One example of these latter problems is the impossibility of the public authorities gaining access to supply contracts among transporters, distributors and major users of gas, or between generators and major users of electricity (in many cases belonging to the same conglomerate).

In short, many of the traits assumed by the Argentine privatization and deregulation process<sup>39</sup> ultimately led to greater imperfections in the market, to greater divergences between private and social benefits, and to similar or greater internal distortions, while at the same time reinforcing the trend towards a semi-closed and oligopolistic economy centred on political quasi-rents.

In fact, this process was a major contributory factor in the change in relative profit margins to the detriment of tradable goods. In addition, while the prices of other non-tradeable goods that have an impact on the costs of tradable goods may be reduced by devaluation or deflation, neither of those measures can bring about a significant reduction in the prices of privatized public services, owing to the fact that they are implicitly or explicitly indexed through the rate of exchange, or owing to their low elasticity, and/or the oligopolistic nature of the respective markets.

<sup>38</sup> This diversification does not take place around a techno-productive nucleus in medium- and high-technology activities usually in the tradables sector (in contrast to what occurs in developed economies), or in a small number of nuclei of this type (as tends to happen in the NICs). For example, one of the main local conglomerates has diversified and expanded from iron and steel into electricity distribution, gas transportation, gas distribution, petroleum production, telecommunications services, rail transport, port services and highway concessions (Basualdo, 1994).

<sup>39</sup> These traits distinguish the Argentine privatization and deregulation process from successful privatization experiences and at the same time make it in many respects similar to the more negative experiences of Eastern Europe (on these, see OECD, 1994).

## IV

### Some conclusions

*"Economic history is overwhelmingly a story of economies that failed to produce a set of economic rules of the game that induce sustained economic growth."*

Douglas North

The structural reforms and economic policies implemented in Argentina since 1991 have given rise to a bubble generated largely by borrowing, privatizations, deregulation and trade liberalization; this bubble intensified the economic elites' seeking of political quasi-rents that were unconnected with technology, investment and competition in external markets, leading to a further decline in the economic structure<sup>40</sup> and in foreign trade, and to an economy as closed as that of the period of import substitution industrialization.

The recommendations of what Ralf Dahrendorf called the conservatism of unconcern, adopted in large measure in the neo-conservative propositions, concur with the socio-economic behaviour of the

traditional economic elite of Argentina (and of many other countries of the region), creating further restrictions on the transition to a more open, dynamic, innovative and competitive economy. In view of this and following the observations of Schumpeter (1968), it is reasonable to think that academic and public policy debate and research should be dealing increasingly with the problems arising in the interaction between institutions and entrepreneurs or, in general, between the institutions, agencies and organizations specific to each economy, since the building of efficient institutions and the establishment of a system of checks and balances between social actors are prerequisites for development (Nochteff, 1994).

(Original: Spanish)

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<sup>40</sup> According to Nochteff (1994), this decline was a continuation of that which began in the mid-1970s.

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# Potential and limits *of health management* reform in Chile

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Against a background of increased expenditure and improved equity, this reform of public health management in Chile, set in the context of a dual health system, aims to consolidate a cost advantage over the private sector. Emphasis has been placed on the distinction between the regulatory, financial and supply functions in the public sector, and a relative opposition of interests between them has been encouraged, with a view to generating quasi-markets. The "management commitments" entered into between the Ministry of Health and the Health Services mark a departure from the strategy of resource allocation guided by historical budgets and make results the decisive factor of funding. These commitments establish each year the types of service that are to be provided, the allocation and transfer of resources, and the performance indicators, in an overall perspective that includes the areas of programme content, financing, human resources and investment, and they govern the many dealings between the Ministry and the Health Services. The other focus of the reform is the improvement of labour productivity, to which end attempts are being made to change the existing conditions of recruitment and pay. The duality of the health model significantly limits the financial control of aspects that are endogenous to it, such as absenteeism and medical hours not worked. The changes also clash with current budgetary frameworks, which inhibit decentralized resource management. Performance measurement has emphasized micro-economic efficiency more than effectiveness: in order to evaluate quality, the ultimate aim of management reform, there is a need to set standards of performance which will make it possible to measure the quality of the service provided.

# I

## The starting points: a necessary preamble

Not all modernization or reform of the State comes within the field of management, which encompasses actions aimed primarily at enhancing the effectiveness and efficiency of public organizations, but from the perspective of implementation, i.e., how to achieve results rather than what results to achieve. Organizational efficiency may serve many different purposes, since it acquires meaning in relation to other values that guide institutions (Prats i Catalá, 1992, p. 32). As Paul Romer puts it, management changes represent limited experimentation in the search, within a virtually unlimited range of possibilities, for ways of doing things better.

In Chile, modernization of the State apparatus and its manpower resources and management styles lags far behind. During the military regime, when the State was considered to be inefficient, bureaucratic and anachronistic, the policies adopted were essentially designed to reduce it. Employment conditions and rates of pay conspired against management modernization, and the State administration and enterprises suffered from backward technology and lack of investment (Marcel, 1995).

Social expenditure on health was severely cut back, while vast resources were allocated to privatizing the social security system and to strengthening the provident health institutions (ISAPRES). Primary care was expanded at the expense of the tertiary level, and the priority given to maternal and child care was to the detriment of care for adults and the elderly and of related preventive care measures, causing imbalances in the health system and reducing technical and economic efficiency in the use of inputs (World Bank, 1992).

The main shortcomings in public health management in Chile have been attributed to four structural problems inherent in an organizational culture focused on policies, processes and methods, rather than on results: i) the management objectives of public agencies are ambiguous; ii) individual staff responsibility is minimal, since the responsibilities are diluted and mediatized from the senior authorities down to the rank and file personnel; iii) there is no network of reciprocal obligations and relations *vis-à-vis* the

user, since the public sector is unilateral and self-referential; and iv) no serious appraisal is made of management (Marcel, 1995, pp. 11 and 12). The particular features of the public sphere and the need to provide concrete answers necessitate specific timing and heterogeneity in this area of reform (Lahera, 1993, p. 33).

The democratic coalition governments in office since 1990 have fostered a gradual modernization of public management, which constitutes the framework for reform in the health sector. Although this reform has been relatively independent in regards various aspects, in the case of the bill amending Law No. 15 076 there has been considerable inter-institutional influence.<sup>1</sup> Political support has been strong and the initiatives have been assisted by the presence of professionals trained in various health administration programmes.<sup>2</sup>

The changes are aimed at introducing health economy criteria that will help to build markets, providing agents with a set of standards requiring: identification of suppliers and consumers, granting them certain rights of ownership<sup>3</sup> over assets and the income derived from the exploitation of those assets; fixing of contractual arrangements to encourage agents to engage in interactions that will bring about socially desirable situations; creation of conditions in which prices act as signals that will assist agents', decision-making; and safeguards to ensure that contracts are fulfilled and that ownership rights are respected (Lenz and Fresard, 1995, p. 11).

<sup>1</sup> Interview with Mr. César Oyarzo, Director of the National Health Fund (FONASA), on 5 September 1995.

<sup>2</sup> Opinions expressed by the Minister of Health, Mr. Carlos Massad, in an interview held on 21 November 1995. As an example of support, he cited the solution to the problem caused by the recent opposition of the Comptroller-General's Office to the payment of performance bonuses to the administrative sector; the necessary law was adopted in a very short time with only one dissenting vote, which is unprecedented.

<sup>3</sup> "Ownership" understood as the economic relationship that makes possible the disposition of resources, and not as legal ownership, since public institutions are involved.

## II

### Management reform as an essential need

The reduction which has occurred in social expenditure since the 1980s in Latin America was essentially a financial adjustment that delayed structural changes in the provision of services; combined with inherent deficiencies, it has placed clear limits on the availability and quality of social services. In order to improve the quality and relevance of such services, increase equity and guarantee adequate coverage, while maintaining the macroeconomic balances as a prerequisite for growth, there is a pressing need to enhance their productivity through management reform, within the framework of different degrees of fiscal leeway and different macroeconomic priorities for social spending, regardless of whether resources are increased, maintained or reduced.<sup>4</sup>

In Chile, management reform in the health sector is taking place against a background of increased expenditure and is seen as inevitable, given the low level of efficiency of the public sector in the prevailing dual system, and the weakness of salary control as its main source of competitiveness. Since the inefficiency is not confined to any specific area or wrapped in a "neat package", but relates rather to the way things are done throughout the length and breadth of the institutions (Osborne and Gaebler, 1992, p. 23), it is important to understand what conditions existing at the beginning of the decade have made the need for a change of direction imperative.

#### 1. Poor Institutional Integration

The health sector was beset by various problems in this area at the beginning of the 1990s. The lack of

coordination and complementarity between levels of care shifted pressures to the hospital emergency services and restricted primary care support. Specialized out-patient care had not been developed: primary and tertiary out-patient services were limited and suffered from problems of coverage. There was a certain geographical concentration of physicians, an imbalance was observed between general practitioners and specialists in favour of the latter, and there were few nurses (World Bank, 1992).

Because of its operational and executive functions, the Ministry of Health hampered the functions of the Health Services, which had to consult repeatedly with the Ministry's different departments, and in the absence of coordination this generated duplicated or overlapping requests. The Ministry did not adequately supervise the Health Services, which in turn failed to exercise adequate supervision over the municipalized primary care, owing to staff shortages and inadequate staff skills (World Bank, 1992).

No system or culture of coordination existed to ensure consistency of action. There was a firmly established centralist attitude, combined with distrust towards the managerial levels of the services, and an aversion to risk on the part of the services, which gave rise to a multiplicity of discussions in order for decisions to be taken (Vignolo, Lucero and Vergara, 1993, p. 58).

Furthermore, the privatization process carried out under the military regime led to a dual health system, by reason of its own nature and the inherent rationale of its design, which encourages those in the higher-income brackets to switch from the public to the private subsystem. The two subsystems follow different approaches and do not compete with each other: State insurance functions on a sharing basis and promotes solidarity, while private insurance operates on the basis of individual risks and accounts. The former is the province of the poor and attracts persons with a high health risk; the latter is taken out by the higher-income and low-risk individuals. This inhibits universal coverage of the population and the

<sup>4</sup> Owing to all these factors, it is inappropriate to attribute the increasing importance being acquired by social sector performance indicators to a presumed increase in the percentage of public expenditure earmarked for the social sectors (Newman, 1995, pp. 2 and 3).

efficient use of resources, and prevents a complementary relationship between public and private care (Oyarzo, 1995, point II).<sup>5</sup>

## 2. Diminishing human resources and competitiveness

Law No. 15 076 was a cornerstone of the health reform in the 1950s. Since then, however, numerous partial amendments have distorted its original purpose, generated negative incentives in the area of manpower resources and introduced high degrees of inflexibility, which have helped to create the "poor pay/steady job" combination and hindered the application of serious performance appraisal mechanisms.<sup>6</sup>

At the beginning of the 1990s there were no systems to evaluate the attainment of targets, compliance with quality standards or local management capability, nor were there any incentives linked to performance quality or results. The system of pay does not adequately reflect the different levels of complexity, responsibility, involvement and commitment connected with the different tasks.

