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Asset accumulation by the middle class and the poor in Latin America: political economy and governance dimensions

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Contents

Tables

Figures

Summary

As Latin America is currently living a period (2004-2006) of accelerated economic growth led by booming commodity prices, it is a good time to address some important long term features of the Latin American economy and society that have been traditionally inimical to stable and sustained development. Recent literature on the relationship between growth, inequality, democracy and development highlights, based both on analytical models and historical data, that at the root of the problems of economic instability and the fragility of democracy lies a combination of often slow growth and distributive conflict in unequal societies. The problem is compounded by the traditional difficulties to ensure adequate governance mechanisms that mediate in the distribute conflict in ways that are favorable to both growth and stability. This paper highlights missing components of current social policies in Latin America that affect the political-economy equilibrium: in particular, the neglect of the middle class as valid subject of social policy, the persistence of income and wealth inequality in a context of moderate growth and the need to put more emphasis on asset accumulation by the poor and the middle class. The paper provides economic and political economy rationales for devising new policies that could correct this neglect.

I. Introduction

Historically, the Latin American economies have been characterized by moderate growth, persistent poverty and inequality coupled with political instability and volatility. In turn, in the political economy realm democracy is often affected by cycles of populism and/or authoritarianism. If the region is to revert these trends and head in the direction of steady economic growth and consolidate democracy an improvement in the social conditions of the population is needed. As Latin America is currently living a period (2004-2006) of accelerated economic growth led by booming commodity prices, it is a good time to address some important long term features of the Latin American economy and society that have been traditionally inimical to stable and sustained development. Recent literature on the relationship between growth, inequality, democracy and development (Smith, 2005, Acemoglou and Robinson, 2006) highlights, based both on analytical models and historical data, that at the root of the problems of economic instability and the fragility of democracy lies a combination of often slow growth and distributive conflict in unequal societies.The problem is compounded by the traditional difficulties to ensure adequate governance mechanisms that mediate in the distribute conflict in ways that are favorable to both growth and stability. This paper highlights missing components of current social policies in Latin America that affect the political-economy equilibrium: the neglect of the middle class as valid subject of social policy, the persistence of income and wealth inequality in a context of moderate growth and the need to put more emphasis on asset accumulation by the poor and the middle class. The paper provides economic and political economy rationales for devising new policies that could correct these neglects.

A chief argument is that stable and prosperous societies tend to have large and stable middle classes with often more extended patterns of asset and wealth accumulation than the type we currently observe in Latin America. The region, thus, could gain both in terms of more accelerated growth as well as by better democratic governance by stressing the role of assets accumulation by largely excluded segments of the population in the design of social policies. The dividend can be more rapid economic growth, lower inequality and a more stable democracy.

Anti-poverty/social protection policies in Latin America during the (neo) liberal era have largely failed to reduce poverty levels in a sustained way; in fact, close to38 percent of the population was considered to be poor in 2005, say over 200 million people, (ECLAC 2006a). Although poverty has been a chronic problem in Latin America, we can identify various causes why current policies have failed to reduce poverty in signifficant ways. These causes often go beyond specific social programs and are linked to the macro and developmental performance of the economies such as: (i) lack of steady economic growth. In the last 15 years, GDP growth in Latin America has not exceeded 3 per cent per year (with even lower GDP per capita gains); (ii) in addition to a relatively modest rate of *average* economic growth, this process has been accompanied by a *high frequency of growth crises* in various countries (see Solimano, 2006). These growth crises often lead to cuts in employment and real wages, thereby introducing instability in income streams that affect more the poor who are often more vulnerable because they own a low level of assets and face stiffer constraints to borrow, (iii) persistent inequality that has reduced the impact of growth on poverty. Social policies have tried to mitigate these macro and structural developments. In the last decade and half or so the emphasis has been on protecting what is considered as the most vulnerable groups and the very poor through targeted transfers. However, the practice of "targeting" in the delivery of social goods and services has faced some unanticipated problems as its information requirements were often underestimated. In addition, some of these policies also created new exclusions of those individuals not receiving transfers because, although being relatively poor they are not "very poor" as to qualify for benefits. Mechanical thresholds to define acute poverty can be very tricky, indeed. Moreover, targeted social policies affect the middle class that pays taxes but do not fully receive the social benefits whose taxes contribute to finance. The middle class is often a forgotten segment in traditional economic analysis albeit the ample evidence that stable and prosperous societies often have large and stable middle classes.