In the case of the public hospitals, the framework for the staff roster is the Health Service and not

the hospital, a situation that hinders proper grading. The only incentives are advancement of grade within the corresponding staff roster and attainment of seniority. Ninety-five per cent of staff are graded in list I, corresponding to meritorious performance, despite an absenteeism level of between 20% and 25%. The result is that "... At the very least, the excellent are not distinguished from the merely good and, however excellent they may be, they must wait years before rising to the highest rank in the staff roster" (Montt and Artaza, in Cámara de Diputados de Chile, 1995, p. 112).

Furthermore, the professions were not properly differentiated in the seniority tables. The Nurses' Association is of the view that the seniority tables should be separated by profession, since they cover nurses, midwives, social welfare officers, etc., without distinction (Corral, in Cámara de Diputados de Chile, 1995, p. 134).

The staff rosters of the hospitals in the respective Health Services are rigidly defined, which makes it impossible to introduce flexible working arrangements or dispose of flexible hours in order to hire different categories of staff on a part-time basis, which is a useful way of obtaining personnel in short supply, such as medical technologists and nurses (Montt and Artaza, in Cámara de Diputados de Chile, 1995, p. 114; Acevedo, *ibid.*, p. 107; Corral, *ibid.*, p. 136).

The excessive differences between public-sector rates of pay and market salary levels make it hard to keep and attract professionals who are more skilled, creative and efficient. The inflexibility makes it impossible to adapt the human resources to fundamental changes, such as improvements in the quality of life, changes in the epidemiological profile, scientific and technological progress and the new demands of the population.

Although the health sector is a major employer—leaving aside primary care, it employs some 68,000 staff—it has no human and labour relations experts (Massad, in Cámara de Diputados de Chile, 1995, p. 93).

There is therefore a vicious circle in the public system between spurious sources of competitiveness, low output, high absenteeism from work, inflexibility and low levels of pay as the main cost-cutting factor. This concatenation suffers from distinct limitations in the face of competition from the private system and the potential increase in pay: in recent years, stringent wage control has proved not to be a stable competitive factor, and pay rises are on the horizon. Management reform in the public health sector is

<sup>5</sup> In Colombia, health system reform has been undertaken on the basis of the Chilean privatization experience, but with interesting modifications to promote competition between the public and private subsystems. According to Iván Jaramillo (in ECLAC, 1995), a distinction is made between health promotion enterprises which have responsibility for financing, and enterprises that provide health services. There are two schemes, the contributory scheme, which is funded by employees' and employers' contributions, and the subsidized scheme, which is aimed at the poorest 40%. There is also a system of equalization between the private entities; a per capita calculation is used to establish the amount of the surplus which goes into an equalization and guarantee fund. There are various cost control mechanisms: an amount of \$ 150 per person, payment per diagnosis undertaken, and a list of compulsory generic medicines have been established. To ensure equity and to guard against consumer deception, a compulsory health plan has been established and mechanisms have been developed to prevent the rejection of women, the chronically and catastrophically sick and the elderly, by means of an allocation of resources per capita according to age groups. At the same time, health insurance is proposed as a private and individual benefit.

<sup>6</sup> This diagnosis and the one in the following paragraph are contained in the opinions on the reform of the law which were expressed by a bipartite commission comprising representatives of the Government and the Chilean Medical Association established by joint agreement in December 1994 (PAL, 1995a).



thus crucial: it is inevitable if the cost advantage is to be maintained (Oyarzo, in *Cámara de Diputados de Chile*, 1995, pp. 96 and 97).<sup>7</sup>

### 3. Inefficient and asymmetrical financing

There was fertile ground for distortions in the fixing of prices and in the pattern of use of Health Services, the transfer of resources was not linked to results, and there were problems in the financing mechanisms: the fee-for-service system adopted for reimbursing municipal facilities (FAPEM) and its monthly ceiling gave rise to large deficits in poor municipalities,<sup>8</sup> and did not promote efficiency in terms of unit costs or an appropriate referral system. For other levels of care, the lag

behind inflation exhibited by the ceiling of the reimbursement on a facility-specific basis for the amount and type of services rendered (FAP), which had to be offset by additional transfers, led to a centralization of expenditure decision-making, which took place on the basis of the global budgetary framework without any negotiations to link resources to results.<sup>9</sup>

Both mechanisms generated negative incentives because they encouraged a purely curative approach and reimbursement for individual actions, rather than for comprehensive care, and discouraged cheap treatment or treatment whose costs were not covered; furthermore, they had an adverse impact on the system of patient referral to and from hospitals (World Bank, 1992).

## III

### The reforms

These are aimed at making the system more equitable, improving quality and consolidating good basic coverage: in general terms, they depend on changes in organizational culture, in legal provisions and in support elements such as staff training and information systems.

#### 1. Harmonious and decentralized institutions

During the military regime, functions that had traditionally shown a high degree of concentration and centralization were separated for the first time. There were three of these, which were to be carried out by different agencies: the rule-making and monitoring function was assigned to the Ministry of Health and the executive function to the Health Services, while

for the financial function the National Health Fund (FONASA) was set up. Nevertheless, these agencies retained hybrid functions because the national reorganization left room for ambiguities as regards the powers and responsibilities of the different bodies (Oyarzo and Galleguillos, 1995, p. 40).

Efforts are currently being made to bring about an effective differentiation of functions, promoting an opposition of interests –for example, between purchaser and supplier– that will help to maximize efficiency; each agency's concentration on the appropriate skills to fulfil its function must necessarily develop expertise in the productive process (Oyarzo and Galleguillos, 1995, p. 32).

In order to build up a harmonious and integrated system, the Ministry will have an exclusively supervisory and regulatory role and should not have executive functions. To that end, it has been organized into three divisions (Health Programmes Division, Strategic Planning Division and Management Support Programmes Division) and a Budget and Administration Department, while a unified office

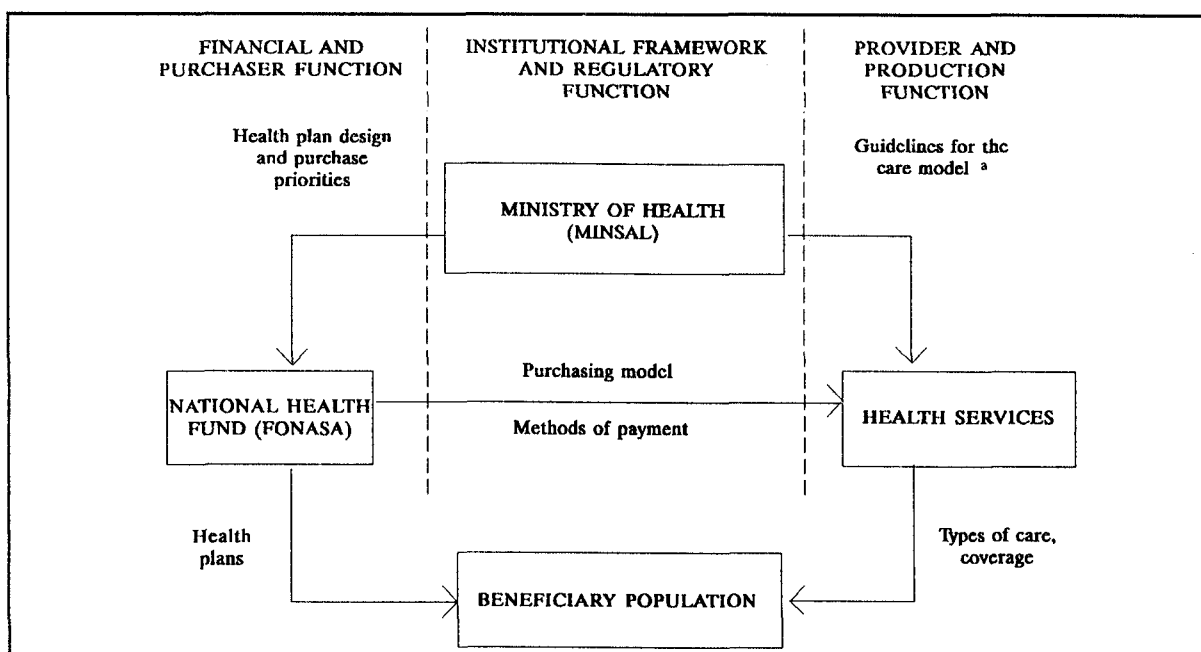
<sup>7</sup> "With pay increases of 25% on average, the costs of care in the public system are greater than in the private system. Some studies conducted on laboratory and other examinations have shown that, in the public system, their cost is higher than for those that FONASA could purchase in the private system. Advantages still exist in areas where there is high salary density and, in particular, in such items as bed-days and surgical operations, since the fees in those areas are manifestly lower than those in the private sector. The problem is viewed as a serious one in the light of the current pressure on pay since, once there is an increase, the public sector may lose one of its biggest advantages" (Oyarzo, in *Cámara de Diputados de Chile*, 1995, p. 97).

<sup>8</sup> See Fielbaum, 1991; Chile, Ministry of the Interior, 1990; Duarte, 1995.

<sup>9</sup> It must also be pointed out that the financial coverage in the other levels of care was always partial, since it applied only to intermediate inputs –the costs of consumer services and goods– while the items relating to pay, investments and disability allowances were budgeted for retrospectively (Miranda, Loyola and Reyes, 1991, p. 10).

FIGURE 1

## Chile: Functional decentralization of the public health system



Source: Prepared by the author on the basis of Lenz and Fresard, 1995.

<sup>a</sup> Human resources, investment in infrastructure, equipment and technology.

has been set up for the Minister and Deputy Minister.<sup>10</sup> The Financial Resources Department has disappeared, and it is FONASA which now performs the financial and purchasing role. The supply and production role is discharged by the Health Services (figure 1).

FONASA, which, in the past, basically administered the preferred provider system, that allowed some degree of free choice of doctors by patients, and served as a collection and payment agency for the Health Services, is now responsible for the administration, control and purchase of public health insurance on a basis of solidarity: it draws up contracts with public and private suppliers with a view to promoting technical efficiency and the efficient allocation of resources; it monitors the proper use of the insurance by beneficiaries and suppliers in order to minimize misuse of public resources; it supervises the collection of contributions so as to keep evasion to a minimum; it offers, directly or through third parties, a brokerage service to facilitate access to bene-

fits and suppliers' interaction with the system, and it administers the structure of benefits and user-fees according to policy and programme priorities within a framework of equity and efficiency (Oyarzo and Galleguillos, 1995, p. 43).

FONASA has contracted out a number of tasks, such as data-processing operations, which ensure proper identification and recording of beneficiaries in order to prevent leakage of benefits and to provide information for the insurance administration. The accounts relating to the indigent and to contributing members have been separated, which is an important step in dispelling the myth regarding the presumed subsidy for poor persons that encourages the move to the ISAPRES.<sup>11</sup> Knowing who its own beneficiaries are and obtaining from the ISAPRES records of their beneficiaries has made it possible to limit cross subsidies; full records of the dependents of ISAPRE beneficiaries will be available in 1997.

<sup>10</sup> Interview with the head of the Management Support Programmes Division, Mr. Cleofe Molina, on 14 September 1995.

<sup>11</sup> This alleged subsidy is based on a calculation—subtracting from contributions the costs relating to the free choice procedure—which underestimates the actual benefits. However, the National Survey of Socio-economic Status (CASEN) indicates a subsidy for contributors (interview with Mr. Oyarzo).

Furthermore, a new network of specialized out-patient services has been established: the Basic Speciality Centres, which permit inter-district referral from municipalized primary care centres and which are administered by the Ministry of Health, and the High-Complexity Diagnostic Centres, which are attached to hospitals but have administrative autonomy. The hospitals have been rehabilitated, with a high investment component, and resources have been provided for their proper operation and maintenance. As far as primary care is concerned, the fundamental change relates, as we shall see, to per capita funding.

Decentralization occupies a key place in the changes and in the achievement of increased equity: the diversity of the country's health problems and the inequalities inherent in the polarized epidemiological transition<sup>12</sup> are causing demand to rise and require flexibility of supply. Thus, decentralization must bring decision-making closer to the people and follow courses of action that are appropriate to the epidemiological and geodemographic features specific to each region: it is a process for distributing power, resources, risks and opportunities to the Health Services (Chile, Ministry of Health, 1994).

Some executive activities that are still being carried out by the Ministry have yet to be transferred to the local level, so that the size of the Ministry should be reduced. The idea of extending functional decentralization by increasing the capacities of the Health Services, which would be transformed from administrators of the public system into agencies managing autonomous medical care units is again being put forward.<sup>13</sup> In this context, it is interesting to note that the Medical Association is calling for the competitively based appointment of directors of services, and that the authorities affirm that they have no objection

provided that the competition process includes managerial and administrative requirements and that the appointees do not have permanent guaranteed tenure.<sup>14</sup>

As regards the private sector, efforts have been made to limit cream-skimming, to guarantee greater transparency and equity in the contractual relations between the ISAPRES and their members, and to control the cross-subsidies and implicit subsidies paid by the public sector (Chile, Ministry of Health, 1995c).

The persistent duality of the system—the different approach in its subsystems and the lack of competition between them—gives rise to controls that might have to be extended and could lead to high administrative costs.<sup>15</sup> The proposals for the most profound changes in the morphology of the sector are currently at a very early stage: prominent among them is the recent suggestion of a comprehensive health plan which, with a reasonable degree of solidarity and universal and compulsory coverage, would guarantee effective freedom to choose health insurance and the supplier of treatment in the public and private sphere, with no possibility of rejection by the insuring institutions (Oyarzo, 1995, item V).

It has been argued that providing this universal service requires joint funding, from individual contributions and a State subsidy, in order to set up a single fund that would be shared by the different administrators of the system, or alternatively a system of adjustment between per capita costs of universal insurance and contributions. The individual contribution could be linked, not to pay, but to the cost of the universal insurance (Massad, 1995, p. 12).

In order to do this, it would be necessary to determine what agency would be responsible for re-distribution, and would act as a second-stage insurer to guarantee the per capita amounts that would finance the comprehensive plan; what agencies would act as first-stage insurers, providing direct health coverage; what agency would have responsibility for reinsurance for catastrophic events, and what agency would be responsible for regulating health social se-

<sup>12</sup> The term epidemiological polarization refers to differences in health welfare distribution among the different population groups, to the detriment of the poor. In countries where this occurs, the epidemiological eras overlap. For technical reasons and for reasons of equity, their related problems have to be dealt with simultaneously. In this connection, see Bobadilla et al., 1990, pp. 19 and 20.

<sup>13</sup> Proposed by the Minister of Health, Mr. Carlos Massad, in *El Mercurio*, 1995, p. C15. For a background account on this proposal, submitted by Héctor Sánchez, see *El Mercurio*, 1991. Some have specifically postulated that "the central factor in the sector's improvement must be the independence of the establishments, while maintaining State ownership and the joint controls already described" (Baeza, 1993, p. 53).

<sup>14</sup> Interviews with the then President of the Medical Association, Dr. Vacarezza, on 7 November 1995, and with Mr. Massad, respectively.

<sup>15</sup> Idea put forward by Mr. Oyarzo at the seminar on "Health in the Chilean Development Process", organized by the Ministry of Health, the Pan-American Health Organization (PAHO) and the Association of ISAPRES, in October 1995.

curity. It would also be necessary to evaluate the amount of the current compulsory contribution and its link with income, and to specify the role of the fiscal contribution and the user-fees (Oyarzo, 1995).

With a view to establishing an integrated and social security system based on solidarity which would at the same time have stability and be viable in financial terms, a switch would be made from an approach based on individual insurance to one based on collective insurance, creating an effective insurance control centre. This would not be to the detriment of the private sector and would represent a major challenge for the current public medical care network in terms of increasing its efficiency. It would also be necessary to establish effective measures to contain costs.<sup>16</sup>

## 2. Performance-related allocation of resources

It has been argued that the problems of health management in Chile are not essentially the result of administrative or institutional limitations, but are due rather to an organizational culture that neither promotes nor requires a well-ordered process of target attainment and result evaluation, which is necessary in any appraisal of efficiency and effectiveness (Marcel, 1993, p. 12).

By contrast, a new contractual tool aimed at delegating authority and permitting the evaluation and supervision of delegated tasks makes the concrete results of management the determining element in resource allocation. This is the system of "management commitments" (*compromisos de gestión*), which are entered into by the Ministry and the directors of the Health Services and which delegate management to the latter. The Health Services in turn negotiate with the hospitals. The annual agreement establishes the services that are to be provided, the allocation and transfer of resources, the growth targets and the performance indicators to evaluate the agreed targets, which are now essentially activity indices (figure 2).

<sup>16</sup> Interview with Mr. Marcos Vergara, Head of the Strategic Planning Division of the Ministry of Health (9 November 1995). In the first half of 1995, the Economic Research Corporation for Latin America (CIEPLAN) organized health workshops, at the request of the Ministry; the conclusions of these workshops also specifically mention the comprehensive health plan (CIEPLAN, 1995).

In the first experiment carried out in 1995, the following indicators were established with equal weighting: formulation of a health plan for 1996; preventive medical examination coverage among the working population; perinatal mortality rate; number of districts with less than 90% inoculation coverage; number of specific preventive oral and dental health activities undertaken out of the total on children aged between 0 and 5 years and between 6 and 9 years; incidence of malnutrition among the infant population; agencies for internal participation and community participation and intersectorality in operation within the Health Services and establishments at the end of 1995, and operating theatre time used, compared with total available theatre time. The following performance levels were set: 5 = very satisfactory; 4 = satisfactory; 3 = mediocre; 2 = unsatisfactory; 1 = very unsatisfactory.

This represents a clear break with resource allocation based on historical budgets. Although the resources provided by FONASA during the 1995 commitment period were equivalent to the historical allocations to the Health Services to date, plus additional resources for reasons of equity where applicable, in future all resources will be dependent on the activity carried out by the Health Services. The commitment for one period does not mean the same resources for subsequent periods.

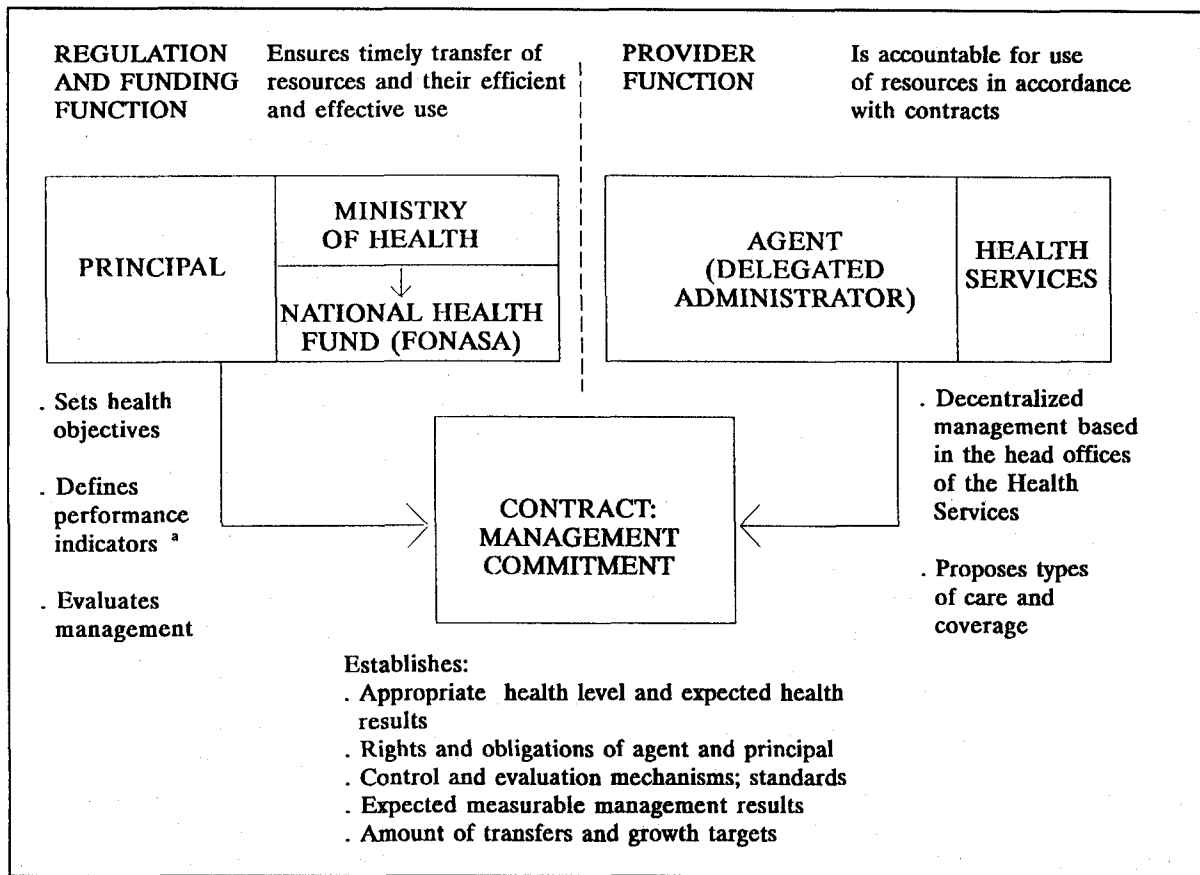
The range of general objectives<sup>17</sup> of management commitment is very broad: to promote effectiveness, decision-making capability and technical quality in the provision of services, and efficiency and transparency in the use of resources; to include equity criteria in resource allocation; to enhance coverage and stimulate user satisfaction; and to modify the administrative culture by transforming a focus on processes into one on achievements, with emphasis on planning and result analysis.

The idea of management commitment is to set clearer objectives, define indicators for monitoring treatment and evaluate the management of delegated tasks. It is a participatory strategy and involves an interplay of power in its negotiation: in conjunction with the Ministry, the Health Services define their mission and their identity, and the related financial requirements, which also reflect the Ministry's targets.

<sup>17</sup> The general objectives are set out in the 1995 Management Commitment Protocol.

FIGURE 2

Chile: Management commitments



Source: Prepared by the author on the basis of official documentation, and Lenz and Fresard, 1995.

<sup>a</sup> Financial, human resource, operational and health result indicators.

This entails changes in interinstitutional relations on a number of aspects: thus, it is necessary for targets to be fixed between the central level and the respective Health Services with a view to resource commitment, for the technical and treatment areas and the administrative and financial areas to be coordinated and made compatible, and for consistency to be ensured between the activities of the Health Services and the national policies and priorities in the field of health (Lenz and Fresard, 1995).