The role of assets in social policy has been a largely neglected topic in Latin America although a few scholars such as Moser (2006) have emphasized the importance of different assets for anti-poverty programs and to reduce vulnerability of low income groups. From another perspective, De Soto (2000) has shown the adverse effects for saving and capital mobilization stemming from the fact that a vast amount of wealth held by the poor in developing countries is untitled becoming de facto equivalent to "dead capital".

This paper highlights the role that asset accumulation by the middle class and the poor can play in fostering a degree of economic autonomy of the non-rich, in improving wealth distribution and in enhancing political stability as in a society with a wider pattern of ownership of assets citizens are less prone to support destabilizing policies, either populist or authoritarian. The paper identifies some priority areas for new policies that protect growth, strengthen the middle class, promote asset building and ultimately, strengthen democracy by giving citizens a stake in the asset base of society. This latter argument is developed further at the end of the paper.

II. Social protection and asset accumulation: evolution, complementarities and differences

1. Early policies of social protection

Although the use of the term "social protection" is relatively new, a main concern of social policies in Latin America has traditionally been to protect citizens from the adverse effects of unemployment, economic crises, health problems and aging (see ECLAC, 2006b). The specific modalities of social policies have evolved according to the broader development strategies adopted by the region and the demands from different social groups for redistribution and social protection. Under the development strategy of import substitution, in place from the 1930s to the 1980s, the main objectives of social policy were social modernization and the formation of human resources needed by the industrialization and modernization process. These policies included the expansion of education at various levels, including higher education (universities), housing policies to cope with the home needs of a growing urban population, national public health systems and pay-as-you-go social security. Labor market policies involved legislation on minimum wages, severance payments and restrictions to firing and hiring by firms to ensure job stability of (incumbent) workers. Land reform was also implemented to correct a highly concentrated pattern of land tenure that characterized most Latin American countries. The social constituency behind these policies was labor unions, various organizations in the public and private sectors and rural workers.

This development strategy cum-social policy delivered respectable growth (for today standards) until the late 1970s and a degree of social modernization. However, the economic model of import substitution also involved micro-inefficiencies associated with high import tariffs and the growth of the public sector. The debt crisis of the early 1980s an its legacy of inflation, fiscal deficits, exchange rate instability and debt servicing problems led to a crisis of that development model in Latin America. The criticism of the old economic model was also extended to its social protection model. Main critical elements of the latter were: (i) social spending was not necessarily reaching the most needy in urban and rural areas; (ii) the subsidy of certain basic goods like foodstuff and other goods was fiscally expensive; (iii) public universities, often tuition free, implicitly subsidized the children of rich households and the upper middle class; (iv) the social security system based on pay-as–you go delivered low pensions and failed to contribute to the development of domestic capital markets.

At political level, import substitution strategies co-existed with democratic, semi-democratic and authoritarian regimes (see Smith, 2005) in the period ranging from the 1930s to the 1980s in which the strategy was tried in the Latin American region.

2. Social protection policies in the 1990s

The economic reforms of the 1990s in Latin America included macroeconomic stabilization, external opening, financial liberalization, privatization and market-deregulation (Chile implemented similar policies earlier in the mid 1970s under the Pinochet regime). These policies often identified with the so-called "Washington Consensus" were oriented to expand the possibilities of wealth creation through private sector activity and the use of markets and international trade in goods and financial assets. However, the application of these policies had social costs and the new policy regime open to markets brought new forms of economic instability and risks that needed to be mitigated. The social policies in the 1990s had the following main features:

i. The main social objective was poverty reduction which was expected to be led by faster economic growth following the adoption of market-based reforms. The main variable to be protected was *income*, defined as the level above or below a certain poverty line. Clearly the definition focuses on the *flows* rather than on the *stocks –or assets*. In fact, the reduction of wealth and income inequality was not an explicit policy priority for these policies (see Solimano, 1998). This is in contrast with several experiments, of varied degree of success or failure, of income and wealth redistribution in the 1960s, 1970s and 1980s in the region[1].