The commitments are wide-ranging: they include the areas of programme content, finance, human resources and investments. The health system is seen as a macro-conglomerate composed of 27 Health Services (conglomerates) and four autonomous institutions. It involves all the units within the Ministry, plus FONASA and the directors of the Services;

FONASA acts as a purchaser of health actions and supervises the attainment of activity targets.<sup>18</sup>

The management commitments also have a fundamental regularizing function: they synthesize the multiplicity of dealings which take place between the Ministry and the Health Services in a single document, which regularizes and explicitly sets out the rules of the game. Traditionally, the Health Services and each specific agency at the central level generated formal and informal bilateral agreements, which led to a lack of coordination, duplication and clashes, and consumed considerable resources in lobbying activities (Lenz and Fresard, 1995, pp. 15, 16 and 37).

<sup>18</sup> Interview with Mr. Oyarzo (see above).

Price adjustments are anticipated in the transfer tariff according to location or where teaching activities are undertaken. Furthermore, in view of the health policy of the Ministry of Health, the Services have to propose a health plan aimed at facilitating access to care, particularly for the very poor, improving hospital management, strengthening protective, preventive and promotional health measures, fostering social participation, and improving health actions from the environmental standpoint.

Management commitments are also being used with the autonomous agencies: in 1995 FONASA, the Public Health Institute, the National Central Supply Office and the Supervisory Authority for ISAPRES signed commitments of this type with the Ministry. In addition, 15 "task forces" of the Ministry, –the same number as the latter's divisions and departments– signed action commitments. These are also being used for municipalized primary care.

The terms agreed have varied greatly from one service to another, for instance regarding coverage targets or the population groups to benefit from preventive medical examinations. The scheme is at an initial learning stage of the evaluation, which has been carried out on a quarterly basis. Although this is a sort of trial run, its use has been perceived as a serious endeavour and an irreversible process, and the evaluation should have an effect on possible removals of directors of Services.

Thought is being given to the quality and relevance of the indicators: those which have been used in the past are specific to the epidemiological pretransition and need to be reformulated to take account of local and regional features, in view of the health plans prepared by the Services.<sup>19</sup> The local health plans must become their interlinking axes, in view of their comprehensive purpose and the need to deal with the singular epidemiological profiles and resulting problems.

As regards similarities with reforms in other parts of the world, particular mention should be made of the United Kingdom's experience, especially concerning the modernization of the national health system, one of the main public-sector modernization initiatives of the 1980s. At that time, internal markets were created by differentiating and separating the

role of the district health authorities, as purchasers of services, from that of the hospitals, as providers of services, with both entering into contractual agreements with each other (Naschold, 1993, p. 49; Bartlett and Harrison, 1993).

### 3. Increased human resource productivity

The management reforms have major political components: introducing new forms of human resource administration means intense conflicts and negotiations, a process that is still under way.

In August 1994, the "Caldera Report", produced by the Ministry of Health, unleashed a fierce debate on the productivity of doctors in the 26 Health Services within the national system of Health Services. The report showed an appreciable drop in three indicators: discharges, medical care and surgical operations in the period 1989-1993. While the contracted doctor-hours had increased by more than 66%, the number of patients discharged per doctor-hour had decreased by 34%, patients attended per doctor-hour had diminished by 34.8% and surgical operations per doctor-hour by 45%.

The calculation did not incorporate adjustments that might have shed light on the causes and factors involved, or on their weighting: for example, taking into account the number of consultations that had to be carried out per hour before and after the expansion of doctor-hours or, with regard to surgical operations, the possibility that a reduction in such operations might reflect efficiency gains at other levels of treatment.

The medical association argued that the report failed to take account of the improvement in service quality, citing as an example the reduced mortality in Temuco, one objective of the increase in doctor-hours; that doctors were being blamed for the general situation in the hospitals, and that the actual increase in doctor-hours was overestimated (Vacarezza, in Cámara de Diputados de Chile, 1995, pp. 127-128).

The doctors put forward some interesting arguments. For instance, they pointed to the need to assess whether the primary level had affected inelasticity of demand, to distinguish subsets in the numerator (e.g., the increase in elective surgery versus the reduction in emergency surgery), to break down the number of hours by speciality, to take account of the increase in some professional hours –corresponding to anaesthetists, haematologists, radiologists and neo-

<sup>19</sup> Interview with Mr. Molina on 14 September 1995 (see above) and interview with Mr. Mauricio Jelves, official of the Ministry of Health, on 25 September 1995.

natologists— that raise quality of care and reduce risk without necessarily being reflected in a rise in the number of discharges, and to examine the reduction in the enrolment in the national system of Health Services as a cause of the drop in demand. They also indicated that the general nature of the indicator, together with the heterogeneous nature of the matter at issue, could lead to deceptive conclusions: an increase in surgical operations, for instance, could even reflect shortcomings in the quality or appropriateness of prior medical care, while a reduction could be partly related to treatment administered on an out-patient basis in line with new procedures and technologies (Colegio Médico de Chile, 1994).

They also stressed the lack of standardization in the calculation of the consultation norm, which dropped, between 1989 and 1993, from six to four patients per hour, and expressed doubts about the quality of the records. They suggested that it was erroneous to identify the number of discharges with the same number of patients: the reduction in discharges could reflect improvements in hospital admission policies and in the curative quality of treatment. Using current standards to calculate the necessary doctor-hours, they even came to the conclusion that there was a deficit of 34,902 hours required for the performance of duties according to quality standards (Colegio Médico de Chile, 1994, p. 7).

CIEPLAN, for its part, applied the same methodology, using a breakdown by Health Services, in order to provide a more detailed diagnostic analysis and contribute to a consensus view of the problem. A national deficit of 30,000 hours, i.e., 9.1% of the total workforce, was estimated, which is less than that indicated by the doctors. However, what was revealing was the contrast between different Health Services: while the Valdivia Service had a deficit equivalent to 46% of its workforce, the Health Services in the metropolitan region, with the exception of the South Metropolitan Service, showed an excess of doctor-hours surplus ranging from 7% to 34% of the actual staffing level. The figures give rise to a number of questions: is this related to failure to fulfil the contracted hours in the metropolitan region, to differences in medical productivity in the different regions, or to differences in the quality of care in the different Health Services? (Celedón, 1994).

The doctors' viewpoint on the relationship between increased doctor-hours and quality improvements has been countered by the argument that the

equipment and infrastructure improvements introduced during the period should have been reflected in a simultaneous increase in the quality and productivity of doctor-hours.<sup>20</sup>

In any event, the Caldera Report gives cause for reflection on the irrational expansion of the staffing rosters<sup>21</sup> and, in general, on their unsuitable structure. The dissociation between the increased doctor-hours and global activity highlights major problems:<sup>22</sup> *inter alia*, overstaffing in areas where the necessary combination of inputs was not adequately ensured; promotion of quality, but viewed as an individual action; considerable inflexibility in manpower administration and recruitment, which means that any change must entail a staff increase; unsuitability of human resources to the new epidemiological profile and new technologies, as well as the need to set 65 years as the retirement age.<sup>23</sup>

The Government's aim to partly link the increase in pay sought by the sector's professional staff to amendments in Law No. 15 076 has made this issue even more controversial, and the measuring of productivity has become a sore point. The Medical Association has categorically rejected the idea that pay should be linked to medical productivity, "since nowhere in the world is there any valid index for measuring it" (Vacarezza, in *Cámara de Diputados de Chile*, 1995, p. 125). The fact that the changes in human resource management mean considerable transition costs is clearly reflected in a number of

<sup>20</sup> Interview with Dr. Susana Pepper, Director of the San Borja Arriarán Hospital, on 18 August 1995: with reference to surgical operations, for example, more sophisticated technology brings about an appreciable reduction in the time needed for certain operations, such as gall bladder operations. The President of the Medical Association, however, in the course of the interview referred to, stated that the introduction of new fibre optic surgery techniques (e.g., for gall bladder operations) does not appreciably shorten the operating time and that the procedure requires two or three surgeons.

<sup>21</sup> It was Dr. Pepper who initially drew our attention to this problem.

<sup>22</sup> Interview with Mr. Oyarzo (see above).

<sup>23</sup> There are several instances of such irrationality. Some Services have excellent heart surgeons, but do not have adequate equipment. In other Services, general practitioners are becoming redundant. Despite an appreciable reduction in the birth rate in Chile, obstetricians account for 30% of the doctors at one hospital. Moreover, despite the new epidemiological profile, there is a shortage of "intensive care specialists" and of doctors in the Intensive Care Units (ICUs). This information was obtained during the above-mentioned interview with Mr. Oyarzo.

positions adopted by the unions and professional associations.<sup>24</sup>

The obvious political component of the reform makes it possible to identify similar problems that have arisen in other countries. In the reform process in the United Kingdom during the 1980s, it was difficult to institute qualitative indicators, despite their importance in improving quality. The staff unions were of the opinion that these indicators had not been given the same priority as quantitative and financial performance indicators, and the important Treasury and Civil Service Committee pointed to the need to publicize the objectives and to decide on satisfactory indicators in consultation with staff and management (Hardy, Towhill and Wolf, 1990, p. 107).

The debate on productivity in Chile highlights the need to clarify the thinking on efficiency indicators. Productivity relates to the efficient use of resources to restore health or to carry out preventive action that will lower morbidity and mortality rates. Nonetheless, a rise in productivity is sometimes mistakenly identified with an abstract increase in health-care services or medical actions, or with an extension of their duration.<sup>25</sup>

Conversely, an increase in the number of medical care actions may reflect a reduction in productivity or low productivity; this occurs when the funding model encourages overprovision of such actions that unnecessarily increases the number needed to achieve a curative effect and leads to rising costs. It may also occur when there is an increase in actions using inputs that were designed for more sophisticated technical purposes, producing technical inefficiency that in fact causes underutilization of installed capacity and a drop in productivity.<sup>26</sup>

<sup>24</sup> The current situation is sometimes defended without any beating about the bush. The National Federation of Health Workers (FENATS) argues as follows: "With reference to economic incentives or the linking of pay to productivity, ... the health authority has not specifically explained how such linking would be carried out and ... has only indicated that it would be connected with grading. This abstract proposal is rejected by the workers, particularly because 92% of all staff are at present graded in list 1, in accordance with current legislation, since no sectoral grading regulations have been issued and it is not known how this will be done in the future given that it has been said that the number of staff graded in list 1 must decrease" (FENATS, in Cámara de Diputados de Chile, 1995, p. 139 —emphasis added).

<sup>25</sup> This is the case in the WHO/PAHO study, 1994a, pp. 40, 45 and 46.

<sup>26</sup> For an analysis of the topic, see Barnum and Kutzin, 1993, chapter 3.

The productivity of increased medical actions for prevention or treatment must be examined as a function of production: it is necessary to consider the costs which it represents in the spectrum of effective technical alternatives for meeting health objectives, the use of installed capacity, and the appropriateness and combination of the inputs used.

After the conflict, talks on productivity<sup>27</sup> have led to important agreements on "measuring results in the area of health", in order to achieve efficiency and equity, and to negotiate resources and adapt them to the epidemiological profile. It was established that the quality standards, measurement methodologies and instruments, and quality indicators for the management commitments should be agreed a priori between those involved and that, in the evaluation of productivity, consideration has to be given also to quality of service and to the satisfaction both of the actors involved in health activities and of the users (WHO/PAHO, 1994b).