ii. Social protection policies had to focus on assisting the most vulnerable segments of the population (the poor, the elderly, children, the handicapped). This was the principle of "targeting". The intuitive idea of reaching the neediest is appealing both from the viewpoint of simple common sense as well from a more instrumental logic of helping to minimize fiscal costs and help macroeconomic stabilization. Nevertheless targeting is not free of problems as its informational and operational requirements are not minor.

iii. Targeting has to be complemented by social emergency funds oriented to provide support income and public works programs to low-income groups in the wake of severe macro-economic crises or natural disasters.

[1] The cases of Cuba in the early 1960s, Chile under Allende in the early 1970s, Nicaragua in the 1980s under the Sandinistas were the most radicalized experiments of redistribution. More gradual policies with a redistributive bend were implemented in Costa Rica and Uruguay among others.

iv. Promotion of private sector participation in the delivery of education, health and pensions as a natural corollary of private sector–led development in other areas of the economy.

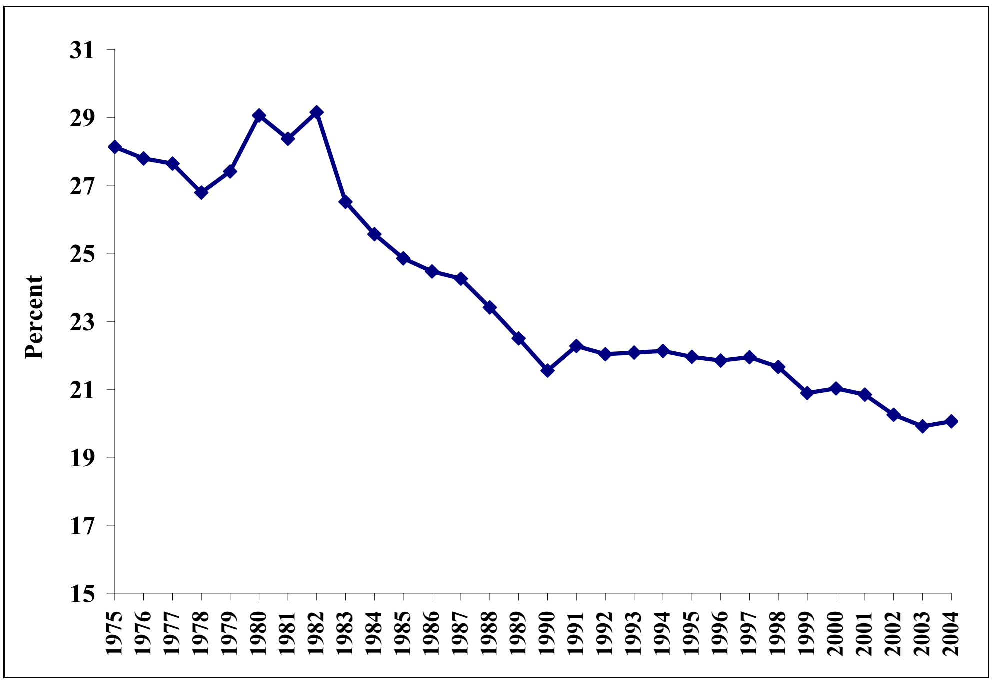
v. Labor markets policies were oriented to ensure more labor "flexibility" by relaxing firing rules reduce severance payments; in addition, minimum wages were de-emphasized as an incomes support policy.

A full evaluation of the results of these economic and social policies is beyond the scope of this paper. However, the results of social and development policies, for the region as a whole, are not encouraging in terms of rapid and sustained growth, poverty reduction and lower inequality. As a consequence of modest growth Latin America's GDP per capita as share of the GDP per capita of more advanced countries (i.e. the US) was stagnant and/or declining in the last 10-15 years (see figure 1).

Figure 1

LATIN AMERICA AND THE CARIBBEAN GDP PER CAPITA (PPP) AS A PERCENTAGE OF THE UNITED STATES GDP PER CAPITA (PPP), 1975-2004

(Percent)



Source: Own elaboration based on figures from World Bank Indicators (WDI).

In addition, modest average growth has been accompanied by *volatility and growth crises* that took place during the last two decades (see Solimano, 2006 and table 1). Needless to say those with fewer assets and lower incomes tend to suffer more in downturns and crises that destroy jobs and increase poverty.

Table 1

GROWTH CRISIS IN LATIN AMERICA AND REFERENCE GROUP, 1960-2003

	Number of years with negative GDP per capita growth rates			Percentage of crisis in total period
	1960-1980	1981-2003	1960-2003	1960-2003
Argentina	6	11	17	38.6
Bolivia	4	9	13	29.5
Brazil	2	11	13	29.5
Chile	4	3	7	15.9
Colombia	2	5	7	15.9
Costa Rica	3	8	11	25.0
Dominican Republic	4	6	10	22.7
Ecuador	3	8	11	25.0
Mexico	0	8	8	18.2
Peru	4	10	14	31.8
Uruguay	5	9	14	31.8
Venezuela	10	13	23	52.3
Average	**3.9**	**8.4**	**12.3**	**28.0**
Korea	2	1	3	6.8
Thiland	0	2	2	4.5
Philippines	0	7	7	15.9
Ireland	2	2	4	9.1
Spain	2	2	4	9.1
Turkey	5	6	11	25.0
Average	**1.8**	**3.3**	**5.2**	**11.7**

Source: Solimano (2006).

Casual evidence suggests unequal access to education and health services by low-income groups and the middle class compared to the upper middle class and the wealthy. The reality in Latin America today is that in several countries the private systems of delivery of social services offer better quality education and health services (although probably below the standards of advanced countries) to the upper middle class but the poor and the lower middle class can not afford paying for private provision unless they receive a subsidy. Most of the time people attend insufficiently funded public education and public health systems. The quality of education is segmented geographically and by income levels (better education is often found in urban than rural areas and in more affluent neighborhoods than in poor ones). Moreover, international test of educational performance in Latin American countries often show significant differences between private and public schools.

In the health sector, public hospitals are often under-funded and queuing time for patients is routine. In Chile, in recent years, thousands o families have left the private health - insurance system of ISAPRES and switched to the state run FONASA system (Fondo Nacional de Salud) because of the escalation of costs in the private system and the limited coverage of the services offered (Solimano and Pollack, 2006).

3. Asset accumulation and social protection: complementarities and differences

The asset accumulation approach (see Moser, 2006) identifies various assets that affect the well-being of individuals and communities such as material assets (land, capital, and housing), financial assets, social capital (the network of contacts, norms, culture among individuals in a certain community), natural capital and others. The approach goes beyond a purely economic approach to the issue of asset formation and focuses also on mechanisms of social interaction and social support in helping people to cope with adverse circumstances.

From an economic perspective (under certain conditions) assets can provide protection (to the owner of those assets) against unexpected shocks, helping to reduce vulnerabilities. If a person suffers a temporary loss of income an asset can provide collateral to borrow to maintain consumption. In the event that the loss of income is of a more permanent nature, a person (or household) can sell the asset although this will reduce his net worth. Economists often emphasize that assets must have an economic value, be traded in certain markets and be potentially *liquid* to be accepted as collateral for borrowing or to find a buyer in the case of selling the asset. In addition, property rights on the asset must be clearly defined. Not all assets comply with these conditions. Non-economic assets such as social capital have a different value to a liquid economic asset. Still, social capital can help cushion negative shocks by providing other non-market mechanisms such as community support to those affected by income volatility, unemployment or other adverse circumstances.