Other initiatives have also contributed to the climate of negotiation, such as support for the statute on primary care and the programme to improve the work environment, whose priorities are defined at each hospital and have ranged from improvements in catering to uniforms and changing rooms. Performance incentive schemes are being tried out with the non-professional staff. A significant number of paramedical staff have been granted technician status, entitling them to the professional remuneration allowance.<sup>28</sup>

Two bipartite agreements, reached in February and July 1995 in the midst of disputes, preceded the report submitted on Law No. 15 076, in September of that year, by a joint commission of the Ministry of Health and the professional associations.<sup>29</sup> This report defined the direction of the amendments to Law No. 15 076 and forms the basis of the bill presented on 4 October 1995 by the Ministry of Health to the

<sup>27</sup> The workshop on productivity, coverage and quality, held in Santiago, Chile, from 20 to 22 October 1994, was attended by representatives of the Ministry of Health, the Chilean Medical Association, the universities, the Federation of Professional Associations, the Chilean Society for Health Promotion and other institutions. In August 1995, the Santiago Regional Council of the Medical Association organized a seminar on health management.

<sup>28</sup> Interview with Mr. Molina.

<sup>29</sup> For a detailed description of the political negotiations, see PAL, 1995a and 1995b.



Chamber of Deputies, with a view to amending the recruitment, pay and other aspects of the employment relationship of surgeons, dental surgeons, chemists or pharmacists and biochemists who work in the Health Services and do not hold positions directly dependent on top government authorities.<sup>30</sup> Nevertheless, there are still differences of opinion with the medical associations, which, because they still support accreditation based on years of service, argue that competitive examinations do not guarantee a staff career.<sup>31</sup>

The bill provides for considerable flexibility in the design of the Health Services' rosters: staffing levels would be determined on the basis of an annual allocation of chronological weekly working hours, to be made by the Ministry of Health. Decision-making is delegated to the Services' directors: for example, they can adapt the roster to new requirements when hours are released because a professional staff member assigned to the higher cycle (see below) ceases his functions for any reason. The grounds for discontinuation of service may also be determined by the director of the Service concerned.

The standard working contract is fixed at a minimum of 11 hours, with a maximum of 44 hours per week, to be allotted from Monday to Saturday, at the discretion of the directors: within this range, a professional staff member may work in more than one Health Service. Outside the contracted hours, professional staff are free to pursue their occupation.

As regards staff career development, the factors of performance, merit and efficiency are added to length of the service. Two cycles are to be instituted: a training cycle, for professional staff in the process of improving and developing their skills, and a higher cycle, for those who perform duties that require them to regularly apply their knowledge and skills, to train new professional staff, or to coordinate and supervise work teams. The higher cycle would have three levels, each of nine years: entry to each cycle and promotion from one level to another would be by competitive examination. If a professional staff member does not qualify for advancement to the next

level, his recruitment could be extended for up to three years, in the current cycle or at the current level, under the same contractual conditions, and he may sit the competitive examinations and will be entitled to the length-of-service allowance.

It is known that, in order to develop managerial capability, it is essential to have senior staff entrusted with that task and to ensure appropriate mechanisms for their selection, advancement and remuneration. This would be encouraged by the new recruitment system, which envisages a varied spectrum of tasks and responsibilities: a distinction is made between strictly medical functions and those with "management responsibility", which require the ability to commit human, physical and financial resources with a view to attaining the objectives set by the plan or programme of the medical establishment concerned. Functions with management responsibility would be open for competitive appointment every five years and could be performed by professional staff from the different cycles and levels established by the law, with a minimum allocation of 22 hours per week, covering at least five days of the week.

The Health Services will be required to assess staff performance annually with the following gradings: outstanding, satisfactory, conditional and deficient. Various bonuses are connected with the grading. Hence there are permanent and temporary pay awards.

Permanent pay is defined as the fixed and continuous monetary remuneration allocated to professional staff in accordance with the cycles and levels stipulated in their contracts or appointments. It comprises:

- i) The basic salary, which is the fixed remuneration paid in equal periods to all professional staff governed by this law, and which constitutes the sole basis for calculating the other pay awards;
- ii) The length-of-service allowance, which is granted to professional staff recruited or appointed to the Health Services for every three years of effective service, subject to a limit of 10 three-year periods;
- iii) The qualifications and experience allowance, which is granted in recognition of the competence of professional staff. It is allotted to the higher cycle in the following proportions: 40% at level 1, 82% at level 2 and 102% at level 3.

Permanency of staff in the service is thus encouraged but linked to competitive examinations. The qualifications and experience allowance also encourages first-rate staff to remain.

<sup>30</sup> See Government of Chile, 1995. The analysis made here of the amendment bill is based essentially on PAL (1995b) and on our reading of the bill in the light of the present study.

<sup>31</sup> Statements in *El Mercurio*, 1995, p. C15.

In addition, significant temporary pay awards and individual performance bonuses are provided for the 25% of staff who achieve the best performance. The temporary pay awards are non-continuous and variable, and are obtained in consideration of duties, working conditions and performance characteristics. They include:

i) Responsibility allowance: this is granted for time spent in discharging management responsibilities. The regulations will fix the levels of complexity of the establishments, the categories of management responsibilities and the functional management posts, which are to be defined by the Health Service concerned. This allowance may not be less than 10% or more than 130% of the basic salary, for the hours assigned to these duties.

ii) Incentive allowance: this is granted for hours of the working week spent on activities, in places or under conditions required by the Health Service concerned for the implementation of health plans and programmes. It is expected to be fixed centrally by the Ministry of Health by means of regulations and endorsed by the Ministry of Finance, which may inhibit management flexibility; whereas according to the general guidelines of the Ministry of Health, each Service's director should be able to establish, by a substantiated decision, the grounds for and specific percentages of the allowance.

iii) Performance bonus: this is granted annually, on an individual basis, to the highest-graded professionals in each establishment and, on a collective basis, to all professional staff of those establishments, or their work units, which meet the institutional performance targets. The individual bonus will be paid annually to the 25% of professional staff who achieved the best performance in the preceding year: 10% for the 15% most highly assessed professionals and 5% for the next 10%, in descending order of assessment. The collective institutional performance bonus may cover 100% of the professional staff of an establishment or work unit and it may be as much as 10% of the basic salary. The regulations will establish the necessary rules for the proper awarding of this benefit.

Furthermore, up to 10% of the total remuneration budget for professional staff governed by this law may be used to engage high-level professionals. It would thus be possible to recruit first-rate professional staff at competitive salaries; however, the effectiveness of this measure may be restricted because

it is intended exclusively for "occasional or exceptional" actions, possibly in response to pressure from the medical unions.

Clearly, the staff career structure and the system of pay are compatible both with the allocation of individual responsibilities in the process of generating output and with the performance incentives.

The linkage that the bill establishes between individual performance and institutional performance in the Health Services is interesting. It can be seen in provisions such as the collective performance bonus, or in the possibility that a reduction in the budget of the Service may lead to the departure of a staff member, which may be fundamental in adjusting manpower resources to the demand for services and avoiding over-supply or scarcity of certain resources. From the standpoint of the management commitments, this encourages adaptation between manpower resources and the agreements reached.

The bill also regulates the training that is made available to professional staff according to the activities set out in the Health Services' annual plans, and which includes specialization programmes of up to three years' duration. The beneficiary must repay the Health Service by working for a period equal to the length of the training programme.

Three grounds for cessation of functions are added to the traditional ones: if the hours worked by a staff member in the higher cycle of the Service are eliminated; if a staff member does not qualify for advancement to a higher level; and finally, if the director of the Service decides, on operational grounds, to terminate the functions of professional staff who meet the requirements for retirement.

The proposed three-level competitive system is somewhat different from the previous agreements with the associations, which provided only for one competition for admission to the permanent staff categories constituted by the posts on the roster. Hence the differences of opinion. The doctors maintain that this procedure does not guarantee a staff career and that the measure means the reduction of staff: competitive examinations should be used only as a means of entry, promotion should be by accreditation, and those who are not promoted should be able to remain in their posts. They criticize the directors' independence of action in modifying post allocations, since they think it is too broad, and say that account should be taken of the views of the heads of the

clinical services and of the hospital managers in order to guarantee greater technical judgement. They argue that it is illegal to convert the zone allowance into a discretionary incentive, since it is recognized in all public recruitment systems.<sup>32</sup>

For their part, the authorities stress that competition makes it possible to determine the structure and rationality of the rosters, with the knowledge of how many people are required at each level. By contrast, accreditation would create a technical barrier in that regard.<sup>33</sup>

It might be wondered whether the temporary pay awards could become distorted in the future, leading to an unstoppable increase in salaries. It will be essential to ensure that the flexible components of merit-based pay do in fact act as an individual reward and do not incite demands for equality from the unions,<sup>34</sup> which would not merely eliminate its sole purpose, but would also cause costs to rise. It is also advisable to give some thought to the relationship between the flexible salary components and the current pay negotiation procedures, and to whether the introduction of flexible pay should change the forms of salary negotiation. For example, ideas<sup>35</sup> are being advanced such as that of replacing the current "triple" negotiation—centralized negotiation with the Ministry of Finance, whose outcome is a "lost base level" for the sectoral negotiations and the decentralized negotiations—with an eminently decentralized negotiation in which the discussions with that Ministry would focus strictly on adjustment for inflation.

Proposals of this kind require liberalization of the budgetary system, since they presuppose that the sectoral authorities would be made responsible for taking decisions on salary improvements linked to performance and to increased service productivity.

<sup>32</sup> Interview with Dr. Vacarezza (see above).

<sup>33</sup> Interview with Mr. Massad (see above).

<sup>34</sup> Although it was not related to merit but rather to the discharge of a specific function, the negotiation successfully concluded a few years ago on emergency treatment later prompted a spiral of claims and appreciably raised the base level at which professional staff negotiated, owing to the disparity between such pay and the pay for other functions.

<sup>35</sup> Opinion of Mr. Oyarzo in the interview referred to above.

#### 4. Funding linked to performance and equity

The traditional funding mechanisms are being replaced by ones that are aimed at increasing efficiency and equity in resource use: efficiency because they help to contain costs and improve health promotion and preventive actions; equity because they are designed to limit the chronic lack of funding that was caused by the traditional mechanisms at the levels of care available to the lower-income population groups.

The per case payment associated with diagnosis (PADS) which should be introduced from July 1996, is a system for the transfer of resources to the Health Services for secondary and tertiary care in hospitals by means of a prospective payment for treatment of a group of diseases; payment is made for each disease dealt with and not for each service provided. A first step involved prospective payments by service provided, based on a study of the production costs—including all inputs except capital—of 103 secondary and tertiary services. The payments for separate services are therefore grouped in fixed payments for each diagnosis; payment is made for each complete in-hospital treatment, on the basis of a calculation of the aggregate cost of all the services required, in order to promote the provision of good-quality health services and to discourage over-provision of services; this would also make it possible to adjust the tariffs so that they cover all inputs with the exception of capital.

A study of the most frequent and the most expensive services identified 40 payments linked to diagnosis, of which 20 were selected, since 18 of them correspond to 30% of hospital expenditure; the remainder continue to be funded on the basis of individual services. This arrangement is designed to limit the system's administrative costs.<sup>36</sup>

The payments for each service and those linked to diagnoses will be made prospectively under the management commitments. The differences between the services planned and those actually provided will be reviewed at the end of each period. Initially, consideration will be given only to the inputs that do not correspond to salaries, which will continue to be paid by the Government until the new law on health personnel is adopted.

<sup>36</sup> Interview with Mr. Molina (see above).