Social protection policies can operate through the assets side and/or through the flows. If a pension system is based on the individual accumulation of assets, as in a privatized system, then individual assets are a cushion against the decline in income associated with ageing. If social protection is based on the provision of temporary income or jobs to the unemployed it will operate more on the flows side and will rely on the decision of government to provide that protection. In a way, individual assets are closer to *self-insurance* whereas social protection is a form of *social insurance*. Social capital is based on "civil society" organizations rather than on the direct intervention of the state and therefore is another way of social insurance.

From a political economy perspective, asset ownership that is spread-out across a variety individuals of different socio-economic status and income levels can have important effects by given a stake to larger segments of population in the fortunes of the economic system and the stability of democracy. Elitist and oligarchic capitalism is probably less stable in the long run than a variety of capitalism in which the ownership of productive assets is more widely shared among the population. The relationship between ownership of assets and the perceived legitimacy (and therefore the stability) of a certain economic and social order is a complex issue. In general we could expect that the social legitimacy of a variety of democracy and capitalism that displays concentrated pattern of ownership of assets (often highly correlated with high concentration in income distribution) will be lower than the legitimacy of a pattern of asset ownership that is more widely held among the population. This underscores the need of incorporating the poor and the middle class in that process of ownership.

The empirical relevance of the asset approach will depend on the pattern of ownership of assets: what type of assets holds the middle class and the poor, their liquidity and the structure of property rights. These issues are taken up in the following sections.

III. Asset distribution in Latin America

Income distribution is (and has historically been[2]) quite unequal in Latin America: cross country average Gini coefficients, a measure of income concentration, are around 0.5 in the Latin American region well above OECD and East Asian levels. A recent study of patterns of asset ownership in Latin America is Torche and Spilerman, (2006) whose main results can be summarized as follows:

i. Housing is the most widespread asset hold by households in the Latin America region. For the vast majority of the population this is the only asset held in their portfolios. A large proportion of the population, (69 percent) owns their homes in Latin America. This proportion of home-ownership is similar to the United States and is relatively uniform across various socio-economic levels in Latin America.

ii. This high pattern of home ownership in Latin America is associated with housing policy for the poor and the middle class and also with (illegal) settlement of public land in cities historically carried-out by movements of *pobladores* (squatters).

iii. Education is another "asset" although of different characteristics than material assets such as housing, land and financial assets as it is embedded in people and therefore far less liquid than these other assets. Education has expanded at

2 Historically Latin America has had a quite unequal pattern of wealth distribution linked to concentrated land tenure and a social structure of relatively limited social mobility.

all levels (primary, secondary and tertiary). In contrast, to the more extended access to “quantity education” we have considerably more social differentiation in the access to “quality education”.

iv. Land concentration has been historically high in Latin America although agrarian reforms in various countries led to a decline in land concentration. The growing urbanization of the region has diminished the importance of land inequality.

v. Capital assets such as business assets, rental property, stocks and bonds are much more concentrated than home equity. The highest income percentiles concentrate the ownership of financial and capital assets in Latin America.

Thus we observe that asset distribution is not uniform across different types of assets with a clear differentiation between financial and capital assets and housing (more egalitarian the distribution of the latter). In addition, a feature of some countries in Latin America is the absence of formal titling for resources and property owned by the popular classes. The typical case is the lack of land titling in urban dwellings a fact that impedes the use of these assets as collateral for obtaining loans by the banking system (see De Soto, 1989, 2000). Incomplete property rights are then considered to be a cause of the limited access to credit and therefore to capital accumulation by the poor as it were mentioned before.

Segmentation in the access to credit and high quality education by socio-economic status is one factor that prevents a more egalitarian distribution of assets. Also variables such as family background (income, wealth, education level of the parents, occupational status, social connections, etc.) are powerful factors that tend to reproduce across generations the inequality in wealth, access to political power and influence in society.

IV. Building blocks for better policies: growth, the middle class and asset accumulation

New and more balanced social protection and development polices for Latin America should recognize broader goals and more instruments. We can identify at least three areas in which development policies can be broadened to include, among other things, asset accumulation by the poor and the middle class (see also Solimano, 2005) for specific proposals in the areas of pensions, health systems and other policies of social protection:

1. Stability and growth

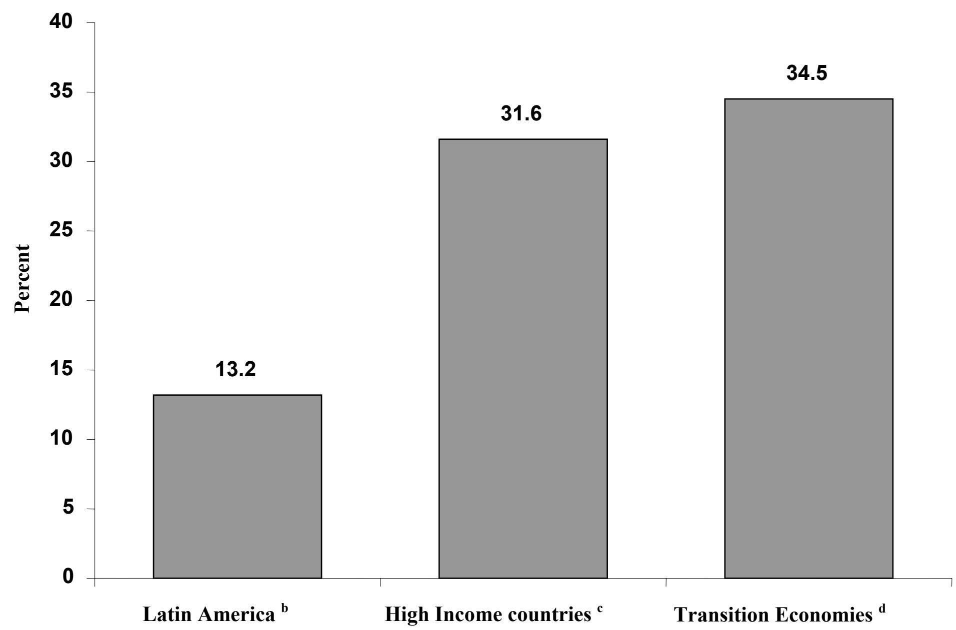
The main macro accomplishments of the 1990s and early 2000s in Latin America have been the reduction and stabilization of inflation, the improvement of fiscal budget and a stronger external sector position. This is important for the poor as inflation affects them more severely than other groups. In addition, macro stability creates conditions for more sustained growth if the growth impulse is there. Unfortunately, growth has been elusive in the last 20 years in most of Latin America. Except in the early 1990s with the resumption of capital flows and the launching of reforms and in the 2004-2006 with commodity price booms, growth has been modest when considered in a medium-term perspective. The lack of sustained growth and its volatility has impeded, as mentioned before, the improvement of social conditions in the region in a sustained way. Growth helps create jobs, boost wages and provide fiscal revenues for the government that can be spend in (good) social policies. It is hard to think of lasting solutions for social problems without stability and steady economic growth. In recent years the main gains in poverty reduction in Latin America (i.e. the case of Chile) and elsewhere (i.e. China) have taken place in countries that experienced rapid GDP growth. Of course, growth is not the whole story and policies to strengthen the middle class, reducing inequality and widening the access to productive assets and social capital are also very important. Let us turn to this now.

2. The middle class and lower inequality

Latin America is a continent of large inequalities as income is concentrated at the top. As a consequence of this *mean income* is often greater than *median income*, a feature typical of concentrated income distributions. Recent studies show that the size of the middle class measured as both a share of the incomes of middle-income groups in total income and total population is often *smaller* in America Latina than in OECD and former socialist countries of Eastern Europe (see Birdsall, Graham and Pettinato, 2000, and figure 2). The smaller size of the middle class is related to the fact that income is concentrated.

Figure 2

SIZE OF THE MIDDLE CLASS [a] (MIDDLE CLASS'S INCOME SHARE)



Source: Birdsall, Graham and Pettinato (2000). Data corresponds to the 1990s.