The fee-for service method in the primary care level has been replaced by a per capita funding arrangement, which is designed to guarantee a basket of services. The amount to be transferred is fixed prospectively in order to cover the cost of standard treatment in four categories of primary care: infant, maternal and adult care, and oral hygiene. In calculating this amount, the population assigned to each primary health service is multiplied by the recom-

mended standard figure for service frequency per user, allowing for salaries, administrative costs and other expenditure, such as drugs, and is divided by the population of the area served by the establishment. The aim of this is to improve the quality of services, to encourage the promotion of health and preventive activities, to increase the coverage under the management commitments with the municipalities.

## IV

### The limits of change

The dual health model significantly restricts the effectiveness of these management reforms, which seek to control, from a financial standpoint, aspects which are endogenous to it, such as absenteeism and doctor-hours not worked, and which are related to differences in pay between the public and private sectors. The measures designed to bring about partial equilibrium, however, can hardly prevent transfers between the two subsystems. These reduce the efficiency and effectiveness of the public sector since, in a dual system, it is generally the weak link that loses out and has to adapt to the other.<sup>37</sup>

This highlights the need to overcome the duality of the model, for example by favouring a collective insurance approach, in which case management would also be crucial in guaranteeing the competitiveness of the public subsystem. However, if the dualism is to be efficiently and equitably overcome, there must be creative collaboration over and above corporate interests, to produce genuine and concerted answers. In this regard, the attitude of the sectors linked with the ISAPRES will be decisive.

Furthermore, the excessive statutory and regulatory provisions with which the Health Services have to comply also hinder improvements in their quality and efficiency. These provisions include rigid budgetary rules that require external approval even for small transactions or changes in cost allocations,<sup>38</sup> as

well as the prevailing inter-ministerial centralism and an attitude of distrust on the part of the Ministry of Finance, which restricts sectoral management (Chile, Ministry of Health, undated). Proposals have been made, for example, to eliminate the discretionary manner in which resources received by FONASA from the Ministry of Finance are allocated, and to establish a global per capita allocation linked to the fulfilment of certain commitments or to the provision of a set of health plans (Oyarzo and Galleguillos, 1995, p. 45).

The management reforms come into conflict with current legal frameworks. While maintaining reasonable budgetary framework limitations, there must be greater resource management capability: the breakdown into specific items makes it difficult to adapt them to circumstances that are, by definition, fluid. Controls would have to be applied *ex post*, and controlling the quality of managers, who would be subject to removal, should be an essential feature.<sup>39</sup>

The success of this reform will thus depend not only on overcoming the current dual morphology of the health sector and on the effectiveness of the new tools to manage and administer manpower resources, but also on far-reaching changes in the Chilean budget system. There have been some sectoral initiatives to introduce flexibility and to increase discretionality in the use of resources: for instance, since 1995 the

<sup>37</sup> This idea was suggested to us by Jorge Katz.

<sup>38</sup> Interview with Mr. Andrew Edwards, consultant (British cooperation with the Government of Chile), on 17 November 1995.

<sup>39</sup> Opinions expressed by Mr. Massad in the interview mentioned above. The Health Services have expressed opinions along the same lines, with a view to promoting greater decentralization of decision-making and to increasing efficiency. See, in this connection, Chile, Ministry of Health (undated).

transfer of resources to the Health Services for payroll and current supplies has been effected on a global basis. Per capita and diagnosis-linked payment are also more flexible than under the previous systems (Chile, Ministry of Health, undated).

The performance indicators used in Chile are essentially quantitative<sup>40</sup> and are related primarily to inputs and not to outputs, which makes it impossible to measure quality, which is the ultimate aim of management reform.<sup>41</sup> In the health sector, the use of activity indices has emphasized microeconomic efficiency more than efficacy. It is therefore necessary to establish performance standards and measurements that evaluate the quality of service,<sup>42</sup> which are also important because they make it necessary to determine what results are expected in this regard.<sup>43</sup>

For financial and management reforms to be viable and far-reaching, essential requirements are the logistical and operational modernization of entities such as the hospitals and, in general, specialization on the functions proper to the institutions, contracting out any secondary functions. Efficiency gains are necessarily associated with increased re-

sponsibilities of the agencies involved and greater freedom of choice, which means intensifying the decentralization process.

There is no economic or social rationale or any determinism that leads inexorably to the modernization of the public administration. On the contrary, the driving force seems to lie in the dynamic processes of political modernization, as suggested at least by recent European experience. If this is lacking, the institutional base of the reform is weak, and courses of action such as management by objectives or by results may easily degenerate into formalism and become a dead letter in the hands of the bureaucracy (Naschold, 1995, pp. 12 and 13).

Reform always requires a balance of differing interests. In the sphere of health, the power of the medical association is a very important factor. The corporativism of the various actors involved in and affected by the reform will underestimate the essential needs facing the sector and could erect obstacles. Creative collaboration, on the other hand, will help to provide genuine and concerted answers.

(Original: Spanish).

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<sup>40</sup> See Chile, Ministry of Finance, Dirección de Presupuesto (undated).

<sup>41</sup> Interview with Mr. Edwards (see above).

<sup>42</sup> In Sweden an attempt has been made to link the changes in productivity and in quality which occurred during the period 1960-1990, and some interesting conclusions were reached on the difficulty of measuring quality changes related to medical diagnoses and treatments affecting morbidity and mortality. Acute and long-term morbidity and the occurrence of complications were measured. The improvements in quality seem to be clearly related not only to the type of treatment but also to the illness, since no progress is observed with regard to some of them. Furthermore, there would appear to be no correlation between quality gains and cost increases: some illnesses are treated with better quality and lower cost, others with better quality and

higher cost, and yet others with high costs and little increase in quality. Another conclusion refers to the difficulties with certain indicators for measuring productivity, such as the number of visits to a doctor and hospital admissions, since they do not adequately reflect the treatment received: if the number of visits and admissions increases with no corresponding increase in the treatments provided, the reduction in productivity is underestimated; conversely, if the treatments have increased without a corresponding increase in the number of visits and admissions, the measurements overestimate the decline in productivity (ESO, 1994, pp. 145 and 146).

<sup>43</sup> The establishment of performance standards thus alters, subtly but importantly, the key question in evaluating impact: instead of inquiring as to the effect or effects, the key point is establishing whether the performance standards have been met (Newman, 1995, p. 6).

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## Guidelines for contributors to *CEPAL Review*

The editorial board of the *Review* are always interested in encouraging the publication of articles which analyse the economic and social development of Latin America and the Caribbean. With this in mind, and in order to facilitate the presentation, consideration and publication of papers, they have prepared the following information and suggestions to serve as a guide to future contributors.

—The submission of an article assumes an undertaking by the author not to submit it simultaneously to other periodical publications.

—Papers should be submitted in Spanish, English, French or Portuguese. They will be translated into the appropriate language by ECLAC.

—Papers should not be longer than 10,000 words, including notes and bibliography, if applicable, but shorter articles will also be considered. The original should be submitted, if possible, on diskettes in IBM compatible Word-Perfect 5.1 format. Otherwise, two typewritten copies should be submitted.

—All contributions should be accompanied by a note clearly indicating the title of the paper, the name of the author, the institution he belongs to, and his address. Authors are also requested to send in a short summary of the article (of about 300 words) giving a brief description of its subject matter and main conclusions.

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

—Special attention should be paid to the bibliography, **which should not be excessively long**. All the necessary information must be correctly stated in each case (name of the author or authors, complete title (including any subtitle), publisher, city, month and year of publication and, in the case of a series, the title and corresponding volume number or part, etc.).

—The editorial board of the *Review* reserve the right to make any necessary revision or editorial changes required by the articles, including their titles.

—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.



## Recent ECLAC publications

### Periodical publications

**Statistical Yearbook for Latin America and the Caribbean, 1995 Edition (LC/G.1908-P)**, Santiago, Chile, February 1996, 775 pages. United Nations publication, Sales No. E.96.II.G.1.

The 1995 edition of the *Statistical Yearbook for Latin America and the Caribbean* contains a selection, updated to the end of December, of the main statistical series available on economic and social trends in the countries of the region.

Part One consists of derived socio-economic indicators (growth rates, ratios or coefficients) which provide an overview of each area of interest, along with the background material needed to make the information suitable for use in specialized analyses.

Part Two provides historical series in absolute figures which can be used for a large variety of purposes.

Although there are currently 33 Latin American and Caribbean member countries of the Commission, the tables giving regional totals generally correspond to the data on 25 countries. In this connection, it should be noted that the statistics of the Caribbean countries are less complete, which is why the regional coverage varies according to the subject area addressed. Efforts continue to be made to overcome this situation and it is hoped that in the medium term complete information will become available, at least on the major macroeconomic statistical items such as national accounts, the balance of payments and foreign trade.

The indicators in Part One of the *Yearbook* correspond, in general, to the years 1970, 1980, 1982, 1985 and the period from 1990 to 1994. When the data have not been sufficiently updated, the last available year for each country is presented. Some of the indicators based on census information apply only to the years when the censuses were taken.

In the statistical series contained in Part Two, data are given for the years 1970, 1980, 1982 and 1985 and for the period 1988-1994, regardless of whether the series have been supplied by the individual countries or are regional estimates.

In view of users' favourable response, as well as the degree of accuracy achieved in previous versions, preliminary estimates for the year of issue of the *Yearbook* (in this case, 1995) are once again given. These estimates are the result of an effort made during the last two months of each year to inform the region about the macroeconomic trends observed during the period.

**Economic Survey of Latin America and the Caribbean, 1994-1995 (LC/G.1873-P)**, Santiago, Chile, March 1996, 332 pages. United Nations publication, Sales No. E.95.II.G.2.

This issue of the *Economic Survey of Latin America and the Caribbean* differs in some important respects from previous years. The *Survey* now appears in a single volume comprising both a regional analysis and reports on each country. The regional section has been restructured. The chapter on economic policy also covers public finances and monetary and foreign exchange policy and includes

two new sections on structural reform and the integration process, and the *Survey* concludes with chapters on the level of activity, inflation and employment; on the external sector, and on economic trends in the Caribbean.

### Other publications

**Latin American and Caribbean Regional Plan of Action on Population and Development (LC/G.1920; LC/DEM/G.159)**, CELADE, Santiago, Chile, February 1996, 60 pages.

The *Latin American and Caribbean Regional Plan of Action on Population and Development* takes account of the main changes in the population dynamics of the region which have taken place since the United Nations World Population Conference held at Bucharest in 1974. The objectives and goals of the Latin American and Caribbean Consensus on Population and Development reflect the views and aspirations of the region in relation to the links among population, development and the environment and to progress in ensuring respect for human rights and correcting the inequality of living conditions observed among different social and ethnic groups and geographic areas and between men and women. To this end, it proposes various types of action to fulfil the general objectives set forth and establishes machinery for following up progress in this respect.

**La inversión extranjera en América Latina y el Caribe. Informe 1995 (Foreign investment in Latin America and the Caribbean, 1995 Report) (LC/G.1890)**, Santiago, Chile, October 1995, 115 pages.

This report on foreign investment and transnational corporations in Latin America and the Caribbean analyses the revival of foreign investment flows in the first half of the 1990s and identifies the factors most affecting their evolution, in order to determine their long-term sustainability and the potential problems the countries of the region will have to cope with in order to ensure the ongoing presence of such capital.