Notes: [a]The "Middle Class" is composed by those households with per capita income between 75% and 125% of the median income. [b]Latin America includes: Brazil, Chile, Costa Rica, Mexico, Panama, and Peru. [c]High Income countries includes: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Ireland, Israel, Italy, Luxembourg, Netherlands, Spain, Sweden, Switzerland, Taiwan, United Kingdom, and United States. [d]Transition Economies includes: Czech Republic, Hungary, Poland, Russian Fed., Slovak Republic.

A stronger and more stable middle class is often considered as a stabilizing factor in politics and economics. Easterly (2000) has shown, based on cross country and panel econometric regressions, that a higher share of income for the middle class (and lower ethnic polarization) is empirically associated with higher income, higher growth, more education and other favorable development outcomes.

Part of the story of building a stronger middle class is providing people a better access to housing and education, the two main assets that the population accumulates. In addition, the middle class is the owner of small and middle size enterprises (productive assets) that are often in need to finance capital investment and working capital.

3. Democratizing asset accumulation

A broader access to asset accumulation by the poor and the middle class can have several positive economic and social effects: (a) it can contribute to mobilize the hidden productive potential of the poor and the middle class with positive effects on economic efficiency, growth and social welfare, (b) individuals with a stronger asset position can develop mechanisms of self-insurance and become less dependent on social insurance for protecting themselves against negative shocks, (c) if asset distribution becomes more evenly distributed in society we can expect that also income distribution will be better distributed.

We can identifiy at least three main impediments for a more evenly distribution of assets in the Latin American region. These impediments can be removed, however, by public policy. One impediment is the limited savings capacity of low income groups (although their savings capacity is not zero). Usually low income families can save to finance the down-payment of a house or other type of property. In addition, in most countries they have a certain economic capacity to acquire durable goods. During the process of economic development, the relationship between savings rates and the levels of per capita income is non-linear and relatively large increases in savings can take place after growth takes off at low to intermediate levels of per capita income. Second, as mentioned before, for assets to be able to mobilize capital, property rights must be well-defined and enforceable. In Latin America low income groups have acquired their main asset (housing) often through non-market mechanisms: occupation of urban dwellings and/or subsidized housing policies. The situation vary across people and households and some house owners have titles on their property while others do not. The legal system unfortunately, is expensive and often unfriendly to the poor. In fact, the design and enforcement of contracts is costly, and it requires some legal education and access to lawyers. The poor often can not afford all that. Third, capital markets are also segmented serving better the elites than the poor and the middle class. The traditional circuits to accumulate material assets and also to acquire higher education such as borrowing and access to capital markets have been largely restricted to the non-poor (the elite hold assets that can be used as collaterals and/or have the right connections to access to credit and get their children in good quality schools). The reform of judiciary systems to make the access of justice more expedite to the poor is essential if we want to make asset accumulation a more egalitarian process.

V. Concluding remarks

This paper highlights the need to go beyond policies based purely on growth-based, poverty reduction and targeted social policies to bring the middle class into the picture and exploit the potential of asset building of the poor to cope with adverse shocks, boost savings, investment and promote upward social mobility. In addition, this paper argues that a wider pattern of ownership of assets can have potentially stabilizing effects for democracy. The reason is that a more even pattern of ownership of assets across wide segments of the population (democratizing the asset base of society) give more legitimacy to the economic system. Inequality in the distribution of economic resources is often inimical to the equality of rights that a democratic system is assumed to entail.

The literature on assets building identifies a wide range of assets ranging form material assets such as housing, land, financial assets to social and communal assets. Economists stress the role of assets in coping with negative shocks. However for assets to be economically valuable for that purpose, property rights must be reasonably well-defined and the assets must be tradeable in markets. Other social scientists emphasize the role of social interactions, family and community relationships –social capital-- as mechanisms of social protection different from self-insurance, market insurance and social insurance provided by the state. In reality individual assets and social capital can complement each other to provide social protection and enhance social progress.

Finally, we argue that a more widespread and less unequal ownership of assets in society can have a *growth dividend* by unleashing creativity, entrepreneurship and innovation latent in groups that traditionally have little access to formal capital markets and the legal system. Moreover, a more egalitarian asset accumulation could have also a political dividend for democratizing the traditionally elitist Latin American societies.

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