The document consists of four sections. First of all, by way of introduction, some reflections are put forward on the nature of the regional and world economic settings in which the different forms of foreign investment are effected, and their main vehicle: the transnational corporations. The idea is to outline a conceptual background matrix to serve as a basis for the analyses presented in subsequent sections.

The second section deals with the return of Latin America and the Caribbean to the international capital markets from 1990 onwards. The analysis concentrates on private capital flows, making a clear distinction between private loan flows (bank and supplier credits), portfolio investments (shares, bonds, commercial paper, certificates of deposit and the like), and foreign direct investment. This makes it possible to identify the latest trends in financial flows, their main characteristics and determining factors, the growing diversification of the means of procuring such finance, and the relative importance of each component in the overall foreign capital flows. All this permits an analysis to be made of the probable behaviour of capital flows to the countries of the region in 1995 and the main problems that governments will have to tackle in order to secure a continuing increase in the resources obtained on the international financial markets, where the region's share went down in 1994 compared with the previous year.

In the third section, an analysis is made of the inflows of foreign direct investment into Latin America and the Caribbean. Their sustained growth in recent years is examined, as is the slackening of the region's share in world foreign direct investment flows in 1994, and it is noted that this share went down in the 1980s to the benefit of the Asian developing countries: a decline which has not yet been fully offset in the first half of the 1990s. Within this analysis, special mention is made of the part played by external debt/equity swap programmes and the privatization of State enterprises and assets. Constant emphasis is placed on the economic climate currently tending to prevail in the region and the growing links of cooperation and integration, which are the result not only of the widespread democratization process of the late 1980s but also, and especially, of the prevalence of a new style of regional development characterized by the leading role of private enterprise and the dominance of the market. In spite of statistical and methodological difficulties, the analysis of foreign direct investment in the region concludes with an effort to identify the main trends by geographical origin and sectoral distribution. A brief summary is also given of the main aspects of the dilemma currently faced by transnational corporations in the region: whether to reduce their investments or restructure their operations.

Finally, an analysis is made of the evolution of policies on foreign direct investment in the region, to which end a review is made of the main changes effected in national legislation and the various international agreements signed on the guarantees and protection to be given to foreign direct investment and more appropriate treatment in cases of double taxation. A summary review is also made of the provisions regarding foreign direct investment contained in the various economic and trade integration initiatives currently under way in the region.

**Productividad de los pobres rurales y urbanos** (Productivity of the rural and urban poor) (LC/G.1849-P), "Cuadernos de la CEPAL" series, No. 72, Santiago, Chile, September 1995, 318 pages. United Nations publication, Sales No. S.95.II.G.14.

This issue in the "Cuadernos de la CEPAL" series brings together the national studies on policies to increase the productivity of the rural and urban poor that were prepared as a contribution to the debates at the Third Regional Conference on Poverty in Latin America and the Caribbean, held in Santiago, Chile, in November 1992.

The publication is in two parts. The first deals with the development of the productivity of the rural poor and comprises five studies on Brazil, Colombia, Dominica, Mexico and Peru assessing the progress made by programmes targeting the poorest sectors in rural environments, together with a summary document presented by the ECLAC secretariat. The second part deals with the urban poor and productivity and contains national studies on Chile, Colombia, Jamaica, El Salvador and Uruguay and a document prepared by the ECLAC secretariat setting forth the proposals and conclusions drawn from the national studies on the urban environment.

The Conference provided the opportunity for a broad assessment of policies directed at combatting poverty in the countries of the region over the last two years. The assessment included a selective history of developments in methods and policies during the period and an examination of regional experiences in targeting and increasing the productivity of the poorest segments of the population. (National studies on targeting were published in "Cuadernos de la CEPAL" series No. 71.)

**América Latina y el Caribe: dinámica de la población y desarrollo** (Latin America and the Caribbean: population dynamics and development) (LC/G.1862-P), "Cuadernos de la CEPAL" series, No. 74, Santiago, Chile, August 1995, 151 pages. United Nations publication, Sales No. S.95.II.G.13.

This document outlines population trends in the countries of the region and their relationship with the economic and social development process. Emphasis is placed on the heterogeneity among the countries, which are grouped according to demographic transition stage. The largest group of countries, which comprises three-quarters of the region's population, is in full demographic transition and has experienced a marked reduction in mortality, fertility and average annual rate of growth. These changes, which are fundamentally linked to the economic and social changes that took place in the first decades of the post-war period, have continued in spite of the crisis of the 1980s.

Not all social sectors have been involved in this transition to the same degree. Attention is drawn to the fact that, in conjunction with social inequities, sub-populations at both extremes of the process in question can exist within the same country. Thus, in some countries there are sectors whose fertility rate is twice that of more affluent groups and whose infant mortality rate can be five or more times higher.

International migration has changed significantly. After having been a region of reception until the middle of the century, the region has experienced ever-increasing out-migration during recent decades. A major increase in intraregional movements has also been observed, some of a permanent nature and some associated with socio-economic and political crises.

The spatial distribution of the population is characterized by sustained trends towards concentration, combined with movements into traditionally depopulated areas. Despite this heterogeneous picture, the degree of urbanization has been increasing – at present, more than 70% of the population lives in cities – but its rate of growth is slackening.

Lastly, the influence of population dynamics on demand for social services and the resulting policy implications is analysed. Attention is drawn to the incipient ageing trend, which can currently be seen mainly in the relative predominance of active and reproductive age groups, but which in the medium term will show up in the upper age groups, which are those that exhibit the highest growth rates.

**Innovación en tecnologías y sistemas de gestión ambientales en empresas líderes latinoamericanas** (Innovation in environmentally sound technologies and environmental management systems in leading Latin American companies), "Estudios e informes de la CEPAL" series, No. 94, Santiago, Chile, July 1995, 206 pages. United Nations publication, Sales No. S.95.II.G.11.

This study is the result of a cooperative effort between ECLAC and 10 Latin American firms which have developed environmentally sound technologies up to the stage of industrial application or market launching. Basically, environmentally sound technologies are defined as those products or processes which protect human health and the environment or which use natural resources and sources of energy with greater efficiency than conventional ones. The definition also encompasses environmental management systems developed and applied in the corporate world.

One of the main assertions of this study is that the environment and natural resources are a suitable sphere for the development of new technologies and technological innovation: opportunities which are within the reach of Latin American firms. Firms engage in technological development especially with the aim of strengthening their position in the market, whether at the local or at the international level.

This paper is divided into six chapters. First, a brief presentation is made of the 10 firms which collaborated in the project. It then goes on to clarify the concepts of environmentally sound technologies, technological research and development and international technological development. The chapter concludes by providing some information on the way in which industry has responded to environmental policies and programmes designed to foster innovation in environmental technologies in a number of developed countries.

Chapter II outlines and examines the case studies prepared by the 10 firms in question. First, a description is given of the main characteristics of these firms. This is followed by an outline of the various technologies developed and an explanation of their relevance to the environment and sustainable development. Next the factors which motivate firms to conduct activities in the fields in question are explored, as are the key features of their technological and environmental management in the light of their business strategies. The experiences with technological cooperation at the national and international levels are then analysed. The chapter concludes with a number of comments by firms with respect to the effectiveness of national policies for technological development in their respective countries.

Chapters III, IV and V present the reports prepared by the firms, grouping them in similar technological fields. Thus, chapter III profiles the four cases of technological development in the field of basic sanitation and treatment of hazardous wastes, while chapter IV profiles the four cases relating to clean technologies with applications in manufacturing, farming and the fishing industry. Chapter V outlines the two cases related to sustainable natural resources management and the upgrading of technologies to use biomass as a renewable source of energy. Finally, chapter VI sets out a number of closing thoughts on environmental management and public policies which aim to support the development, application and dissemination of environmentally sound technologies.

**Legislación modelo de conservación vial** (Model road conservation legislation) (LC/L.899), ECLAC, Santiago, Chile, May 1995, 114 pages.

This study presents, in legal terms, the concepts on road conservation which were developed in ECLAC with the aim of overcoming the traditional neglect with which this issue has been treated and ensuring that public roads are kept in a good state for their use. The basic proposals in this respect were put forward in the document *Roads: A new approach for road network management and conservation* (LC/L.693/Rev.1).

In the work reviewed here, the aim is to give shape, in the Latin American context, to a body of legislation giving legal form to the proposed ways of managing road conservation. It represents a model or prototype that will need to be adapted by the countries interested in applying it, since it is of course not possible in a single body of laws to reflect the wide variety of different conditions prevailing in the various countries of the region as regards political, economic, social and legal aspects, domestic forms of

organization, terminology, legislative techniques, dividing lines between legislative and regulatory authorities, etc.

Chapter I summarizes the proposed concepts on conservation, which include in particular: i) financing road conservation through charges to users which, like the charges made for public services, constitute payment for a service provided rather than a mere tax; ii) transferring the management of road conservation from the civil service to private-enterprise bodies which will be under a strict obligation to publicly account for their activities; and iii) protecting the right of users to defend their interests, without prejudice to the State's duty to defend the interests of the community.

Chapter II contains a Conservation Statute, drafted in the form of a law. It has five sections dealing respectively with conservation as a service to road users, its implementation through contracts, financing through charges to users, the body to be responsible for conservation, and the process of transition. In many cases it puts forward optional ideas or provisions, in order to offer a broader range of possibilities, and it warns of the need to adapt the proposed provisions to specific actual situations.

Finally, chapter III describes the various alternatives which were considered when preparing the Statute and explains the reasons for choosing the options which were finally included.

**Comercio internacional y medio ambiente: la discusión actual** (International trade and the environment: the current debate) (LC/G.1860-P), "Estudios e Informes de la CEPAL" series, No. 93, Santiago, Chile, April 1995, 112 pages. United Nations publication, Sales No. S.95.II.G.7.

As the relationship between economics and ecology grows closer and closer within the process of internationalization and world economic integration, there is an ever-clearer need for international trade strategies to incorporate environmental considerations.

This study includes a broad review of the existing literature on international trade and the environment, most of the authors of which come from the developed countries, where more studies of this kind are published and the concepts involved are treated in greater depth.

On the one hand, this study seeks to identify the elements which may or may not justify the application of restrictive trade measures at given moments within a changing and controversial context. On the other hand, it seeks to assist in analysing the compatibility of trade and environmental policies within GATT. In addition, on the basis of the North American Free Trade Agreement signed by the United States, Canada and Mexico, it offers elements for the evaluation of economic and trade relations between countries with different levels of environmental legislation.

**América Latina y el Caribe: dirección del comercio exterior de los principales productos alimenticios y agrícolas según países de destino y procedencia, 1970-1993** (Latin America and the Caribbean: direction of foreign trade for the main foodstuffs and agricultural products, by countries of destination and origin, 1970-1993) (LC/G.1859-P), "Cuadernos Estadísticos de la CEPAL" series, No. 22, Santiago, Chile, April 1995, 224 pages. United Nations publication, Sales No. S.95.II.G.12.

This statistical monograph contains information on the exports and imports of the main food products of 21 Latin American and Caribbean countries, by the most important countries of destination and origin. In addition, on the basis of data at the country level, it

gives breakdowns for the following groups: Latin America and the Caribbean (21 countries), the Latin American Integration Association (LAlA), the Central American Common Market (CACM) and the Common Market of the South (Mercosur).

The statistics presented cover the years 1970, 1975, 1980, 1985, 1990, 1991, 1992 and 1993. They are organized in line with the Standard International Trade Classification (SITC, Rev.1), section 0 of which, "Food and live animals, chiefly for food", contains a systematic breakdown of this type of internationally traded goods.

Originally, it was contemplated presenting the data of section 0 of the SITC, Rev.1 in the maximum breakdown of up to five digits, but after a test run with data for countries of different economic sizes it was found that the 139 items making up this area of trade, for all the countries of destination of exports and origin of imports, resulted in an excessive volume of information which was not justified by its value to users.

Consequently, consideration was given to an alternative which, while covering a high percentage of the value of trade in this type of goods, indicated which of them were most important and the respective trading partners involved. Thus, the ten foodstuffs and agricultural products which were most important in terms of the values traded in the latest available year were selected, but as in these cases exports and imports were rather uneven in terms of the number of countries involved, it was decided to take into account the ten main destination countries in the case of exports and the five main countries of origin in the case of imports, according to the values registered in each year. This decision was adopted because the number of suppliers was much smaller than the number of purchasers.

It should be noted that, having selected the ten main foodstuffs and agricultural products exported and imported, according to their relative shares in a given year, these products remained the same for each country and group in all the years studied. In contrast, the trading partners involved vary from one year to another and generally exceed the numbers established in the two trade flows. This also brings out the directions in which the trade in foodstuffs and agricultural products has been tending to concentrate.

The decision to use SITC, Rev.1 as the frame of reference for organizing the statistics presented here was taken mainly because this is a widely accepted international classification which shows trade trends over the long term. Although it is true that there are two other SITC revisions (SITC, Rev.2 and SITC, Rev.3), these were adopted in the region only in the mid-1980s and early 1990s, respectively, so that they only provide quite short statistical series.

The adoption of SITC, Rev.1 led to some loss of precision in the identification of the specific goods traded, but not in their essential nature, while the geographical direction of trade was defined by the most important importing or exporting countries.

**Imágenes sociales de la modernización y la transformación tecnológica** (Social images of modernization and technological change) (LC/G.1834-P), "Libros de la CEPAL" series, No. 38, Santiago, Chile, March 1995, 198 pages. United Nations publication, Sales No. S.95.II.G.5.

In order to achieve changes in production patterns with social equity, it is necessary that both governments and the various agents making up the fabric of a given society should have a decisive capacity for innovation. These capacities may be different, and the question of which should play the leading role in this respect is a

matter of ongoing debate in the fields of both sociological and economic theory.

The study reviewed here seeks to carry out a first exploration of this subject. The idea is to determine whether something like a new ideology of modernization and technological change is being shaped, or rather various ideologies which may enter into conflict. It also aims to identify some pointers as to the possible supporters of the various options, the interests reflected by the actors in the process of technological change and the new modernization, the differences and common ground existing between them, and the possible points of conflict or agreement.

In its first chapter, by way of introduction, the study seeks to situate the subject within the overall field of sociology and mentions the way it has been treated so far, especially in Latin America. In subsequent chapters, the concrete results of the research are organized in accordance with the views and attitudes of employers, engineers and technicians and of workers who act as trade union leaders in the enterprises. The report seeks above all to describe rather than interpret the information obtained, so that the text is liberally scattered with the quoted opinions of the persons interviewed, since it is hoped that it will form a basis for reflection and for proposals for more specific and restricted studies.

The procedure used was to select five countries (Argentina, Bolivia, Brazil, Chile and Ecuador) which could at least reflect—since it is not suggested that they are totally representative—the Latin American situation as regards the process of modernization and technological change. In each country, six companies were selected for study, seeking to ensure that they included public or State enterprises, domestically-owned private companies, and companies of foreign or multinational origin. An effort was also made to ensure that they covered a variety of economic activities, by choosing companies in the fields of industry, mining, agriculture and services (such as telecommunications, transport and banking).

In each company, using methods designed to come as close as possible to the so-called "in-depth interviews", those interviewed comprised an owner or high executive, an engineer or technician, and a trade union leader of the firm. The main issues dealt with concerned the elements determining whether the attitudes to the modernization and innovation processes are favourable or unfavourable; the types of social relations and mutual images maintained among the various actors in these processes; the foreseeable and desired effects of the new technologies on the nature of work; the forms of wage relations desired; the relations established between the incorporation of new technologies and the modernization process; and the attainment of economic and social goals both within the company and in society at large. Investigations were also made of the role assigned to the State and to the market in the light of the type of development implied by the new technologies.

For each of the interviews, a qualitative analysis was made of its content and it was sought to outline both the issues seen as being most important and the views and attitudes held regarding them.

**Estructura de gasto de consumo de los hogares en América Latina** (Structure of household consumption expenditure in Latin America), "Cuadernos Estadísticos de la CEPAL" series, No. 21, Santiago, Chile, February 1995, 274 pages. United Nations publication, Sales No. S.95.II.G.3.

Among the surveys carried out for different purposes in Latin America, special mention may be made of those on family income and expenditure. The main objective of these surveys in Latin

America has been to update the weightings of the consumer price index. They normally cover a period of one year, and if the research methods and tools are used properly they can provide good-quality data. Because of their complexity and high cost, however, they are usually carried out only every five or ten years, and with only limited geographical coverage.

However, the multifarious demands for information on the consumption structure of different income groups arising from the research and projection studies carried out in ECLAC and other international and national bodies have brought out the desirability of assembling in a single document, as systematically and homogeneously as possible, the statistics which are available on the structure of household consumption expenditure, by type of expenditure and income groups, even though in most countries the results of these surveys were already published at the time by the bodies which carried out the surveys. This is confirmed by the warm welcome given to a systematization effort of this type carried out previously by ECLAC, the results of which are given in the Annex to the document reviewed here.

This document includes family budget surveys carried out during the period 1982-1992 in 13 countries of the region: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Mexico, Panama, Peru, Uruguay and Venezuela.

Some of these surveys are of nationwide scope, others cover all the urban areas of the countries in question, but most cover only the metropolitan area of the capital or the main cities. It was not always possible, however, to obtain information for all the areas covered by the surveys or to obtain such information at the desired level of breakdown.

In addition to giving the official title of each survey and of the body that carried it out, the document gives a summary of its main features, as recorded in the corresponding technical file in the Household Surveys Data Bank maintained by the ECLAC Statistics and Projections Division. It also indicates in each case the specific documentary source from which the data were taken.

The tables retain the classifications by type of expenditure used in each survey, reduced to a common level of expenditure groups and sub-groups. Wherever possible, the results are presented by groups of households classified by total and/or per capita household income or expenditure. The income/expenditure groups in which the households are classified correspond to given percentage groups of households (deciles, quartiles or quintiles) or simply to certain values published by the countries, expressed in national currency. The information is complemented with data on the distribution of households, average income and expenditure per household and per person, and average size of the households, as registered in the surveys.

Finally, as regards the relative reliability of these statistics, it may be noted that in all cases the data were screened and checked for consistency by the institutes which carried out the surveys, but this checking did not generally include analysis for possible non-sampling errors. It should therefore be borne in mind that there are probable skews in the direction of under-estimation of both income and expenditure, which, if they vary across the distribution, would affect the classification of households. These errors could mean that a certain proportion of the households in each low and middle income group might really correspond to households with significantly higher income, with consumption patterns substantially different from the rest of the group, and this would affect the average consumption structure calculated for that group of households as a whole. Nevertheless, the consumption statistics presented here provide the fullest picture that could be obtained from aggregated

information on how the family budget is reallocated as income rises.

**Estudios sociodemográficos de pueblos indígenas** (Socio-demographic studies on indigenous peoples) (LC/DEM/G.146), Series E, No. 40, Latin American Demographic Centre (CELADE), Santiago, Chile, December 1994, 576 pages.

The Eastern Bolivian Indigenous Confederation (CIDOB), the Bolivian National Statistical Institute (INE), the Ibero-American Cooperation Institute (ICI), the Latin American Demographic Centre (CELADE) and the United Nations Population Fund (UNFPA) together organized the seminar/workshop on current socio-demographic research on indigenous peoples which was held at Santa Cruz de la Sierra, Bolivia, from 18 to 22 October 1993. The seminar dealt with various aspects of the methodologies for collecting information on indigenous peoples and analysed various subjects of importance from the socio-demographic point of view, such as the situation of women and mother and child health, migrations of indigenous persons to the cities, population and development issues, and organizational and legal proposals concerning indigenous peoples.

The document reviewed here takes the issues dealt with and the papers delivered at this seminar and groups the selected studies in six parts. Part I presents material connected with various methodological proposals for the identification of the indigenous population and their main characteristics in population censuses or specific censuses of indigenous peoples, setting out and analysing the implications of using the different criteria employed in censuses (language spoken, self-perception and geographical location being the most used).

Part II includes material on the application of anthropological and non-traditional methods for studying the socio-demographic and cultural situation of indigenous peoples. These methods have a mainly qualitative purpose, since they seek, rather than making statistical generalizations, to detect the chain of substantive relations between the different aspects of reality. Some of these studies used mixed methods, combining different levels of analysis, and novel procedures for studying the actual situation of these peoples. The papers delivered reflect strong concern for the situation of women, their reproductive health, and the living conditions of mothers and children.

Part III includes material designed to gain a better knowledge of the conditions in which the process of reproduction takes place and the situation as regards mother and child health. Part IV presents papers on the indigenous presence in the cities, with emphasis on the rural-urban migration process and its main features in terms of employment and health. Part V presents the results of completed or currently progressing demographic, socio-economic and anthropological studies, some of them carried out with the collaboration of international agencies, which might be useful for gaining a better knowledge of the situation of the indigenous population of the region, and aspects of the relationship between population and development among the indigenous peoples are also explored, in the light of their special cultural features and socio-economic situation. Finally, Part VI analyses the consequences of the processes of organizational and institutional development and the national and international presence of the indigenous peoples, as well as the processes of political assertion of identity in defining the "indigenous population" and their concrete implementation in legal and juridical terms.

Annex 1 contains the conclusions of the seminar, which highlight the main features of the proceedings with the aim of identifying useful lessons for future research on the indigenous peoples.







## ECLAC publications

ECONOMIC COMMISSION FOR LATIN AMERICA AND THE  
CARIBBEAN  
Casilla 179-D Santiago, Chile

1986,	734 pp.	1986,	729 pp.
1987,	692 pp.	1987,	685 pp.
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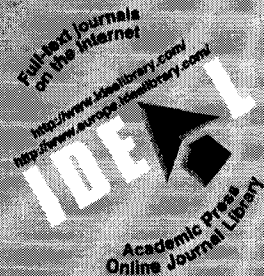
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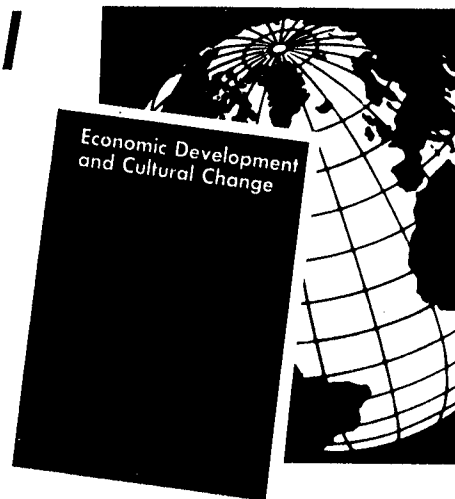
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